Accountants' Civil Liability to Third Party Financial Statement Users--A Case for Uniformity.

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ACCOUNTANTS' CIVIL LIABILITY TO THIRD PARTY
FINANCIAL STATEMENT USERS--A CASE
FOR UNIFORMITY

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by
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ABSTRACT

The legal concepts inherent in the area of accountants' civil liability have evolved over a period of many years. The English Courts contributed the basis of this evolutionary process by delineating a set of legal doctrines which, if necessary, could have been applied to cases of accountant-third party litigation. The American Courts later gave impetus to the development of this body of law by interpreting and specifically applying the early legal doctrines. Yet, the most significant step in the developmental process was the result of the New York Court's attempt to balance legal equity with social need. This judicial balancing process produced a doctrine of accountants' civil liability which has severely limited the ability of third parties to recover pecuniary losses from public accountants.

Today, the American Courts are continuing in their attempts to balance legal equity with social need. Yet, in attempting to accomplish this task, the individual courts have created two significant legal problems for the public accounting profession. First, the attempts of the individual courts to implement this balancing process have resulted in a series of decisions which have produced
a significant gap between legal and professional interpretations of the public accountant's audit responsibilities. Second, the attempts of the individual courts to implement this balancing process have resulted in the promulgation of at least six distinct concepts of liability placement. These two problems have forced members of the accounting profession to assume a defensive posture, and therefore, have significantly hampered the profession's attempts to keep pace with the growing information needs of economic society.

An analysis of the reasoning and facts underlying this judicial balancing process produces two significant results. First, such an analysis reveals that there are significant legal reasons for extending the third party liability of public accountants. Second, such an analysis reveals that such an extension of the public accountant's third party liability will not have detrimental effects on either the accounting profession or economic society. Thus, an analysis of facts and reasoning inevitably results in the conclusion that the liability of public accountants to third party financial statement users should be extended.

To implement this conclusion, and to provide a basis for solving the problems which confront public accounting, a five step approach was presented. First, it was proposed that the public accounting profession should be allowed to establish the standards of conduct by
which its members will be judged. Second, it was proposed that the courts continue to use the concept of the reasonable man as a means of comparing the activities of individual accountants with those which would have been required by professional standards. Third, it was proposed that the courts refuse to recognize the legal validity of overly broad disclaimers or qualifications of opinions. Fourth, it was proposed that the courts continue to hold accountants liable to third parties in cases of pure fraud. Finally, it was proposed that the courts hold public accountants liable to all reasonably foreseeable third parties when the accountant is guilty of any form of negligence. Such a five part doctrine of accountants' liability will introduce both certainty and equity into an otherwise confused area of the law.
CHAPTER I

INTRODUCTION

The issue of accountants' legal liability to financial statement users has been one of significance for both the accounting and legal professions. The constantly evolving relationship which exists between certified public accountants and the users of the financial statements that they examine has been one of the most volatile elements of the auditing environment.

In the early part of this century, this legal relationship was one which was limited to the individual client and a chosen accountant (i.e., the accountant-statement user relationship was totally contractual). Management hired the public accountant as only one more in the series of controls designed to assure the proper functioning of the employees of the firm. The primacy of this accountant-client relationship was so significant in 1931, that Justice Cardozo was led to say, "... public accountants are public only in the sense that their services are offered to anyone who chooses to employ them." ¹

The relationship between the accountant and third party statement user was not given significant consideration until 1930. Soon after the securities frauds of the late twenties and early thirties were revealed, the economic sector realized that this "secondary" relationship was one of extreme importance. At this point, even Congress recognized that without independent professional assistance issuers of securities could not be relied upon to provide adequate information for purposes of investment. Therefore, Congress sought to institutionalize certain professionals as the public's first line of defense through the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. The certified public accountant was to become a major component of that line of defense.

Since the passage of the Securities Acts, the relationship existent between the public accountant and third party investors has become steadily more important. The continued growth and expansion of industry, the growing complexity of business relations and the increasing specialization of business functions have all forced the investor to rely upon the representations of accounting specialists. As recently as 1958, there were only nine

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million Americans involved in stock investments. By 1968, that figure had increased to more than twenty-four million. The 1970's have seen a continued growth of individual involvement in stock transactions. Recent estimates indicate that nearly thirty-one million persons are involved in some form of stock investments. These figures only serve to exemplify the fact that the number of individuals affected by the accountant's opinion has increased greatly.

The extent of the necessary relationship between the accountant and third parties has grown throughout this century. Today, the third party investor is the primary user of the financial statements examined by the certified public accountant. If not for the requirements of the third party statement user there would be little or no need for the protection provided by the services of the independent auditor.

Yet, this increase in the reliance placed on the auditor's examination has brought with it problems for the public accountant. As the third party statement user became a more significant consideration for the auditor,

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legal suits, based on the negligence of some accountants, and instigated by third party investors, became a more significant problem for the public accounting profession as a whole.  

Any attempt to determine the exact number of cases presently involving public accountants and third party statement users would necessitate an examination of the dockets of all civil courts in this country. Such a survey would be highly impractical for two reasons. First, if the data obtained—the number of presently pending cases—were viewed in relation to the effort expended, the results would seem highly counterproductive. The actual value of the data to be obtained by such a study is somewhat questionable. Second, the results obtained in such studies would be highly questionable as a quantification of the accountant-third party legal relationship. For one reason or another, many suits which would be instigated by a third party are settled out of court. Thus, an attempt to quantify the number of presently pending cases would fail to include all those cases which never reach the courtroom. Nevertheless, several authors have undertaken

7Ibid., pp. 357-358.

partial studies of the significance of this problem. These studies, in general, produce two conclusions.

First, most of the limited surveys indicate that the actual number of cases, and the pecuniary damages involved, are significant. A survey conducted over the 1966-1967 period concluded that there were between eighty and one hundred cases pending involving damages of no less than twenty million dollars. A later survey which was specifically limited to the firm of Peat, Marwick and Mitchell found that firm to be involved in twenty-eight suits with damage claims of approximately twenty million dollars.

A second general conclusion reached by most studies is that the degree of accountant-statement user legal involvement is increasing. One general study produced the conclusion that there were as many lawsuits brought against accountants in the 1967-1968 period as in the twelve immediately preceding years. This conclusion is backed by a study of a specific underwriting firm which was involved in only forty-four cases in 1964. By 1968, this figure had grown to seventy-seven, and by 1969, it had reached eighty-three.

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9 Daus, pp. 835-836.


11 Louis.

This increase in the number of legal actions involving public accountants would seem to be definitely related to two major factors. First, there has been a considerable increase in the reliance of third parties on the financial statements prepared by certified public accountants. Second, there has been a considerable liberalization of the courts' attitude toward the use of class actions by financial statement users. While the relationship between these factors and increased litigation seems obvious, the actual legal situation in which the accountant is involved is not quite so evident. A discussion of the theoretical problems underlying the accountant-third party legal situation follows.

Statement of Problem

With regard to his potential liability to third party financial statement users, the public accountant is faced with two problems of major legal significance. First, when considering the service areas from which third party liability may arise, the accountant is presented with a situation which is shrouded by a great deal of judicial uncertainty. Second, and probably more important, when attempting to determine the conditions under which third party recovery will be granted by the courts, the accountant is forced to analyze a number of legal precedents.

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which contribute to an almost incomprehensible maze of judicial theory. A basic discussion of these two problems follows.

The Judicial Interpretation of Professional Responsibilities

Traditionally, the audit services performed by the public accountant, the financial statements examined in the course of those services and the opinion expressed on the fairness of those financial statements were the primary links between the accountant and third party financial statement users. The investor, in most cases, is forced to rely upon the audit report in making his investment decisions. The failures of the accountant in preparing this report were initially the greatest source of both potential harm for the third party statement user, and potential legal responsibility for the public accountant. While the audit services, as defined by professional standards, would seem to be the logical basis of all legal responsibility, recent court decisions have broadened the scope of the accountant's legal involvement.

Some recent judicial attention has centered on the issue of the auditor's responsibilities in dealing with information obtained subsequent to the performance of the actual audit services. Prior to 1967, there had been little or no attention given to this subject area, but at that time, the significance of the issue was realized.

14Daus, p. 835.
Since this realization, the courts have recognized that when the accountant has reason to believe that statement users are relying on an audit report which is untrue, that accountant has a legal obligation to correct that report.15 Thus, even if the accountant feels that his audit report was correct at the date of issuance, the negation of this belief by subsequently acquired information imposes upon him an obligation to disclose that information to the third party statement user.

Accountants' legal liability for the detection of corporate fraud has provided the courts another opportunity for comment. While the accounting profession has always argued that accountants cannot be expected to detect fraudulent activity on the part of corporate insiders,16 the courts have shown a tendency toward imputing more exacting standards to the activities of public accountants. As the courts have begun to apply these more exacting standards, they have also begun to hold the accountant to a level of legal responsibility concomitant with these new requirements. Thus, accountants have recently been held liable to third party statement users for failing to detect the existence of fraud.17


17Hochfelder v. Ernst and Ernst, 503 F. 2d 1100 (7th Cir. 1974).
The preparation of unaudited financial statements has created a third new area of legal concern for the certified public accountant. Traditionally, it was assumed that the standards of the accounting profession would guide the courts in the placement of liability. It followed from that assumption that accountants had no legal responsibility when dealing with unaudited write-up work, since the accounting profession did not require any techniques of verification to be applied to the preparation of such statements. This feeling of total insulation from third party suits was soon to be destroyed.

In *1136 Tenants Corporation v. Max Rothenberg and Company*¹⁸ (*1136 Tenants*) the court held that under recently espoused concepts of negligence liability, an accountant may be held responsible for injury suffered by third parties due to the use of unaudited financial statements. Courts have reasoned that if accountants, for any reason, fail to detect fraud which has occurred in the business activity of the firm, an innocent third party may be unnecessarily harmed. This reasoning led the court in *1136 Tenants* to conclude that, if certain other conditions are met, the fact that financial statements are unaudited

does not bar a third party from seeking recovery from the public accountant.\textsuperscript{19}

As the financial world becomes more complex, and investors become more sophisticated, the demand for information concerning the financial position of the firm becomes greater. Ultimately, potential investors will demand information concerning the current value of a firm's assets,\textsuperscript{20} and forecasts of the firm's future financial position.\textsuperscript{21} If the trends of the past hold true, there will be a need for independent verification of these new pieces of information to protect the public from unfair manipulation. The public accountant will probably provide a major source of this independent verification. If at the same time, current legal trends hold true, the areas of forecasted and current value financial statements may soon represent a major part of the legal problems of the certified public accountant.

When the accountant was held legally responsible for his actions in the performance of audit services, there


existed a great deal of agreement between the standards set for him by the courts and those established by his profession. As the judiciary became more liberal, by imposing liability for services beyond the performance of the traditional audit function, a gap appeared between the legal and professional standards established for public accountants. This gap creates a great deal of confusion as to the professional responsibilities of the accountant, and thus, contributes to a severe judgemental problem.

The Judicial Interpretation of Liability Placement

Even if the public accountant is capable of determining which of his specific undertakings are to be subject to judicial review, the accountant is faced with a second, and possibly more significant, problem. At present, there is no substantial body of law available to deal with the conditions governing the legal boundaries of the accountant-third party relationship. While there have been many decisions advanced over the past one hundred years, there has been almost no agreement as to a single concept of liability placement.22 There are many rudimentary concepts, but when these are integrated into the system of civil law, constantly changing doctrines of accountants' liability are obtained. At this time, there exist no less than six major concepts of liability placement which are potentially applicable to cases of

22Daus, p. 836.
accountant-third party litigation. A brief outline of these concepts, and their relation to the problem of accountants' third party responsibility, follows.

The earliest, and most universally accepted, legal concept which has been applied to the area of accountants' liability to third party statement users is that of liability for fraudulent misrepresentation. As early as 1889, the English Courts, in the case of Derry v. Peek (Derry), recognized the existence of an action based in deceit. Such an action allowed an injured, yet innocent, third party a means of recovery when a fraud was perpetrated against him. Yet, the Derry Court made it very clear that the fact that the defendant misrepresented his position was not in itself sufficient grounds to justify recovery. Beyond the basic misrepresentation, it must be shown that the defendant intended to deceive, and thus, inflict harm upon the third party.

The American Courts were quick to establish the basic distinction pointed out in Derry. The courts

23Derry v. Peek, 14 A.C. 337 (1889).
25Derry.
immediately distinguished between fraudulent and negligent misrepresentation, and thus, barred recovery in the latter of the two situations.\textsuperscript{27} It is the concept of fraudulent misrepresentation—inclusive of its required element of intent—which has been universally applied by the American Courts to the area of accountants' third party liability. Unfortunately for the public accountant, when the courts attempt to define the liability of accountants in situations which involve something less than pure fraud, the doctrines of liability placement are less than universally accepted, and often, become confused and incomprehensible.

If the public accountant is guilty of only negligence in the performance of his services (i.e., if he does not intend to deceive the third party statement user) a twofold legal problem develops. First, the judicial system must determine the degree to which the accountant was negligent. Second, the system must determine the type of relationship which existed between the accountant and the third party statement user. These two factors, and the interpretations of them used by particular courts, contribute greatly to an already perplexing situation.

One of the two major types of negligence which may be committed by the accountant is termed "gross negligence". In rendering its decision, the Derry Court made a major

\textsuperscript{27}See Rastetter, p. 412; and Landell v. Lybrand, 264 Pa. 406, 197 A. 783 (1919).
distinction between this type of misrepresentation and ordinary negligence. The court argued that pure fraud required an element of direct intent on the part of the defendant; yet, certain unintended actions could constitute gross negligence, and thus, be used as an inference of fraud on the part of the defendant. If an individual makes a statement which he knows will be relied upon by others, there exists an obligation to exercise care in the making of that statement. If the statement is made recklessly, or without care as to its truth or falsity; if the maker of the statement has no reasonable grounds for believing that statement to be true, he will be held liable to the third party for his gross negligence as if he had been guilty of pure fraud. This concept of gross negligence as the equivalent of fraudulent misrepresentation was later to be institutionalized by the New York Court as a viable cause of action against public accountants. Yet, different courts have attached different meanings to the term gross negligence, thus further contributing to the problems inherent in the area of accountants' legal liability.

When the courts determine that the public accountant is not guilty of gross negligence, the issue of liability is still far from concluded. Over the years, four

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28 Derry.

29 See Rastetter, p. 413; and Ultramares; and State Street Trust Company v. Ernst, 278 N.Y. 104, 15 N.E. 2d 416 (1938).
doctrines of liability placement in cases of "simple or ordinary negligence" have evolved. Each of these four legal doctrines is inherently dependent upon the relationship which exists between the accountant and third party. An outline of each of the potentially applicable doctrines follows.

In many early decisions—none of which involved accountants—the general rule was established that privity of contract (the existence of a contractual relationship) was a necessary element of any legal action based on simple negligence in the performance of a contract. By 1931, the year of the New York Court's first ruling on the issue of accountants' third party liability, the concept of privity as a prerequisite to recovery had diminished greatly in terms of its legal significance. This decline in the importance of the privity doctrine was summarized quite well by Justice Cardozo when he said, "... the assault upon the citadel of privity is proceeding in these days apace." Yet, it was in that very case that Cardozo reinstated the concept of privity of contract as a major legal doctrine. In his first comment on the issue, Cardozo imposed privity as a legal barrier between an injured third party statement user and a negligent accountant.

30 Seaver v. Ransom, 224 N.Y. 233, 120 N.E. 639 (1918).
31 Ultramares.
32 Prosser, p. 231.
While Cardozo asserted the lack of privity of contract between the plaintiff and defendant as the Court's reason for prohibiting the recovery of pecuniary losses, most analysts feel that there was a further factor motivating the court's decision. The court recognized that the services of public accountants were a social necessity; furthermore, the court believed that the extension of liability to third parties in cases of simple negligence would create liability of such a great amount as to potentially ruin the accounting profession. This fear of the extension of potentially ruinous liability in cases of ordinary negligence would seem to be the true reason for the direction of the New York Court's initial decision.33

No matter what reason is accepted as the basic factor in the New York Court's decision, the lack of privity of contract was established as a barrier between third parties and negligent accountants. This concept of liability placement remained relatively unscathed until the 1960's.34 At that time, a reanalysis of prior dicta produced some attempts at modifying the New York Rule.

As early as 1922, the New York Court recognized that the privity concept was not an all encompassing legal  


doctrine. In *Glanzer v. Shepard*\(^{35}\) (Glanzer) the New York Court saw fit to extend an obligation beyond an existent contract, to a third party. The court reasoned that because the defendant knew that his services were to primarily benefit the third party, an obligation did exist. When the third party is "the end and aim of the transaction" a relationship equivalent to that of privity of contract exists and recovery for negligent misrepresentation should be granted.\(^{36}\) Yet, for many years courts passed over this concept of primary benefit by ruling it inapplicable to the area of accountants' liability to third party statement users.

It was not until the late sixties that the concept of primary benefit was applied by the judiciary to the area of accountants' liability. At that time, several courts postulated that when the accountant specifically knew the third party, and when the public accountant specifically knew that his work was to be relied upon by that third party in making financial decisions, the Glanzer Rule of primary benefit, and not the Ultramares Rule of privity of contract should be applied.\(^ {37}\) Thus, the concept


of primary benefit was advanced as a major inroad into the Ultramares Concept of the legal liability of public accountants for negligence in the examination of financial statements.

With this one inroad into the precedent of the New York Court established, several courts were willing to take the next step toward the institution of more liberal concepts of accountants' third party liability. The first step toward such a liberalization was the broadening of the primary benefit rule of Glanzer. Many courts sought to eliminate the limitation of the Glanzer Rule, and therefore, argued that the accountant should be held liable for his negligence to that class of individuals which was actually foreseen by the accountant and which did actually rely upon the misstatement of the public accountant.38 The general argument which has been presented by these courts is that a rule which allows recovery by all members of a specifically foreseen class more equitably distributes the burden of the misstatement between the accountant and the third party.39 While the concept of foreseeability has been generally accepted


in cases of personal injury, its evolution into the area of pecuniary loss has been a slow and tedious process.

The final judicial interpretation of the accountant's liability to third parties for the negligent examination of financial statements is also the most liberal interpretation. In 1933 and 1934, Congress instituted the Securities Acts as measures of protection for the investing public. Section 11 of the Securities Act of 1933 imposes upon public accountants civil liability for the misrepresentation or omission of material facts which are required to be set forth in the registration statement. In a similar manner, the Securities Exchange Act of 1934 imposes liability for false or misleading statements.\(^{40}\) While the 1934 act requires the third party to prove that he relied upon the misrepresentation, the 1933 act assumes the existence of this factor. The total effect of these two pieces of legislation, and the administrative rules promulgated under them, is to impose upon the accounting profession a virtually unlimited amount of liability for negligence in the handling of the financial statements of registered corporations.

While the Securities Acts were passed in the early thirties, they had no significant effect on the area of accountants' liability until the sixties. The first significant case was decided in 1968, and seemed to open

\(^{40}\)Murphy, pp. 389-390.
a whole new area of legal concern. In Escott v. BarChris Construction Corporation the court used the provisions of the Securities Acts to hold an accountant liable for negligence in the performance of his audit duties. Thus, the broadest theory of the accountant's legal responsibilities became a significant point of consideration for the certified public accountant.

The accountant can be—and has often been—held liable to third party statement users for any act ranging from fraud to simple negligence. The exact degree of responsibility can only be determined by a given court at a given time. Ultimately, that degree of responsibility will be directly dependent upon the theory of liability placement selected and applied by the court. Therefore, the accountant is confronted with an ever changing, and thus, extremely complex situation.

Statement of Purpose

The problem existent in the area of accountants' liability is a complex one, for at present, there is no firm basis upon which the accountant may evaluate his potential legal responsibility to third party statement users. The solution to this problem is quite obvious. There must be established a workable set of rules that the courts can apply to individual fact situations. While several such workable principles are available to the

courts, no single concept, or combination of concepts, has been generally accepted by the courts.\textsuperscript{42}

The common law is not in itself self-executing; that is, legal doctrines may remain dormant for many years before a single court in a single situation sees fit to resurrect that concept for application. For this reason, the common law cannot be relied upon to produce an effective doctrine of accountants' legal liability.\textsuperscript{43} Since the answer to the accountant's problem is not to be found in the common law, accountants must rely upon some outside source for any workable solution.

This dissertation attempts to develop a basic concept of legal liability upon which such a solution may be based. In striving for this goal two basic definitions are sought. First, an attempt is made to define a mechanism which could be employed to reconcile the professional and legal interpretations of the accountant's responsibilities. Second, this dissertation attempts to define the conditions necessary for the imposition of third party liability. In pursuing this task the goals of equity and certainty are always kept in mind. In this way the rights of both the third party and the accountant are properly balanced, and the applicable legal doctrines will be


understood by each. By accomplishing all of these tasks, the path will be cleared for the development of a single concept of accountants' third party liability.

Statement of Methodology

In the pursuit of these goals, this dissertation takes a threefold approach. First, a study of the literature—both from legal and accounting sources—has been undertaken in order to gain a basic understanding of the arguments surrounding the area of accountants' third party liability. Second, an examination has been made of all existent statutes and legal dicta which relate to the topic of accountants' liability. Such a study has revealed the principles and reasoning which currently underlie the legal theory of accountants' liability. Finally, a study of other related areas of the law, and potentially applicable legal doctrines, has been undertaken in an attempt to survey the logic behind doctrines basic to other areas of the law of torts. This information has been used to synthesize the various concepts of tort law into one formal concept which could govern the area of accountants' liability to third party statement users.

Summary

The certified public accountant faces a complex and confusing legal situation when dealing with third party financial statement users. Both the decisions and dicta of the modern courts have added to the legal problems of
the public accountant. The courts have not only commented on the degree of liability which governs specific types of accountant-third party relationships, but have also commented on the duties and practices of the accounting profession as a whole.

This dissertation attempts to find a solution to the complex legal problems facing public accountants. In pursuing this goal a four step approach has been taken. First, the historical development of the concepts which today govern accountants' legal liability is traced. Second, a detailed analysis of the current legal situation is provided. Third, the major arguments surrounding the area of accountants' third party liability are discussed. Finally, a set of basic concepts to govern the accountant-third party relationship is developed. Such a systematic approach to the problem yields a useful and workable solution to the legal problems of the public accounting profession.
CHAPTER II

THE HISTORICAL DEVELOPMENT OF ACCOUNTANTS' LIABILITY

The legal liability of certified public accountants to third party statement users has its roots in two separate and distinct bodies of law. While the common law doctrines of accountants' legal liability developed first, statutory liability, as codified in the securities legislation of the thirties, has also played a major role in the evolution of the accountant's current legal predicament. This chapter takes a two step approach in tracing the historical development of the concepts of accountants' legal liability. The first section of this chapter traces the evolution of the concepts which today form the basis of accountants' common law liability to third parties. The second section of this chapter traces the evolution of the statutes which combine with common law doctrines to form the entire basis of the accountant's third party legal liability.

Development of Accountants' Common Law Liability

It was once argued, by Justice Holmes, that the common law had inherent in it an element of certainty.
Yet, the case by case nature of the common law, which continually allows individual courts to make changes and accommodations, has often turned this supposed element of certainty into a myth.\(^1\) This same case by case system of accommodation and change was the legal entity which eventually produced the common law doctrines to govern the relationship existent between the certified public accountant and the financial statement user.

The specific common law doctrines which were to be applied to the accountant-third party relationship developed in several stages. First, there were the early English Cases which dealt with the basic concepts of tort and contract law. The concepts developed in these cases were later to provide the theoretical foundation upon which accountants' common law liability would be administered. Second, there were the cases in which the American Courts advanced interpretations of the early British Theories. It was here that the early theories were often modified to deal with particular situations. Finally, there were the cases which precipitated the New York Rule. The development of this rule represented an attempt on the part of the New York Court to consolidate the common law of accountants' liability, while, at the same time, providing for the basic needs of economic

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society. A discussion of these three stages of common law development follows.

The Early English Doctrines

The first of the English contributions to the area of accountants' third party liability was set forth in the case of Winterbottom v. Wright (Winterbottom). In this case, Lord Abinger ruled that where a person was injured as a result of the negligent performance of a contract to which he was not a party, that injured person had no right of action based upon the contract. Where there was a lack of privity between the parties, there was a lack of an existent duty which was a necessary element of all actions based upon a charge of negligence. In expressing this sentiment, the Winterbottom Court stated:

There is no privity of contract between these parties; and if the plaintiff can sue, every passenger, or even any person passing along the road, who was injured by the upsetting of the coach, might bring a similar action. Unless we confine the operations of such contracts as this to the parties who entered into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue. . . .


^Winterbottom.
Thus, the first of the applicable common law concepts—that of privity of contract—was not the result of any specific legal doctrine, but instead, was the result of the court's belief that the only safe policy to pursue was that of limiting liability to those who were parties to a particular contract.\(^5\)

While the bar of privity of contract as espoused by the English Courts would seem to have been an absolute preclusion to third party recovery, the courts were quick to specify situations in which recovery would be allowed. In 1889, the English Courts accepted a charge of fraudulent misrepresentation as the basis of an action. In *Derry v. Peek*\(^6\) (Derry) the court recognized the right of a third party to recover damages caused by the fraudulent statements of a defendant. A charge of fraud, according to the Derry Court, could be based on either false statements, or statements made with a reckless disregard for the truth.\(^7\) The court delineated the basis of any such action by saying:

\[\ldots\] where a man makes a statement to be acted upon by others which is false, and which is known by him to be false, or is made by him recklessly, or without care whether it is true or false, that is, without any reasonable grounds for believing it to be true, he is liable in an action of deceit at the suit of anyone to whom it was addressed or anyone of the

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\(^5\)Ibid.

\(^6\)Derry v. Peek, 14 A.C. 337 (1889).

\(^7\)Rastetter.
class to whom it was addressed and who was materially
induced by the misstatement to do an act to his
prejudice.®

Yet, in defining the limits of an action based on
fraudulent misrepresentation, the Derry Court was careful
to point out the basic distinctions which existed between
actionable fraud and other nonactionable torts. In
doing so, the court stated:

A false statement, made through carelessness and
without reasonable ground for believing it to be
true, may be evidence of fraud but does not necessarily
amount to fraud. Such a statement, if made in the
honest belief that it is true, is not fraudulent and
does not render the person making it liable to an
action of deceit.9

Thus, the English Courts began to assault the citadel
of privity by allowing third parties a means of recovery
under certain well defined circumstances. Yet, this
first assault was a highly qualified one, for before an
action for fraudulent misrepresentation would be accepted
by the courts, the plaintiff was required to prove that
the defendant knew of the falsity of the statement, and
that the plaintiff's reliance upon the misrepresentation
caused him to suffer injury. Fraudulent misrepresentation,
therefore, was a valid cause of action, but action for
negligent misrepresentation was still to be precluded
by the bar of privity.

8Derry.

9Ibid.
While some of the major areas of the English Common Law seem to have been closing in on the public accountant, there was one area of the law which provided the accountant with a great deal of legal protection. When the courts were finally required to define the limits of the public auditor's responsibility, the concepts adhered to were no more stringent than those which the public accountants had established for themselves. In two separate decisions, the English Courts held that public accountants were not guarantors. The courts felt that accountants did not provide individuals with a warranty as to the accuracy of their reports. Accountants, the courts reasoned, could not be expected to find every mistake or defalcation, but instead, could only be expected to apply the skill and care which would be used by a reasonable and prudent accountant in the same situation.\(^\text{10}\) In one of these two English Cases the court went so far as to specify the duties of the auditor by saying:

... in determining whether any misfeasance or breach of duty has been committed, it is essential to consider what the duties of the auditor are. ... Shortly they may be stated thus: It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with

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\(^{10}\)See In re London and General Bank [1895] 2 Ch. 673; and In re Kingston Cotton Mill Company [1896] 2 Ch. 279.
suspicion or with a foregone conclusion that there was something wrong. He is a watchdog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.\textsuperscript{11}

It was this concept as put forth in the early English Decisions, which institutionalized public accounting as a skilled profession. Thus, accountants were afforded the opportunity to design the legal standards by which they would be judged.

The nineteenth century English Courts advanced four concepts which were to play significant roles in the evolution of accountants' common law liability. The concept of privity of contract, the definition of fraudulent misrepresentation, the distinction between fraud and other lesser torts, and the definition of accounting as a skilled profession were all to be significant factors in the development of further legal doctrines. The stage was thus set for other courts to apply these judicial theories to some specific fact situations.

The American Interpretations

One of the major factors in the industrial development of the United States was the ability of the corporate form of organization to facilitate the separation of

\textsuperscript{11}Kingston Cotton Mill.
management and ownership. As this functional separation grew, there arose the need for an independent check on the activities of management. The accounting profession migrated to this country in an attempt to alleviate that need.

As the profession moved from England to the United States, the legal doctrines which had been developed to govern the accountant-financial statement user relationship became a more significant part of the American Common Law. While the American Courts were quick in adopting the concepts initially developed in the English System, the courts were also quick to modify and to advance further interpretations of these basic principles.

In Seaver v. Ransom\(^{12}\) (Seaver) the American Court noted that several jurisdictions had extended liability beyond the parties to a contract, to individuals which the court called "beneficiaries" of the contract.\(^{13}\) Yet, the Seaver Court made it extremely clear that the general rule governing such extra-contractual relationships was the earlier concept of privity of contract. The court expressed this feeling by saying:

The general rule, both in law and equity was that privity between a plaintiff and a defendant is necessary to the maintenance of an action on contract. The consideration must be furnished by the party to whom

\(^{12}\)Seaver v. Ransom, 224 N.Y. 233, 120 N.E. 639 (1918).

\(^{13}\)Ibid.
the promise was made. The contract cannot be enforced against the third party, and therefore it cannot be enforced by him.¹⁴

One year later, in the case of Landell v. Lybrand¹⁵ (Landell) the American Courts set out to formalize the distinction between fraud and negligence which the Derry Court had alluded to several decades before.¹⁶ In making this basic distinction, the court said:

There were no contractual relations between the plaintiff and defendants, and, if there is any liability from them to him, it must arise out of some breach of duty, for there is no averment that they made the report with intent to deceive him. The averment in the statement of claim is that the defendants were careless and negligent in making their report; but the plaintiff was a stranger to them and to it, and, as no duty rested upon them to him, they cannot be guilty of any negligence of which he can complain. . . .¹⁷ (Italics mine.)

Thus, the Landell Court interpreted the element of intent to be the major factor of distinction between pure and actionable fraud and simple and nonactionable negligence. This distinction would seem to have provided honest accountants with an insurmountable defense against third party actions.¹⁸

¹⁴Ibid.
¹⁶Rastetter.
¹⁷Landell.
Even as the Seaver and Landell Courts were reasserting the validity of the early English Theories, other American Courts were advancing significant modifications of the basic legal concepts. This slow process of modification was eventually to result in a series of third party actions based on simple negligence.

When Donald C. MacPherson was injured in a defective Buick Motor Car, the process of modification began. The New York Court in *MacPherson v. Buick Motor Company*19 (MacPherson) circumvented the concept of privity of contract, and allowed an injured third party to recover damages from a negligent manufacturer. In justifying its decision, the court referred to the eminent danger associated with the use of certain products, and thus, embarked into a new area of manufacturers' product liability. The court justified its finding by stating that:

> If the nature of a thing is such that it is reasonably certain to place life and limb in peril when negligently made, it is then a thing of danger. Its nature gives warning of the consequences to be expected. If to the element of danger then is added knowledge that the thing will be used by persons other than the purchaser, and used without new tests, then, irrespective of contract, the manufacturer of this thing of danger is under a duty to make it carefully.20

Liability for negligence in the manufacture of a physical product was to be the furthest extension of

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20 Ibid.
the common law for six years. Then, in the case of Glanzer v. Shepard\textsuperscript{21} (Glanzer) the New York Court was presented with the opportunity to express an opinion on the liability of a professional for negligence in the performance of a service. In the Glanzer Case, the court imposed upon a weigher of beans an extra-contractual duty, extending beyond his employer to a third party plaintiff. The court argued that while the plaintiff, the buyer of the beans, was not a party to the contract, he was the primary beneficiary of the contract. The court expressed its opinion of the duties of the weigher by saying:

We think the law imposes a duty toward buyer as well as seller in the situation here disclosed. The plaintiffs' use of the certificates was not an indirect or collateral consequence of the action of the weighers. It was a consequence which, to the weighers' knowledge, was the end and aim of the transaction. Bech, Van Siclen and Company [the seller] ordered, but Glanzer Brothers [the buyers] were to use. The defendants held themselves out to the public as skilled and careful in their calling. They knew that the beans had been sold, and that on the faith of their certificate payment would be made. . . .\textsuperscript{22}

The Glanzer Case was thought to be the first step toward allowing third parties to recover pecuniary losses caused by the negligence of others.\textsuperscript{23} This trend toward

\textsuperscript{21}Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922).

\textsuperscript{22}Ibid.

liberalization of the laws of negligence was to continue for another eight years.

The American Courts soon began to supplant the old English Doctrines with the new, more liberal, concepts of the Galnzer and MacPherson Courts. In the case of International Paper Products v. Erie Railroad Company24 (Erie) the court applied the primary benefit rule of Galnzer in allowing an injured third party an opportunity to recover the pecuniary losses which were caused by a negligent misrepresentation. Yet, the Erie Court went one step beyond the Galnzer Decision by delineating the four basic conditions which were necessary for such recovery. First, the court felt that the defendant in such an action must have had prior knowledge that the information was desired by the plaintiff for a serious purpose. Second, the court found that the defendant must have had prior knowledge as to the plaintiff's intent to undertake action based on the information. Third, the court ruled that the defendant must have realized that false information would result in injury to the plaintiff. Finally, the court argued that the relationship existent between the parties, disregarding the existence of a contract, must have been such that in good conscience the plaintiff had the right to rely on the information,

and the defendant had the duty to supply the information with care.\textsuperscript{25}

The liberalizations of the common law which resulted from the decisions in the Glanzer and MacPherson Cases, and the interpretation of those decisions by the Erie Court, would seem to have produced serious cracks in the once impregnable citadel of privity. The primary benefit rule as espoused by the Glanzer Court had become so well entrenched that in 1930, in the case of \textit{Doyle v. Chatham and Phenix National Bank}\textsuperscript{26} (Doyle), the concept was applied to the relationship which existed between a bank and the purchasers of a group of indemnities which the bank had certified to be completely secured. By this time, it seemed that only one further legal step was necessary to reach the public accountant.

While the early American Courts rarely had an opportunity to comment on the common law liability of public accountants, their liberal rulings on other related matters would tend to indicate a great degree of receptivity to third party suits. With the basic doctrines of the American and English Courts established, it remained for the New York Court to fashion these various legal theories into a unified approach to the

\textsuperscript{25}Ibid.

accountant's common law liability to third party financial statement users.

The New York Rule

While the first three decades of the twentieth century provided the courts with a number of opportunities to comment of the liability of professionals to third parties, public accountants were the subject of few of these cases. Yet, the financial collapse of 1929, brought with it not only an increase in the awareness of the certified public accountant's role, but also, an increase in the belief that public accountants were infallible detectives. This over dependency on the reports of public accountants soon provided the courts with the opportunity that had been lacking for almost thirty years.

Ultramares Corporation v. Touche, Niven and Company\(^{27}\) (Ultramares) represents the first case in which the courts attempted to develop a set of legal doctrines which could govern the liability of public accountants for losses suffered by third parties and caused by the negligence, or fraud, of the accountant. Eight years later, the decision advanced in State Street Trust Company v. Ernst\(^{28}\) (State Street) joined Ultramares


to form a solid base of common law precedent (the New York Rule) which would control the area of accountants' liability to third parties for more than twenty-five years.  

The Ultramares Court took quick action to put a halt to the progressive trend which had been started by the courts in *MacPherson, Glanzer, Erie* and *Doyle*. In refusing to extend the liberal doctrines any further, the Ultramares Court specified only two situations in which an injured third party could recover damages from a public accountant. In the first situation, a third party could recover damages from the accountant if it could be proven that the accountant was fraudulent in making the misrepresentation. In the second situation, the third party could recover damages from the accountant if it could be proven that the third party was both the primary beneficiary of the accountant's contract, and specifically known to the public accountant. The existence of either of these situations was to be a question of fact, and thus, was subject to the decision of a jury.

The reassertion of the old privity doctrine by the Ultramares and State Street Courts constituted a

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significant limitation in the progression of the law of negligence. Yet, the courts did offer to the injured third party two significant expansions of the law of fraud. First, the scope of the accountant's liability for fraudulent misrepresentation was expanded to include those parties who would foreseeably rely upon the accountant's certification. Prior to the Ultramares and State Street Decisions, professionals had been held responsible only to the parties who were intended to be influenced by the fraudulent action. Second, the laws governing fraudulent misrepresentation were expanded to allow a jury to draw an inference of fraud from evidence which only proved the gross negligence of the certified public accountant. As Judge Finch pointed out in the State Street Decision:

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.\textsuperscript{33}

This interrelationship between the law of gross negligence and the law of fraud was to constitute a most complex doctrine of common law liability.

Although the plaintiffs in \textit{Ultramares} asked the court to apply the previously espoused concepts of \textit{Glanzer}, \textit{Erie} and \textit{Doyle}, the court proceeded to delineate several fine distinctions which precluded the application of the earlier doctrines. In distinguishing the \textit{Glanzer} and \textit{Ultramares} Cases, the court argued that the relationships existent between the parties to the suits were different in the two situations. In explaining these differences, the \textit{Ultramares} Court said:

Here [\textit{Glanzer}] was something more than the rendition of a service in the expectation that the one who ordered the certificate would use it thereafter in the operations of his business as occasion might require. Here [\textit{Glanzer}] was a case where the transmission of the certificate to another was not merely one possibility among many, but the 'end and aim of the transaction,' as certain and immediate and deliberately willed as if a husband were to order a gown to be delivered to his wife, or a telegraph company, contracting with the sender of a message, were to telegraph it wrongly to the damage of the person expected to receive it . . . The bond was so close as to approach privity, if not completely one with it. Not so in the case at hand [\textit{Ultramares}]. . . .\textsuperscript{34}

This policy of distinction, based on the relationship existent between the parties, was continued with respect

\begin{footnotesize}
\textsuperscript{33}State Street.
\textsuperscript{34}Ultramares.
\end{footnotesize}
to the Erie Decision. In explaining this distinction, the Ultramares Court said:

Here [Erie] was a determinate relation, that of bailor and bailee, either present or prospective, with peculiar opportunity for knowledge on the part of the bailee as to the subject-matter of the statement and with a continuing duty to correct if erroneous. Even the narrowest holdings as to the liability for unintentional misstatement concede that a representation in such circumstances may be equivalent to a warranty. . . .35

The process of distinction was brought to a close with Justice Cardozo's comment on the Doyle Case. The Ultramares Court pointed to the basic differences in circumstances by saying:

. . . [Doyle] is even more plainly indecisive. A trust company was a trustee under a deed of trust to secure an issue of bonds. It was held liable to a subscriber for the bonds when it certified them falsely. . . .36

The primary beneficiary relationship of Glanzer, the prospective bailor-bailee relationship of Erie and the trustee-subscriber relationship of Doyle were the legal distinctions advanced to justify the change in direction which was taken by the Ultramares Court. Yet, further analysis would tend to indicate that the New York Rule was predicated more upon social considerations than legal distinctions.37

35Ibid.
36Ibid.
When examined in the light of earlier common law decisions, the rulings in *Ultramares* and *State Street* seem slightly inconsistent. Legal precedent would have dictated the imposition of liability in both of these cases. Yet, beyond the basic legal considerations, Justice Cardozo advanced three extra-legal arguments to justify the establishment of the New York Rule.

First, while the courts advanced the lack of privity as the reason for the *Ultramares* and *State Street* Decisions, the fear of an indeterminate liability weighed heavy on the minds of the jurists. The *Ultramares* Court felt that the imposition of legal liability in this particular case would place upon the entire accounting profession an enormous amount of legal pressure. The court further believed that this legal pressure would ultimately result in the financial collapse of public accounting, and thus, the loss of a valuable discipline. Justice Cardozo expressed this fear by saying:

> 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 imposition of a duty that exposes to these consequences. . . .

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39Miller, p. 603.

40*Ultramares*. 

Second, the courts in *Ultramares* and *State Street* seemed to believe that if third party liability for negligent misrepresentation were extended to the accounting profession, the same degree of legal responsibility would soon be applied to all other skilled professions. Lawyers, architects and engineers would soon be subject to the same "indeterminate" liability as accountants.\(^{41}\)

The *Ultramares* Court expressed its fear of this almost certain result by saying:

> Liability for negligence if adjudged in this case will extend to many callings other than an auditor's. Lawyers who certify their opinion as to the validity of municipal or corporate bonds, with knowledge that their opinion will be brought to the notice of the public, will become liable to the investor, if they have overlooked a statute or a decision, to the same extent as if the controversy were one between client and advisor. Title companies issuing titles to a tract of land, with knowledge that at an approaching auction the fact that they have insured will be stated to the bidders, will become liable to purchasers who may wish the benefit of a policy without payment of a premium. These illustrations may seem to be extreme, but they go little, if any farther than we are invited to go now. . . .\(^{42}\)

Finally, the *Ultramares* and *State Street* Courts expressed the belief that the services of public accountants were provided primarily for the benefit of their clients. The *Ultramares* Court expressed its view of the "public" in public accounting by saying that:

> . . . public accountants are public only in the sense that their services are offered to any one

\(^{41}\)Gammel v. Ernst and Ernst, 72 N.W. 2d 364 (Minn. 1955).

\(^{42}\)Ultramares.
who chooses to employ them. This is far from saying that those who do not employ them are in the same position as those who do.\textsuperscript{43}

Thus, it would seem that these three considerations of social policy, and not pure legal precedent, served as the basis of the New York Rule.

The English Courts began the development of the common law liability of public accountants by delineating a set of basic legal principles. While these principles did not constitute a complete doctrine of common law, they did supply a foundation upon which other doctrines could be built. The American Courts began this building process just after the turn of the century. It was here that the basic English Concepts were interpreted, and finally modified into a set of legal doctrines which could be applied to the area of accountants' liability. Thirty years later, the New York Courts began the process of balancing these legal concepts with the basic concepts of social need. This balancing process was to result in the promulgation of the New York Rule—a concept which was to govern the common law liability of public accountants to third party financial statement users for many years to come.

\textbf{Development of Accountants' Statutory Liability}

As the twentieth century began, the activities of most business enterprises were both expanding and

\textsuperscript{43}\textit{Ibid}.\textsuperscript{43}
While the ordinary citizen's involvement in the world of commerce had become more intense, the average investor had found that it was virtually impossible to personally obtain all of the information necessary for the making of economic decisions. Therefore, the prudent investor found it desirable to rely upon information procured, and verified, by other parties. The public accountant was to be one of those other parties.

While the investing public was making the necessary transition, most state legislatures, and the United States Congress, were realizing the significance of this newly formed relationship. It was this realization which spurred most of these law-making bodies toward the enactment of specific pieces of legislation. These pieces of legislation were passed in an attempt to provide a firm base of information upon which the entire economic system might develop.\textsuperscript{44} This element of statutory control evolved through three stages. First, there were the "blue sky laws" which were enacted by various state legislatures. Second, there were the Securities Act of 1933 and the Securities Exchange Act of 1934 as established by the United States Congress. Finally, there were the rules and regulations promulgated by the Securities and Exchange Commission. An historical perspective of each of these

statutory mechanisms, and a discussion of their immediate effects upon the accounting profession, follows.

The State Blue Sky Laws

Prior to 1930, most states enacted some form of statute in an attempt to prohibit the sale of fraudulent securities. While these blue sky laws did not have a significant effect upon the liability of public accountants to third party statement users, an examination of their failings provides some insight into the development of similar, and more significant, federal legislation.

In general, the blue sky laws which were enacted by the states failed to control the sale of fraudulent securities for three reasons. First, business activity had evolved to a level where interstate transactions were ordinary. Due to this evolution, the smart salesman could avoid the laws of a specific state by simply staying out of that state's jurisdictions. While the Constitution did provide for the mandatory extradition of criminals, a loophole in the law allowed most parties guilty of

\[45\] The Constitution states, "A person charged in any State with Treason, Felony, or other Crime, who shall flee from Justice, and be found in another State, shall on Demand of the executive Authority of the State from which he fled, be delivered up, to be removed to the State having Jurisdiction of the Crime." U.S., Constitution, art. IV, sec. 2. Unfortunately for state governments, the courts interpreted the word "flee" to mean that the individual must have been present in the state at some prior time. Thus, if the seller of securities totally avoided the state where the sale was made, no extradition would be possible. Louis Loss, Securities Regulation (Boston: Little, Brown and Company, 1951), p. 56.
a securities related crime to avoid punishment. Second, while most blue sky laws did provide for adequate punishment, the legislatures which enacted those statutes usually failed to provide funds adequate for their proper enforcement. It was not uncommon for a poor and weak agency of the state to face a rich and powerful corporation in a legal battle over the enforcement of blue sky laws. The result of such a battle often weakened the entire structure of the state law. Finally, many of the laws passed by the states were simply illusory. While most of the state statutes seemed airtight on the surface, the exemption provisions attached to those statutes often negated their effect.\(^\text{46}\) Thus, it would seem that the attempts of individual states to regulate interstate commerce met with utter failure.

The Federal Securities Statutes

The federal government soon realized that the state statutes would not be effective in controlling securities transactions. As such, efforts to effectuate truth in securities transactions through legislative means began at the national level as early as 1919. In that year, the Taylor Bill was introduced to the House of Representatives. This particular piece of legislation was modeled after the English Companies Act, and thus, would have required companies involved in interstate

\(^{46}\text{Loss, pp. 56-58.}\)
commerce to register their securities with the Treasury Department. Furthermore, the bill would have imposed upon anyone signing the registration statement civil liability for material misstatements. One year later, Representative Volstead sponsored another form of securities legislation. Unfortunately for the unsophisticated investor, neither of these bills was ever to be reported out of committee. 47

It would seem that the stock market crash of 1929 was the force which was necessary to spur Congress toward the finalization of specific statutes designed to control the major securities markets. After that economic collapse, and several years of the deep depression which followed, Congress took definite steps to insure that potential investors would always have the information necessary for the making of their economic decisions. These steps culminated in the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. Each of these pieces of legislation was eventually to have a significant impact upon the area of accountants' legal liability to third party financial statement users.

When Congress implemented the Securities Act of 1933 it seems that the accomplishment of two basic goals was sought. First, the statute was designed to provide investors with necessary financial information. To accomplish this purpose, Congress required all affected

corporations to file registration statements concerning the issuance of new securities. The information contained in these registration statements was to be sufficient to allow a prudent investor to make an adequate appraisal of any new security issue.48 Second, and probably more important for the public accounting profession, the statute sought to establish a force which would deter the financial abuses which had been so prevalent only ten years before. To accomplish this task, the act imposed civil liability upon anyone making a material misstatement in the registration of an affected security.49 Section 11 specifically imposes such civil liability upon experts associated with the registration statement by saying:

In case any part of the registration statement when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may, either at law or in equity, in any court of competent jurisdiction, sue . . .

. . . 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 . . .50


Congress soon realized that while the element of control inherent in the Securities Act of 1933 was significant, the fact that the control feature only applied to issues of new securities represented a serious limitation in the legislative scheme. To correct this flaw in the 1933 act, Congress instituted a system of continuous control through the passage of the Securities Exchange Act of 1934. The 1934 act was similar to the earlier legislation in that it provided for both information dissemination and civil law deterrence. The deterrence feature of this particular piece of legislation was provided in Section 18 which stated:

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 ..., 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.

While it was almost thirty years before any court undertook to define the exact liability which these acts imposed upon the accounting profession, it was generally accepted that these statutes would impose upon the certified public accountant liability at least

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as great as that which was barred by Justice Cardozo just three years earlier. 53

The Securities and Exchange Commission Regulations

While Congress felt that the Securities Act of 1933 and the Securities Exchange Act of 1934 provided an adequate means of securities regulation, some farsighted members of the legislature realized that flexible laws were prerequisite to controlling a constantly changing financial world. Thus, Congress established the Securities and Exchange Commission in an attempt to provide an authoritative body which would constantly administer the Securities Acts in such a way as to guarantee investor protection. One of the first major rules which was to be promulgated by this quasi-judicial body—Rule 10b-5—was eventually to have a significant impact upon the liability of public accountants to third party financial statement users.

Soon after the passage of the Securities Acts, the Securities and Exchange Commission realized that it had little or no power over frauds perpetrated by security purchasers. To rectify this situation, the Commission asked Congress to amend Section 17(a) of the Securities Act of 1933. 54 In 1942, one year after the unanswered


request for congressional action, the Securities and Exchange Commission took steps on its own to fill this gap which existed in its arsenal of protective devices.\(^{55}\)

To accomplish this, the Commission adopted Rule 10b-5 which states:

> 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 operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.\(^{56}\)

While the initial promulgation of Rule 10b-5 was perceived to have little effect upon the accounting profession, it was to play, in time, a significant role in the development of accountants' legal liability.

Thus, like the common law of accountants' liability, statutory law was to emerge through three stages. First, there were the blue sky laws which were adopted by the individual states. Second, there were the Securities Act of 1933 and the Securities Exchange Act of 1934. While these laws have been quite effective, their impact


upon the area of accountants' third party liability has been a recent phenomenon. Finally, there were the rules and regulations instituted by the Securities and Exchange Commission. These regulations were initiated in an attempt to keep the package of securities related legislation in step with a constantly evolving financial world. In time, these national securities regulations were to play a significant role in the determination of accountants' liability to third party financial statement users.

Summary

Distinct doctrines of accountants' liability to third party financial statement users have evolved in two separate areas of law. The common law doctrines of accountants' liability began to develop as early as 1842 in England. The interpretation, development and modification of these concepts continued for almost one hundred years. The statutes which affect the accountant's legal liability, on the other hand, did not begin to take shape until the beginning of the twentieth century. Yet, within a period of fifty years, significant federal legislation had taken form. This legislation was later to play a significant role in the determination of the accountant's responsibility for injury suffered by financial statement users.

While the common law was the major force in the early development of accountants' liability, the statutes and regulations established in the thirties and forties
were to join the common law as significant factors in years to come. Chapter three examines this blending of the law, and in doing so, presents a discussion of the legal situation which presently confronts the certified public accountant.
CHAPTER III

THE CURRENT LEGAL SITUATION FACING PUBLIC ACCOUNTANTS

The legal concepts of accountants' third party liability have evolved into a most complex set of judicial principles. During the last thirty years, many cases on the issue of accountants' liability have been decided by the courts. Yet, while there is a dearth of decided cases, there is no unified body of law defining the accountant's responsibilities to third party financial statement users. Many of these cases provide doctrines which could be universally applied to the area of accountants' liability, but most of the doctrines established represent the logical conclusion of an individual court acting in an individual fact situation. Thus, the available decisions provide the accountant with only a rudimentary basis upon which to assess his legal liability.¹

This chapter proceeds with a discussion of the legal concepts which have been applied by various courts

to the area of accountants' civil liability. In accomplishing this task a two step approach has been taken. First, a discussion of the judiciary's interpretations of the professional responsibilities of accountants is presented. This section of the chapter concentrates on an analysis of the gap which has developed between the standards established for the accountant by the courts and the standards established for the accountant by the accounting profession. Second, a discussion of the judiciary's interpretations of the legal responsibilities of accountants is presented. This section of the chapter concentrates on an analysis of the doctrines of liability placement which are currently applicable to the accounting profession. This two step approach facilitates an understanding of the perplexing legal situation which today confronts the certified public accountant.

The Public Accountant's Professional Responsibilities

As early as 1895, public accountants were recognized by the courts to be members of a skilled profession.2 This judicial recognition brought with it special legal treatment, for skilled professionals are usually allowed to establish the legal standards of conduct by which they will be judged. These legal standards are often the same as the standards of conduct set by the profession to

2See In re London and General Bank [1895] 2 Ch. 673; and In re Kingston Cotton Mill Company [1896] 2 Ch. 279.
govern its members' activities. This practice of allowing professionals to set the standards of conduct by which they will be judged has been generally accepted by the courts for two specific reasons. First, this legal practice was established so that the professionals themselves would delineate the rules of conduct by which they would customarily abide. Second, this legal practice was established to prevent the courts from overburdening other professions with liability based on unsophisticated judgment.³

The judiciary has accepted this concept of self-imposed professional responsibility for many years. In fact, the concept has become so well entrenched as to lead one court to assert that, "Accountants should not be held to a standard higher than that recognized in their profession. . . ."⁴ Yet, while several other courts were also asserting the validity of this doctrine of self-regulation,⁵ the concept itself was beginning to create some major problems for the public accountant.

The special privilege which the courts had extended to the certified public accountant caused the profession


⁵See Rhode Island Hospital Trust National Bank v. Swartz, Bresenoff, Yavner and Jacobs, 455 F. 2d 847 (4th Cir. 1972); and Hochfelder v. Ernst and Ernst, 503 F. 2d 1100 (7th Cir. 1974).
as a whole to focus on the audit as the primary source of legal problems, and thus, begin to take action which would limit the potential for the realization of that liability. As such, the profession began to deny any responsibility for actions which were beyond the basic audit examination. This narrowing of the accountant's assumed responsibility continued to such an extent that the profession eventually asserted that the primary responsibility for the fair presentation of financial information lies not with the public accountant, but instead, with corporate management.\(^6\)

Many courts have now concluded that this narrowing of the public accountant's assumed responsibilities has caused a shift in the priorities of the accounting profession. These courts have often reasoned that the public accountant no longer seeks to serve the investor by presenting fair financial information, but instead, seeks to protect himself by meeting certain "esoteric" accounting standards. This perceived shift in priorities has led many courts to believe that accountants should no longer be allowed to determine the standards by which their conduct will be judged. As one recent court stated:

Much has been said by the parties about generally accepted accounting principles and the proper way for an accountant to report real estate transactions. We think this misses the point. Our inquiry is

properly focused not on whether Laventhol's report satisfied esoteric accounting norms, comprehensible only to the initiate, but whether the report fairly presents the true financial position... to the untutored eye of an ordinary investor. 7

Thus, the courts today are not only finding deficiencies in the way auditors examine financial statements, but also, are finding deficiencies in certain accounting principles, and the way those principles are applied to specific fact situations. 8 A discussion of some of the major areas of judicial comment follows.

Disclosure of Subsequent Events

Since World War II, the accounting profession, and the services provided by that profession, have expanded at a very rapid pace. Today, the average public accounting firm supplies to its clients not only the basic audit service, but also, supplies tax and management advisory services. While these additional service areas provide the accountant with an opportunity to develop a closer relationship with the client, they also provide an opportunity to obtain further information concerning the financial condition of the client firm. Such subsequently acquired information can have a significant effect on the previously expressed opinion of the public


accountant, the action taken by a potential investor and the legal liability of that accountant to that investor. The extent of this potential liability has been a major question in the past few years.

Initially, the accounting profession argued that the report issued by a certified public accountant represented the opinion of that accountant on the fairness of a set of financial statements as of the end of the audit examination. Therefore, if the accountant had complied with accepted auditing standards in the performance of his examination, and if the accountant's opinion had been advanced in good faith, no legal liability could arise out of that particular engagement. Even if a subsequent event, or discovery, should change the auditor's opinion at some later date, the profession reasoned that there was no need to disclose this new information for it had no significance in relation to the dated audit opinion. This theory of professional responsibility was to be eventually challenged by the judiciary.

Two significant, but isolated, events served as a prelude to a final decision on the responsibility of public accountants for the disclosure of subsequently acquired information. First, in 1883, the U. S. Second Circuit Court of Appeals held that one party to a contract has a duty to correct any misapprehensions which were affecting the actions of the other party to
the contract. Second, the Securities Act of 1933 imposed upon the accountant a duty to disclose all information obtained subsequent to the audit, and prior to the effective date of the registration statement. While neither of these events applied to the general accountant-third party relationship, they did indicate a trend on the part of the law-making bodies. This trend toward the imposition of a duty to disclose subsequent events was to be the main thrust of the law for many years, but the final decision was not to come until 1967.

In the case of Fischer v. Kletz (Fischer) the court fashioned a rule which drew heavily from those earlier situations. It was here that the court ruled that where there exists reason to believe that people are continuing to rely on a representation which is not true, the individual responsible for the representation must see that it is corrected. The court justified

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9 Loewer v. Harris, 57 F. 368 (2nd Cir. 1893).

10 In the Matter of Charles A. Howard, E. Harold DeNoyelles, Elmer W. Maher, William B. Atwater, 1 SEC 6 (1934).


the establishment of such a rule of professional responsibility by saying:

I can see no reason why this duty to disclose should not be imposed upon an accounting firm which makes a representation it knows will be relied upon by investors. To be sure, certification of a financial statement does not create a formal business relationship between the accountant who certified and the individual who relied upon the certificate for investment purposes. The act of certification, however, is similar in its effect to a representation made in a business transaction: both supply information which is materially and justifiably relied upon by individuals for decisional purposes. Viewed in this context of the impact of nondisclosure on the injured party, it is difficult to conceive that a distinction between accountants and parties to a business transaction is warranted. The elements of 'good faith and common honesty' which govern the businessman should also apply to the statutory 'independent public accountant'.

Thus, an accountant who makes a representation which he knows will be relied upon by third parties is under a duty to disclose to those third parties any information obtained subsequent to the initial representation. This was to be the first inroad into the accountant's right to establish the professional standards by which he would be judged—by no means was it to be the last.

Detection of Insider Fraud

The rapid growth of the economic sector produced two basic problems for the public accounting profession.

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14 Fischer.

First, the growth of corporate entities made it virtually impossible for the public accountant to perform a complete examination of the financial records of most corporations. If the accounting profession as a whole were to require a complete examination of all financial records, the result would almost certainly be audit costs which are prohibitive to most corporate entities. Second, the growth of corporate entities produced an atmosphere more conducive to insider fraud. Since the public accountant could not examine all financial transactions, a group of employees could easily subvert the audit examination, and thus, defraud the corporation and the investing public.\[^{16}\]

With these problems contributing to serious deficiencies in the traditional audit procedures, the public accountant was forced to rely on tests, samples and internal control as the basis for the expression of his opinion. The accountant soon realized that this shift in audit procedures made it impossible to guarantee the detection of all corporate fraud. This realization was expressed in the profession's auditing standards in the following manner:

In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate misrepresentation by

\[^{16}\text{Jerry D. Trites and Barry M. Grant, "Set the Watchdog Free," Chartered Accountant Magazine 106 (January, 1975):24.}\]
management, or both. The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud ... arises only when such failure clearly results from failure to comply with generally accepted auditing standards.17

While the accounting profession has denied any responsibility for the detection of corporate fraud, third parties, and certain courts, have argued that the imposition of such a responsibility upon the profession is not unwarranted. These certain courts were to eventually use Section 10(b), and particularly Rule 10b-5, of the Securities Exchange Act of 1934 as the means for imposing civil liability for failure to detect corporate fraud upon the public accounting profession.

Section 10(b) and Rule 10b-5 of the act provide a broad remedy for persons injured by fraudulent acts perpetrated in the purchase or sale of securities. Since these provisions only relate to activities "in connection with the sale or purchase of securities", accountants have always felt that they could not be

17American Institute of Certified Public Accountants, pp. 2-3.
applied to the members of their profession. Yet, several recent court decisions have suggested that Section 10(b) and Rule 10b-5 can be applied to certified public accountants when certain prerequisite conditions are present. As one recent court pointed out:

The purpose of the financial statements is to inform the man on the street and the underlying policy of the Securities and Exchange Acts and of Rule 10b-5 is to assure that he can have truthful information in buying securities regardless of the intended victim of the fraud. Moreover, the defendants have set themselves up to be independent certified public auditors. As such, they have assumed a peculiar relationship with the investing public. As accountants, the defendants clearly cannot be immunized from suit.

In general, the courts have advanced five conditions which must be present before an accountant will be held liable for aiding and abetting a corporate securities fraud. First, it must be demonstrated that the accountant had a duty to inquire into the financial position of the firm. Second, it must be proven that the plaintiff was a beneficiary of this duty of inquiry. Third, it must be shown that the accountant was guilty of a breach of that duty of inquiry. Fourth, it must be demonstrated that the accountant breached a concomitant duty of disclosure. Finally, it must be proven that adequate

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inquiry on the part of the accountant would have uncovered the fraud.20

To prove the existence of these five specific conditions, the third party plaintiff need not prove that the accountant acted in a fraudulent manner, or even that the accountant benefited from the fraud. Instead, the courts have held that it is sufficient to show that an aider and abettor knew, or should have known, that the actions of the primary parties (the purchasers or sellers of the securities) were being carried out in violation of Rule 10b-5. Therefore, an accountant can be charged with aiding and abetting a 10b-5 violation if he was negligent in the performance of his audit, and if this negligence resulted in the accountant's failure to detect that violation.21

It was this charge of aiding and abetting a Rule 10b-5 violation which produced a serious difference in the accounting standards adhered to by the profession and those adhered to by the courts. As yet, the extent of this difference has not been determined, but, fortunately for the accounting profession, the Supreme Court has agreed to define the limits of the accountant's liability for the detection of fraud sometime during the

20Hochfelder.

1975 Winter Session. Only after such an ultimate legal definition is attained, will the accounting profession be able to promulgate professional standards which conform to the legal standards established by the courts.

Preparation of Unaudited Financial Statements

Another area in which there are major differences between the professional standards established by accounting, and those established by the courts, is the area of legal responsibility for the preparation of unaudited financial statements. With regard to this area of professional activity, the public accounting profession has argued that unaudited financial statements are not the subject of any specific examination processes, and therefore, cannot be the potential source of any third party legal responsibility. On the other hand, several recent courts have asserted different interpretations of both the accountant's professional duties and legal responsibilities when dealing with these unaudited financial statements.

In the case of 1136 Tenants Corporation v. Max Rothenberg and Company (1136 Tenants) the court was

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22"Top Court Will Define When an Auditor is Liable for Client's Securities Violation," Wall Street Journal, 15 April 1975, p. 4.

23Murphy, p. 385.

presented with its first opportunity to comment on the liability of public accountants for negligence in the preparation of unaudited statements. It was also here, that the court determined that such third party liability does exist. The New York Court reasoned that theories of negligence liability could be applied in such a manner as to require a public accountant to act with reasonable care when dealing with any type of financial representation. The court in 1136 Tenants further reasoned that since negligence on the part of the accountant will contribute to third party injury in both audited and unaudited situations, a professional's duty to third party statement users exists in either situation.25

While the decision advanced by the 1136 Tenants Court did have a major impact upon the accounting profession, the reasoning that the court used in arriving at that decision has had a more significant impact upon the professional standards of public accountants. The court in 1136 Tenants directly contradicted traditional accounting standards by arguing that the accountant has an obligation to perform certain techniques of verification to determine the fairness of financial representations, even when that accountant is dealing with a simple set of unaudited financial information.25

25Murphy, p. 388.
statements. One later court interpreted this basic contradiction by saying:

Even when performing an unaudited write-up, an accountant is under a duty to undertake at least a minimal investigation into the figures supplied to him. He is not free to disregard suspicious circumstances.26

Yet, the accounting profession reacted to this newest intrusion by the courts with arguments, instead of their usual acquiescence. Accountants have advanced several arguments in an attempt to discredit the 1136 Tenants Decision. First, the accounting profession has argued that the fee charged by Rothenberg for his services could not have possibly compensated him for the performance of any verification processes. Second, the accounting profession has argued that it is highly unlikely that Riker (both the embezzler and employer of Rothenberg) would have hired someone to specifically uncover his fraudulent activities. Finally, and most importantly, the accounting profession has argued that all of the financial statements issued by the accountants contained legends which revealed the inherent lack of verification and examination.27 Thus, the accounting


profession has contended that the basis for the decision in 1136 Tenants was totally unfounded.

Prior to the 1136 Tenants Decision, certified public accountants were held liable for negligence only when an opinion was issued as the result of an audit examination. While the scope of the accountant's liability for audited financial statements has expanded over the years, the courts had not previously extended such legal liability to other areas of accounting services. Yet, in spite of the arguments of the accounting profession, the 1136 Tenants Decision has made such an extension. It would seem that this case shall remain as a major legal precedent, at least until another court, acting in a similar situation, sees fit to overrule this New York Decision.

Future Trends

While the attest function of the certified public accountant has been traditionally limited to the expression of an opinion on a set of audited financial statements, there has been a great amount of recent discussion concerning an expansion of the scope of the public accountant's examination. Yet, the recent court decisions which have held accountants responsible for activities

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28 Ibid.

beyond the limits of their basic professional standards have caused most accountants to believe that the risks involved in such an expansion of their work would far outweigh any benefits which would be derived. This fear on the part of the accounting profession is not based upon pure speculation, but instead, is the result of some recent decisions which have been promulgated by the courts.

One area of potential audit expansion is that of attesting to the accuracy of financial forecasts. Most financial analysts feel that projections of a firm's future economic performance are necessary for well informed investor decisions. Furthermore, these analysts feel that if such projections should be presented, some type of independent verification would be necessary. The certified public accountant is in a perfect position to supply this independent verification. Yet, most members of the accounting profession are of the opinion that if examinations of financial forecasts are to become an inherent part of the audit function, there must be some special legal treatment associated with these projected figures. Basically, professionals argue that since financial forecasts are so speculative, there should be no legal responsibility for their certification. ³⁰ Unfortunately for public accountants, the courts

have not seen fit to agree with this line of argumentation. Instead, the courts have held that projected financial information constitutes a material fact under Rule 10b-5 of the Securities and Exchange Commission. Therefore, it would seem that accountants could be held liable for certain failures in the examination of forecasted financial information.

A second area of potential audit expansion lies in the preparation of current value financial statements. Here again, the accounting profession argues that since current value statements are so indefinite, there must be special legal treatment afforded those who issue them. Yet, the courts, again, have taken a contradictory approach to the problem. In several recent decisions, the courts have ruled that current value financial information is a material fact. Therefore, it would again seem that accountants shall be held legally responsible to third party financial statement users for failure to exercise due care in the examination of current value financial statements.

The problems associated with the appearance of the professional man in the courts have always been great.


Initially, the courts sought to reduce these problems by allowing skilled professions to establish the standards by which their members would be judged. Through this mechanism, the courts assured professionals that the standards by which they would be governed in a court of law would be the same as those by which they would be governed in the performance of their business activities. Unfortunately for the accounting profession, some courts have now discarded this once universally accepted legal doctrine. Various courts, commenting on various business situations, have questioned the reasonableness of certain generally accepted auditing standards. These recent judicial comments have contributed greatly to the existence of a gap between the legal standards by which an accountant will be judged and the professional standards by which an accountant will act.

The Courts' Doctrines of Liability Placement

The doctrines of liability placement which are today used in determining the accountant's liability to third party statement users have evolved over a period of more than one hundred years. Yet, even this long period of evolutionary development has not produced a concept of liability placement which is generally accepted by all courts. While the members of the judiciary have agreed that two factors—the degree of care exercised by the accountant, and the relationship which existed between the accountant and third party—enter into the
placement of civil liability, the courts have not established a general relationship between these two factors and the imposition of legal liability. This section of this chapter presents an analysis of the most commonly accepted doctrines of liability placement. In so doing, it is intended that an insight into the legal situation which presently confronts the certified public accountant will be gained.

Liability for Pure Fraud

Legal liability to third party financial statement users for fraud, or intentional deceit, is the oldest of the concepts of liability placement which have been applied to members of the public accounting profession. Furthermore, the concept of legal responsibility for intentional deceit is the only concept of liability placement which has been universally accepted by the courts. With almost no exception, the American Courts today hold that an individual who makes a fraudulent misrepresentation of fact, opinion, intention or law is liable for the injury suffered by individuals who have relied upon the misrepresentation. Therefore, an accountant who intentionally deceives the investing public will be held liable to all of the members of the general public who were injured due to that accountant's deceit.

While the courts have accepted a charge of fraudulent misrepresentation as a valid basis for actions against the certified public accountant, they have generally required that certain underlying conditions be met before an injured third party will be granted recovery. The first of the underlying requirements of an action based in pure fraud is that of scienter, or knowledge. If the accountant is to be charged with fraudulent misrepresentation, the third party plaintiff has an obligation to prove that the accountant actually knew that his representation was false. If on the other hand, the accountant is not aware of the fact that he is deceiving the public, he cannot be charged with pure fraud, and instead, must be charged with some other, less actionable, tort.

A second prerequisite to any third party action based on a charge of fraudulent misrepresentation is that of intent. An accountant who makes a fraudulent misrepresentation is liable only to those parties whose action he intended to influence. While this element of intent would seem to place a severe limitation on third party recovery, the limitation is only minor due to several liberalizations of the law. First, most courts will rule that an individual intends a particular result to occur, if the individual either acts in a way which will

cause the result to occur, or acts under the belief that there is substantial certainty that the result will occur. Therefore, accountants are not only liable for the occurrence of one particular result, but also, are held responsible for any number of substantially similar results which might eventually occur. Second, the intent of an accountant's actions is not limited to its effect on one individual, but instead, extends to many different groups of individuals. A fraudulent misrepresentation made with the intent of inducing more than one person, or group of persons, to act, subjects the maker to liability to any of those individuals.\textsuperscript{35} Therefore, a certified public accountant who makes a fraudulent misrepresentation is liable to all those who he should have reasonably foreseen as being injured by his deceit.\textsuperscript{36}

The final prerequisite to a third party action based on a charge of fraudulent misrepresentation is that of reliance. The third party plaintiff must be able to prove that he both relied upon the fraudulent misrepresentation of the accountant, and that this reliance was justified. For a third party to prove reliance on a financial representation, that third party

\textsuperscript{35}American Law Institute, pp. 71-74.

need only show that the financial representation had a significant impact upon his final course of action. On the other hand, proving that this reliance was justified is not quite so easy.

To prove that his reliance was justifiable, the third party must prove two independent facts. First, the third party plaintiff must be able to prove that the fact misrepresented by the public accountant was a material one. To accomplish this task, the third party must show that the misrepresented fact was one to which a reasonable man would attach significance. Second, the third party plaintiff must show that he had no knowledge as to the falsity of the misrepresentation. If the third party either knew, or should have known, of the false nature of the representation, his reliance was not justifiable, and therefore, liability for fraudulent misrepresentation cannot exist.

When a third party financial statement user is capable of proving scienter, intent and reliance, the courts will hold accountants liable for fraudulent misrepresentation. Yet, while pure fraud has become an accepted basis for legal action, the difficulty involved in proving such a charge has made such actions a rarity.

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37 American Law Institute, p. 106.
38 Ibid., pp. 84-86.
Therefore, the courts have turned to some more liberal doctrines of liability placement when dealing with members of the public accounting profession.

**Liability for Gross Negligence**

While the traditional third party action for deceit was based in fraud, the courts soon realized that the requirements of scienter, intent and reliance were overly strict in relation to the situation with which they were dealing. As the attitude of the courts began to shift toward a more favorable view of third party litigation, the idea of gross negligence as an inference of fraud began to seep into the law of accountants' liability. This idea of gross negligence as a replacement for certain of the fraud requirements was to represent a significant expansion of the law of fraudulent misrepresentation.

Gross negligence, or constructive fraud, consists of a false representation which induces a third party to take action detrimental to his well being. While a charge of pure fraud would require definite proof of the existence of each of the prerequisite factors, a charge of gross negligence requires proof of only a

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false representation on the part of the defendant and justifiable reliance on the part of the plaintiff. Thus, without actually proving the existence of pure fraud, a third party plaintiff may provide evidence which sustains a charge of gross negligence, and therefore, may be used by a jury to infer fraud on the part of a certified public accountant.

In order to prove that such a false, or grossly negligent, misrepresentation has been made by the accountant, the third party statement user needs only to show that the public accountant had no factual basis upon which to make his representation. Since the opinion of the accountant implies that he has made a firm factual examination of the financial records of a particular company, a substantially wrong representation which indicates that the accountant has made no such factual examination is sufficient to prove the gross negligence, and possible fraud, of that certified public accountant.\(^2\)

As one recent court stated:

> To be actionable deceit, the representation need not be made with knowledge of actual falsity, but need only be an 'assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true . . . .'\(^3\)

Through the use of this gross negligence concept, the courts developed two means by which a jury can

\(^2\)American Law Institute, p. 65.

conclude that the activity of a public accountant was fraudulent. Unfortunately, this attempt on the part of the judiciary to provide a more liberal approach to the issue of fraudulent conduct has created a great deal of confusion. The existence of these two doctrines of liability placement has only contributed to the substantial amount of overlap which exists between the legal concepts of pure fraud and simple negligence.  

**Liability for Negligence—The Privity Concept**

Almost all of the court jurisdictions in the United States have accepted both the concept of pure fraud and the idea of gross negligence as an inference of fraud as viable forms of third party legal action. Yet, the judiciary is a great deal less consistent in its interpretation of the law of accountants' third party liability when the accountant is guilty of nothing more than simple negligence. Although the courts have commonly agreed that simple negligence on the part of the accountant consists of a failure to perform a service, or make a report, with the due care commonly exercised by accountants and required by professional standards, the courts have been quite inconsistent in their application of this concept. This inconsistency results from

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45. Gormley, p. 1206.
the insertion of another factor into the issue of liability placement. Beyond determining whether the accountant is actually guilty of negligence in the performance of his services, the courts have also attempted to determine whether the relationship existent between the third party and the public accountant is sufficient to require the accountant to exercise that duty of due care. This second requirement has resulted in the proliferation of several doctrines of liability placement, none of which is generally accepted by all courts.

In 1931, Justice Cardozo, rendering the decision of the court in Ultramares Corporation v. Touche, Niven and Company (Ultramares), halted what he had termed "the assault upon the citadel of privity". Cardozo took this step in an attempt to shield the accounting profession from the potentially crushing burden of third party liability for simple negligence. It has been this same prerequisite of privity of contract which has successfully insulated the accountant from most third party legal action.


48 Prosser, p. 239.

49 Reiling, p. 40.
While the attack upon the citadel of privity did continue to move forward on some legal fronts, the area of liability in which the public accountant is most primarily involved (i.e., that of liability for the pecuniary losses suffered by third parties) is heavily protected. By 1960, the requirement of the existence of a contractual relationship between parties had been all but discarded by the courts in dealing with cases of physical injury; yet, where the injury suffered by the third party was pecuniary in nature, the courts were not so willing to abandon privity of contract in favor of third party recovery.51

Today, many courts automatically apply Cardozo's prerequisite of a relationship equivalent to privity of contract when dealing with suits instituted by third parties who have suffered pecuniary loss due to the ordinary negligence of others.52 Therefore, it would seem that where the privity doctrine is followed, an accountant will not be held liable to a third party for

50 Prosser, p. 232.


nigilent misrepresentation. While this doctrine represents the state of the law in many court jurisdictions, there have been indications that the assault upon the citadel has not been completely abandoned.53

Liability for Negligence--The Primary Benefit Rule

While many American Courts were applying the New York Rule of privity of contract to all situations involving third parties and negligent public accountants, other courts, both American and English, were taking a second look at the all encompassing Ultramares Decision. This second look at the decision rendered by Cardozo in Ultramares produced some significant liberalizations in the law of negligent misrepresentation.

When reinterpreting the Ultramares Decision, several courts realized that the determination of whether or not a defendant in a specific case should be held liable to third parties not in privity of contract is a matter of policy, and thus, involves the balancing of many legal and social factors. These factors include such things as: the extent to which the representation was intended to influence the third party plaintiff, the foreseeability of the harm which the third party plaintiff suffered, the degree to which the injury suffered by the third party plaintiff was certain and the closeness

of the connection between the defendant's negligence and the injury suffered by the third party plaintiff.\textsuperscript{54} This careful balancing process has resulted in an expanded doctrine of accountants' third party liability which has been termed the primary benefit rule.

While the primary benefit rule was actually first espoused by the New York Court in \textit{Glanzer v. Shepard}\textsuperscript{55} (Glanzer), the rule itself remained relatively dormant for almost fifty years. Then, in several different court decisions, both the American and English Judiciaries began to reassert this doctrine of liability placement as a means of circumventing Justice Cardozo's prerequisite of privity of contract. This process of circumvention was to represent a serious move toward the final abandonment of privity as a requirement in cases involving negligent misrepresentation.

The process of reasserting the primary benefit rule began in the English Case of \textit{Hedley Byrne and Company v. Heller and Partners}\textsuperscript{56} (Hedley Byrne). It was in this case that the English Court recognized the right of an injured third party to recover pecuniary damages which were caused by the negligent misrepresentation of another.

\textsuperscript{54}\textit{Aluma Kraft Manufacturing Company v. Elmer Fox and Company}, 493 S.W. 2d 378 (Mo. App. 1973).


The court argued that this right of recovery should be granted whenever a certain "special relationship" existed between the parties. While the English Court left the exact limits of this special relationship undefined, it would seem that the public accountant would often find such a relationship existing between himself and a third party financial statement user.\(^{57}\)

The American Courts were quick to apply the doctrine of primary benefit to cases involving certified public accountants and third party financial statement users. The Rhode Island Court based its decision in *Rusch Factors v. Levin*\(^{58}\) (*Rusch Factors*) on this early common law doctrine. In so doing, the Rusch Factors Court held that accountants did owe a duty to exercise due care to those third parties who are specifically foreseen, and known, by the public accountant. One year later, the Iowa Court in the case of *Ryan v. Kanne*\(^{59}\) (*Ryan*) expressed this same sentiment by saying:

> This being a case of first impression in Iowa, we are disposed to reject the rule that third parties not in privity of contract or in a fiduciary relationship are always barred from recovery for negligence of the party issuing the instrument upon which the third party relies, to his detriment. It is unnecessary at this time to determine whether the rule of no liability should be relaxed to all foreseeable


\(^{58}\)Rusch Factors.

persons who may rely upon the report, but we do hold it should be relaxed to those who are actually known to the author as prospective users of the report...60

Thus, it would seem, that certain jurisdictions recognize an accountant to be legally responsible for pecuniary losses suffered by third party financial statement users and caused by the negligent misrepresentation of the public accountant. Such liability shall be recognized, even though there is an absence of privity of contract, if the financial statement user is specifically known to the negligent accountant.61

Liability for Negligence—The Foreseen Class Concept

Most of the jurisdictions which have accepted the primary benefit rule as a means of liability placement have also found that the rule has inherent in it a severe limitation as to the number of individuals who will be allowed a means of loss recovery. In an attempt to lessen this limiting factor, many of these liberal courts have introduced the idea of the foreseen class to the area of accountants' third party liability.62 Under such a concept of liability placement, the accountant would not only be held responsible to those individuals

60Ibid.
61Ibid.
62See Rhode Island; and Rusch Factors; and Shatterproof Glass; and Ryan.
who are specifically foreseen, but would also be legally responsible to all members of any class of individuals which is specifically foreseen by the accountant. In this way, the courts have expanded the number of third parties that could recover pecuniary damages suffered due to the negligent misrepresentation of the public accountant. Thus, if the public accountant knows that his financial representation will be used by his client for a specific purpose, and further, if the accountant realizes that a specific class of persons will rely upon his financial representation in fulfilling that purpose, the accountant will be held liable for the damages suffered by any member of that class due to their reliance on his financial misrepresentation. This concept of liability placement provides a substantial expansion of the accountant's third party responsibility, while not yet embracing the indeterminate liability which was once so feared.

Although many courts have disregarded privity of contract, and thus, held professionals liable for the pecuniary losses of third parties, accountants have not been totally stripped of the protection which was once provided them. While some courts do render decisions, and express dicta, contrary to Cardozo's New York Rule, 

no court has ever attempted to overrule the Ultramares Decision. More importantly, there is no indication that any court will attempt to do so in the near future.64

Rusch Factors provides an example of this combination of judicial attitude and action. While the Rusch Factors Court disagreed with the reasoning used to arrive at the New York Rule of privity, the Rusch Factors Court made careful efforts to distinguish, and not overrule, Ultramares.65 In distinguishing the cases, and thus, accepting the primary benefit rule, the Rusch Factors Court said:

This Court need not, however, hold that the Rhode Island Supreme Court would overrule the Ultramares decision if presented with the opportunity, for the case at bar is quantitatively distinguishable from Ultramares.66

It would seem that, depending upon the jurisdiction, the primary benefit rule, the foreseen class concept or the prerequisite of privity of contract will be applied by the courts to determine the liability of negligent accountants to third party financial statement users.

Liability for Negligence—The Foreseeability Concept

The current, and more liberal, trend of legal thought seems to run contrary to the idea of privity of

64Reiling.


66Rusch Factors.
contract and the entire Ultramares Decision. Perhaps this judicial trend is due to a general breakdown in the privity doctrine in other areas of the law; or, perhaps this trend is due to a recognition of accounting as a public service. No matter what the reason, the decline of the prerequisite of privity of contract has precipitated a substantial expansion of the accountant's legal liability to third party financial statement users.67

One of the means by which the courts could implement this expanded liability is through the acceptance of reasonable foreseeability as the guide to liability placement. Under such a doctrine of liability placement, the negligent accountant would be legally responsible to all of those third parties which he should have reasonably expected to rely on his financial representation.68 This concept of liability placement would facilitate the most significant expansion of the accountant's liability to third party statement users.

The concept of reasonable foreseeability, like the primary benefit rule, is not new in origin. In fact, it was Justice Cardozo, expressing the decision of the New York Court in *Palsgraf v. Long Island Railroad*69 (*Palsgraf*), who first mentioned the concept as a viable

67Murphy, p. 387.

68Shatterproof Glass.

means of liability placement. As Cardozo said, "The risk reasonably to be perceived defines the duty to be obeyed, and risk imports relation; it is risk to another or others within the range of apprehension."\textsuperscript{70} It would seem that Cardozo felt that the foreseeability of the risk determined the extent of the relationship between parties, and thus, the concomitant liability.

While no American Court has yet applied the standard of reasonable foreseeability to the public accountant-third party relationship,\textsuperscript{71} other courts, in cases dealing with members of other skilled professions, have sought to embrace such a concept of liability placement.\textsuperscript{72}

Yet, beyond this basic acceptance in other areas of the law of negligence, there are two factors confronting the public accounting profession which indicate the significance of the reasonable foreseeability concept. First, the Securities Act of 1933 relies on the concept of foreseeability in defining the limits of its civil liability. Section 11 of the act imposes liability upon public accountants for negligence in the preparation of a registration statement. This liability extends to

\textsuperscript{70}Ibid.


all parties who purchase securities covered by that registration statement. 73 Thus, under this legislation, the accountant is liable to every member of this foreseeable class. Second, many courts have indicated a favorable attitude toward the doctrine of foreseeability when dealing with accountants' common law liability to third parties. 74 It would therefore seem that the courts of several jurisdictions will be willing to accept a doctrine of reasonable foreseeability as a means of liability placement if confronted with a particular accountant-third party situation.

The statutory and common laws of accountants' third party liability provide the courts with six concepts of liability placement from which to choose. While the selection of a particular doctrine is the result of a careful balancing process, the courts have indicated a judicial attitude toward expansion of the accountant's third party liability. This attitude toward expansion, when combined with the variety of legal doctrines, confronts the public accountant with a most confusing legal situation.

**Summary**

The liability of public accountants to third party financial statement users represents a most

73 *Securities Act of 1933, U.S. Code, Title 15, sec. 77(k) (1970).*

74 See Shatterproof Glass; and Ryan.
perplexing area of the law. The perplexing nature of this area is the result of a combination of two factors. First, the judiciary has introduced an element of uncertainty into this area of the law by establishing legal principles of professional responsibility which differ substantially from the standards which the accounting profession has established to regulate the activities of its members. This gap between professional and legal standards has often stultified the profession in its attempts to keep pace with the economic needs of society. Second, the judiciary has introduced an element of uncertainty into this area of the law by establishing six different doctrines of liability placement which can be applied to the accountant-third party relationship. These doctrines have made it virtually impossible for the public accountant to determine the scope of his third party liability. In general, it would seem that the public accounting and legal professions are today faced with the problem of developing a workable doctrine of accountants third party liability. Chapters four and five attempt to explore, and eventually provide a solution to, this problem.
CHAPTER IV

THE CASE FOR EXTENDED ACCOUNTANTS' LIABILITY

Today, a careful balancing process is inherent in the determination of the public accountant's civil liability to third party financial statement users (see chapter three). This careful balancing not only involves a search for legal doctrines which will introduce equity and certainty into the law, but also, involves a search for a full understanding of the potential nonlegal impact of each of those doctrines of law.

This chapter undertakes an analysis of the recent liberal trends inherent in this judicial balancing process. To facilitate the accomplishment of this task, a two step approach is used. First, a discussion of the most often used justifications for extended accountants' liability is presented. This discussion is structured to reveal both the legal and extra-legal significance of each argument. Second, a discussion of the major effects of such a liability extension is presented. This discussion is structured to reveal the impact which such a liability extension would have on society and the accounting profession. Such a two step approach provides a sound basis upon which a unified concept
of the public accountants' third party legal liability may be built.

Justifications for Extended Liability

In 1931, Justice Cardozo could find no significant reason to impose upon negligent public accountants liability for the injuries suffered by third party financial statement users. Since Cardozo first espoused this lack of justification, however, the courts have generally followed a path which has continually led to greater third party liability for the public accounting profession. These more liberal courts have usually relied upon three justifications for their movement toward the imposition of a greater degree of liability. First, the courts have agreed that public accounting is a "skilled profession". Therefore, some authorities argue that accountants should assume a degree of legal responsibility concomitant to this professional status. Second, the courts have reasoned that third parties are forced to rely upon the public accountants' examination as their major verification of financial information. Therefore, many authorities have argued that the public accountant owes a duty of due care to the third party statement user. Finally, the courts have reasoned that the pursuit of legal equity would require the judiciary to extend a helping hand to the innocent, but injured, third party. Therefore, legal authorities have argued that the public accountant, and not the third party, should bear
the burden of the accountant's misrepresentation. A further analysis of each of these justifications follows.

Accounting as a Skilled Profession

Members of the accounting profession have always sought to convey to the public an image equivalent to that of the skilled professions of medicine and law.¹ While for many years, the profession was burdened with the public image of the green visored bookkeeper, today the extensive reliance placed on the financial statements and opinion prepared by the certified public accountant has elevated accounting to that desired position of professional status.² The independent auditor is now viewed by society as an expert at his calling, an individual who possesses skills above and beyond those of the ordinary man.³

This professional status to which the public accountant has been elevated has brought with it three significant advantages. First, this rise to professional status has precipitated a significant increase in the fees received by public accountants. Second, this rise


to professional status has produced a concomitant rise in the prestige afforded public accountants by various segments of our society. Finally, this rise to professional status has, for the most part, produced significant legal advantages for public accountants. These three specific advantages have had a tremendous impact upon both the public accounting profession and its members.

For the members of most professions, the advantages which are gained due to an increase in status are accompanied by an increase in certain of the profession's legal responsibilities. Professional men, in general, and all others who undertake a type of work which calls for the use of special skills, are required by the courts not only to exercise reasonable care in the performance of their service function, but also, are required to possess a minimum level of special skill and ability. If such a professional person professes to speak with knowledge on a particular subject about which he should know, or a subject about which he has a duty to know, that skilled professional should be held responsible for any damages suffered due to his failure to apply

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6 Ibid., p. 161.
reasonable care in the making of his representation of that knowledge to others. If this professional duty of due care were universally applied by the courts, it would seem that such a duty would apply to the accountant-third party relationship. Yet, the courts have never attempted such a universal application.

Since the promulgation of the New York Rule, two forces have had a significant impact on the area of the professional's legal liability to third parties. First, the legal liability of negligent professionals for the pecuniary losses of third parties has, in general, increased steadily. This increasing trend is due to the courts' acceptance of more liberal concepts of liability placement in most areas of the law of negligence. Second, the legal liability of public accountants to third party financial statement users has failed to keep pace with the other areas of professional negligence liability. This trend is due to the unwillingness of many courts to abandon the concept of privity of contract when dealing with the accountant-third party relationship. Thus, while the public accounting profession is eager to reap the benefits associated with professional status,


public accountants have not been forced to assume an equivalent amount of legal responsibility.9

If the public accounting profession is to maintain its public image, individual accountants must be willing to accept the responsibilities inherent in that image. The certified public accountant should become a professional reporter.10 Therefore, he should accept, at least to some degree, liability to third parties for failure to exercise reasonable care in the performance of his public attest function.

The Third Party's Forced Reliance

As far back as the thirties, there existed an extremely close relationship between the public accountant and the third party financial statement user. Although this accountant-third party relationship was an extremely close one, it was generally agreed upon that the services of public accountants were primarily for the benefit of client corporations. Justice Cardozo had expressed the judiciary's agreement with this sentiment as early as 1931 (see chapter two). Today, the relationship existent between the third party and the public

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accountant has grown even closer.\textsuperscript{11} No longer does the certified public accountant primarily serve his employer. Instead, the primary goal of the public accountant's function is to provide an opinion as to the fairness with which a particular financial representation could be used by outsiders. In fact, the accountant-third party relationship has become so primary that if not for the demands of third party statement users, most publicly held corporations would not find the services of independent public accountants at all necessary.\textsuperscript{12}

This increase in the primacy of the accountant-third party relationship is directly related to an increase in the reliance placed on certified financial statements by third parties. There are four major reasons for this increase in the third party's reliance on independently verified financial statements. First, third parties generally lack the expertise necessary for proper analysis of a particular entity's financial position. Second, third parties generally lack access to the information necessary for a complete financial analysis of any corporate entity. Third, both the third party and the corporate entity would soon find the cost of individual financial examinations to be highly


\textsuperscript{12}Norman O. Olson, "The Auditor in Legal Difficulty--What's the Answer?," \textit{Journal of Accountancy} 129 (April, 1970):43.
prohibitive. Fourth, individual financial examinations would eventually place an unwarranted burden upon the record keeping operations of any particular business entity. These four factors, when combined with the fact that the third party is seldom capable of choosing the public accountant upon whom he will rely, force the third party statement user to place blind faith in the opinion of any member of the public accounting profession.

This increased third party reliance has forced the accounting profession to operate in a more public sphere. This public sphere is governed by the laws of free competition, and as such, attempts to provide each entity with complete information in order to guarantee efficient and accurate allocations of scarce resources. Any misstated financial information will result in resource misallocation and waste. Since the public is not expert at this process of information procurement and dissemination—and the certified public accountant is—the public is at the mercy of the professional accountant. Therefore, the old rules of law based upon the more or


14 Ibid.

less private relationship between the auditor and his employer must be abandoned.\textsuperscript{16} The trend toward the public watchdog function of accounting must continue.\textsuperscript{17} It would seem to be in the public interest for the courts to take a serious look at a possible extension of the accountant's public responsibilities.\textsuperscript{18}

The Lack of Legal Equity

In 1931, the New York Court used what might be called some "novel" theories of tort liability placement to protect the public accountant from a potentially ruinous third party legal liability. The result of the imposition of these novel theories of liability placement was that in choosing between the injured third party statement user and the negligent accountant, the court concluded that the innocent third party should be forced to bear the burden of the pecuniary damages suffered due to the public accountant's financial misrepresentation (for justification see chapter two).\textsuperscript{19}

Prior to the establishment of this rule of tort liability placement, the courts had generally recognized

\textsuperscript{16}Tellie, p. 357.


\textsuperscript{18}Olson, p. 39.

\textsuperscript{19}Texas Tunneling Company v. City of Chattanooga, 204 F. Supp 821 (E.D. Tenn. 1964), rev'd 329 F. 2d 402 (6th Cir. 1964).
that legal equity made it necessary to place the burden of any damages suffered due to the negligent manufacture of an inherently dangerous object upon the maker of that particular object.  

According to MacPherson v. Buick Motor Company, 217 N.Y. 382 (1916), while this concept of negligence liability has been almost totally accepted by the courts when dealing with cases which involve negligence resulting in personal injury, the judiciary has not found this concept to be universally desirable when dealing with cases which involve public accountants, third party statement users and pecuniary damages.

This dichotomy in legal reasoning leaves a basic question unanswered. Is a negligently audited set of financial statements any less dangerous to a potential user than a negligently manufactured automobile? The first of these acts causes the potential loss of an individual's financial resources, the second potentially causes the loss of the individual's ability to generate those resources. In a complex industrial society, the public accountant's opinion as to the fairness of a particular financial representation can inflict upon a statement user damage more potent than any injury which can be inflicted by a particular manufacturer's tools.  

While the lack of any distinction between the

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21 Miller, p. 605.
22 United States v. Benjamin, 328 F. 2d 854 (2nd Cir. 1964).
consequences of these acts seems quite apparent, the courts have, for some reason, found a discernable distinction existent. This difference, and its repeated judicial application, have produced a significant impairment of the legal equity inherent to the system.

An extension of the third party civil liability of certified public accountants would enhance the equitable nature of the judicial system in three ways. First, by forcing the members of the public accounting profession to assume the financial burden created by their mistakes—a financial burden which would almost certainly be passed on to the general consuming public in the form of higher audit prices—the legal system would provide for an equitable distribution of that financial burden over the whole of society instead of causing the manifestation of the injury to be limited to one particular financial statement user. An extension of the third party civil liability of certified public accountants would enhance the equitable nature of the judicial system in three ways. First, by forcing the members of the public accounting profession to assume the financial burden created by their mistakes—a financial burden which would almost certainly be passed on to the general consuming public in the form of higher audit prices—the legal system would provide for an equitable distribution of that financial burden over the whole of society instead of causing the manifestation of the injury to be limited to one particular financial statement user.23 Second, by forcing the members of the public accounting profession to assume the financial burden created by their mistakes, the legal system would shift the impact of the financial loss from the party who only relies upon the financial misrepresentation to the party who actually created that misrepresentation.24 Third, by forcing the members of the public accounting profession to assume the financial burden created by their


24Earle, p. 67.
mistakes, the legal system would create a great deal of judicial balance between tort liability for personal, property and pecuniary damage.\textsuperscript{25} Thus, it would seem that an increase in the public accountant's civil liability to third party financial statement users would enhance the equity inherent in the existent system of law.

Legal authorities, and many courts, have reasoned that a certified public accountant should, at least to some extent, be responsible to third party financial statement users for misrepresentations which cause pecuniary loss. The fact that public accountants are members of a skilled profession, the fact that the general public is provided with no alternative other than to rely on the representations of members of that profession, and the fact that the current legal system fails to achieve a state of equity, all contribute to the case for extending the accountant's civil liability. Yet, any law of accountants' liability must, by necessity, result from the application of a careful balancing process. The remainder of this chapter discusses the factors inherent in the other half of that process.

\textbf{Effects of Extended Liability}

The second half of that judicial balancing process consists of weighing the effects that an extension of the

\textsuperscript{25}Miller, p. 605.
accountant's civil liability would have upon the public accounting profession, and potentially, the rest of economic society. In general, it has been argued that there would be three major effects caused by an extension of the legal responsibilities of members of the public accounting profession. First, an increase in the legal responsibilities of public accountants might foster the development of better accounting principles, procedures and practices. Second, an increase in the legal responsibilities of public accountants might seriously affect the cost and availability of malpractice insurance. Finally, an increase in the legal responsibilities of public accountants might create a serious economic threat to the entire accounting profession. The remainder of this chapter seeks to analyze each of these potential effects.

The Effect on Accounting Services

Contrary to the arguments which have been advanced by several writers, a liberalization of the legal concepts which presently govern the accountant-third party relationship would not necessarily leave the certified public accountant without adequate protection from third party litigation. Even if all courts were to universally accept such an extension of the public accountant's legal responsibilities, the individual accountant could be held responsible to third party statement users only for pure fraud, failure to act in good faith or a failure
to exercise due care in the performance of the attest function. In other words, the accountant must, at least to some extent, be guilty of some degree of fault if third party liability is to be imposed by the judiciary.

It would seem that the proficient public accountant (i.e., the public accountant who applies the standards which have been established by the profession in a careful and accurate manner) would be able to rely upon the principles and procedures of the accounting profession as a prime mechanism for avoiding an expanded third party legal liability. Yet, it would further seem, that the threat of this potential legal liability would constitute a positive force for professional action. This threat of third party litigation would provide an incentive for the profession, and its members, to take action to insure the avoidance of such liability.26

These positive professional actions would take several forms. First, the potential for increased liability would force the public accountant, and the profession in general, to take steps to improve the results of the audit process. An increase in the scope of many audits, an increase in the independent auditor's personal adherence to generally accepted auditing standards and an increase in the general level of those standards

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would probably be an inherent part of the process of upgrading the auditor's attest function. Second, a potentially greater legal responsibility to third parties would force the accountant to become more aware of the existence of the primary user of his financial representations—the third party. No longer would the public accountant be able to satisfy his legal responsibilities by providing information adequate to meet his client's needs. Instead, the certified public accountant will have to supplant this old client orientation with a new form of user orientation.

Third, an increase in the legal responsibilities of public accountants would tend to push substandard accountants away from certain engagements. Engagements which involve potentially great amounts of liability would be handled by those accountants most able to deal with the specific problems which might arise. Finally, the acceptance of a legal doctrine which would hold the accountant liable to a greater extent would definitely lead to an increase in the use of cautionary devices. All members of the profession would approach each engagement with a great deal more care and caution.

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28 Miller, p. 609.

29 Rusch Factors.
Thus, an upgrading of professional services seems to represent at least one major advantage of an extension of the public accountant's third party responsibility.

The Effect on Malpractice Insurance

Although it is highly probable that an extension of the public accountant's legal liability will produce certain beneficial effects, most recent writers have concentrated on the fact that such an extension of legal responsibility will create certain major disadvantages for both the accounting profession and economic society. One of these major disadvantages lies in the effect that increased legal liability would have upon the institution of accountants' malpractice insurance.

As the potential for legal liability for injury suffered by third party financial statement users has become an integral part of the accountant's audit function, more and more members of the profession have turned to malpractice insurance as a means of obtaining protection from judgments arising out of third party litigation. Yet, most accountants, and many insurance underwriters, have expressed the opinion that an increase in the third party responsibility of the public accounting profession would both create upward pressure on the price of such insurance protection, and force underwriters to limit the number of firms to which such protection could be
offered. For these reasons, accountants fear that adequate insurance will not be available to protect them from the economic effects which would result from an increase in third party liability.

While the cost of adequate malpractice insurance coverage would almost certainly rise as the courts extend the legal responsibilities of the public accounting profession, the prudent public accountant would be capable of taking appropriate steps to prevent this sudden increase in insurance cost from seriously damaging his practice. One available mechanism for dealing with the problem of increased insurance premiums is that of including a deductible provision in the policy. As early as 1970, insurance companies were offering this type of policy to members of the accounting profession. One such policy was then based on a sliding scale which presented accountants with the opportunity to gain anywhere from a seven percent reduction in the premium for assuming a $250 deductible to a thirty percent reduction for assuming a $10,000 deductible. Thus, by acting as a self-insurer for a portion of any legal liability,


the accountant can significantly reduce the burden of the increased insurance costs which would result from extended third party civil liability.

Beyond affecting the cost of malpractice insurance, an extension of the public accountant's legal responsibilities would also significantly affect the availability of that insurance. In fact, there is a great deal of justifiable doubt as to whether the private sector could continue any such policies in the face of such a liability extension. With no experience under the legal conditions which would be prevalent, the private insurance underwriters would find it impossible to immediately determine a sound rate structure. Therefore, most companies would, at least temporarily, withdraw their policies from the market. Yet, again, if the profession reacts to this problem in a prudent and rational manner, the situation will not have a serious impact upon the practice of public accounting. As a primary action, the profession could develop its own malpractice coverage to reduce the negative economic effect of increased liability.

The American Institute of Certified Public Accountants and some state societies have already taken this type of action. Such action is designed to guarantee members

some type of malpractice insurance coverage. If this type of professional action is capable of providing individual accountants with a basic amount of temporary protection, private sector insurance companies will soon fill any gap which might remain. As the new legal doctrines become more clear, claim patterns will tend to stabilize and private insurers will again be in a position to offer the accountant adequate malpractice insurance. Thus, in the long run, adequate insurance coverage will always be available to members of the public accounting profession.

Although problems in the areas of cost and availability of malpractice insurance coverage represent significant drawbacks to any extension of the public accountant's legal liability, proper action on the part of the profession could mitigate the effects of such problems. Thus, it would seem that the balancing process still weighs in favor of an increase in the third party civil liability of the public accounting profession.


34Mentzer.

35Miller, p. 606.
The Economic Effect on Public Accounting

While many members of the public accounting profession do fear the effect that increased legal responsibility will have upon the institution of malpractice insurance, the profession's greatest fear takes the form of the indeterminate economic liability which Cardozo had sought to avoid more than forty years ago. Today, accountants have reiterated Cardozo's economic fear in a variety of forms. First, the accounting profession has continually argued that a liberalization of the concepts presently governing the accountant-third party relationship will create a tremendous economic burden in the form of court imposed settlements.36 Second, certain members of the accounting profession have argued that increased legal responsibilities will eventually force smaller public accounting firms to redirect their efforts away from areas of potentially large liability settlements. This redirection of efforts, it is argued, will eventually result in a shortage of certain types of accounting services.37 Third, most public accounting firms have argued that an increase in legal responsibility will eventually produce an increase in the cost, and thus the price, of audit services.38 Although each of these


37 Dawson, p. 699

38 Ibid., p. 701.
lines of argumentation has some basic degree of merit, a further examination will reveal that the relative significance of each is somewhat questionable.

The primary fear of most public accountants, and the factor which motivated Cardozo, is that the imposition of extended legal responsibility will eventually result in the financial ruin of the entire profession of public accounting. While the factors inherent in the realization of this fear may have been significant enough to warrant a liability limiting decision in 1931, the economic circumstances which surround the activities of public accountants today give rise to questions as to the present validity of that decision. In the early thirties, it was estimated that the gross income of all individuals and firms involved in the practice of public accounting was $60 million.39 At that same time, the average market value of the stock issued by a New York Stock Exchange Company (a measure of the maximum potential third party liability of public accountants) was below $59 million.40 Yet, by the early seventies, these relationships had changed significantly. While the average market value of a New York Stock Exchange Corporation's stock had risen to a level slightly less


than ten times that existent in 1930,\textsuperscript{41} the gross income of persons and firms involved in public accounting rose to a level at least fifty times as great as that in the earlier period. In 1974, one public accounting firm, Arthur Andersen and Company, reported gross income of more than $200 million.\textsuperscript{42} It would therefore seem that the potential of the public accounting profession to withstand the economic effects of extended liability has increased substantially over the last forty years. Yet, even beyond this basic change in the economic situation, there has been a second occurrence which today protects members of the accounting profession from the financial ruin which might result from third party litigation. Today, unlike the period of the thirties, most accounting firms carry some form of professional malpractice insurance. This insurance coverage provides accountants with at least partial compensation for any losses which are incurred due to court imposed legal settlements. Thus, the economic growth of the profession and the development of professional malpractice insurance coverage serve to reduce the chances of court imposed financial disaster for the public accountant.

As the public accountant's legal liability to third party financial statement users increases, some

\textsuperscript{41}Ibid.

of the smaller members of the industry may find it desirable to reorient their service functions away from areas of potentially high third party involvement. Certain members of the profession have recently argued that this redirection of efforts on the part of small firms may create a shortage of available audit services for publicly held corporations.\(^3\) Yet, a further analysis, again, reveals the lack of significance of this line of argumentation. At present the "big eight" accounting firms handle approximately eighty percent of all audits conducted on publicly held clients.\(^4\) Surely, an increase in the efforts of these major firms, combined with the general efforts of the large regional firms, would guarantee the existence of adequate services to meet the needs of both new and old publicly held corporations.

Since an extension of the public accountant's third party legal responsibilities would create a need to increase the scope of some audit examinations, cause the profession to incorporate an increased number of cautionary techniques into the audit function and place increased upward pressure on the cost of professional

\(^3\)Since publicly held corporations represent the area of greatest relationship between the public accountant and the third party financial statement user, members of the profession fear that many of the smaller accounting firms will avoid such a great amount of contact with potential third party litigants by avoiding engagements which involve these publicly held corporations.

malpractice insurance coverage, members of the profession would soon feel the need to increase the price of an audit examination. Accountants have recently argued that such an increase in audit costs would first, force smaller clients to abandon the use of independent financial verifications, and second, cause many small accounting firms to lose their ability to compete for the available client market. Yet, again, there are several factors which significantly reduce the weight of these arguments. First, a combination of Securities and Exchange Commission Requirements and the need for certified financial statements as a prerequisite to the consummation of many types of business transactions would force most business entities to maintain their present policy toward the engagement of public accountants for audit purposes. Second, since increased liability will potentially affect all firms equally, no particular accounting firm should be able to gain a competitive edge in terms of prices without incurring a reduction in profits, or an increase in financial risks. Thus, it would seem that while an increase in audit costs would be most certainly passed on to clients, these increased costs would not have a significant effect on the public accounting profession or its members.

While larger court imposed settlements, a redirection of the efforts of some smaller accounting firms and an increase in audit service costs would result from increased
legal liability, the profession can, and most probably would, take action to negate the disadvantageous nature of these economic effects. Since these economic effects, and the effects on the institution of malpractice insurance, can be significantly reduced, and since an increase in legal liability would produce better accounting practices, it would seem that the balancing process weighs, at least in terms of professional and societal effects, in favor of an increase in the public accountant's legal responsibilities to third party financial statement users.

**Summary**

After performing the balancing process which is applied to the area of accountants' liability, two conclusions may be drawn. First, there are significant legal reasons for extending the accountant's third party responsibilities beyond their present limits. Second, while there were, in 1930, significant extra-legal reasons for not obeying the dictates of legal precedent, these same extra-legal reasons do not exist, or can be significantly militated, today. Therefore, public accountants should be held responsible to third party financial statement users. Chapter five attempts to present a unified legal doctrine which could be used by the courts to apply the results of this legal balancing process.
CHAPTER V

A PROPOSED CONCEPT OF ACCOUNTANTS' LIABILITY

With the basic process of balancing justifications and effects completed, it becomes possible to progress beyond the underlying analysis of situations and reasoning, to the development of a basic set of legal principles which can be applied by the courts as a means of regulating the relationship which exists between the public accountant and the third party financial statement user. At this point, two generalizations concerning such a legal concept may be advanced. First, any such set of judicial doctrines must be designed in a manner which will provide the third party statement user with at least a minimum degree of legal recourse to members of the public accounting profession. Unless provided with such a means of recovery, the third party will continue to bear the financial burden of the certified public accountant's mistakes. Second, any such set of judicial doctrines must be based upon a legal concept which can be consistently and equitably applied by the courts, while also being easily understood by members of both the public accounting profession and
the general investing public. Without this degree of consistency and predictability the courts, third parties and the public accounting profession would soon find a legal situation similar to the confusing state of the law which confronts them today.

This chapter attempts to formulate a workable legal concept through the use of a two step approach. The first section of this chapter presents a proposed concept which could be used to determine the professional responsibilities of certified public accountants. This section centers on selecting a method of responsibility determination which could eventually bring the legal and professional interpretations of the accountant's audit responsibilities into greater harmony. The second section of this chapter attempts to delineate a doctrine of liability placement which could be used in all instances of accountant-third party litigation. This section concentrates on defining the relationship and degree of fault which should be considered necessary to justify third party recovery. Such a two step approach provides the basis of a solution to the perplexing problems which currently surround the accountant-third party legal relationship.

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1Henry B. Reiling and Russel A. Taussig, "Recent Liability Cases--Implications for Accountants," *Journal of Accountancy* 130 (September, 1970):47.
The Determination of Professional Responsibility

It was initially decided by the judiciary that there was no justification for the imposition of court espoused, uneducated, standards of conduct upon members of the recognized "skilled professions". In an effort to implement such a philosophy of responsibility determination, the courts, in general, sought to allow members of those professions, and their authorized regulatory agencies, to promulgate the rules of professional conduct which would be adhered to by persons practicing those particular skills. This degree of conformity between the judicial and professional interpretations of the standards of professional conduct contributed greatly to the continued growth and prosperity of the public accounting profession.

Unfortunately for the public accounting profession, several recent courts have seen fit to circumvent this generally accepted rule of legal conduct, and in so doing, have imposed upon certain public accountants legal responsibilities above and beyond those which had been previously established by the profession. While these clashes between the standards established by the courts and those established by public accounting have, so far, been limited to the areas of disclosure of subsequent event, detection of the existence of fraudulent activity, preparation of unaudited financial statements and disclosure of current value financial information, most
authorities have expressed the belief that any further infringement by the courts upon the standards of public accounting will further contribute to an attitude of over conservatism which is currently embraced by many members of the profession. This attitude of over conservatism can seriously stultify the accounting profession in its attempts to keep pace with the information needs of economic society (see chapter three).

A specific concept of professional responsibility determination must be developed in order to close the gap which presently plagues the judiciary, third parties and public accountants. Such a legal concept must necessarily include three basic parts. First, such a concept of professional responsibility determination must provide for a uniform method of developing the legal and professional standards by which a public accountant will be judged. Second, such a legal concept must include a method by which the specific activities of an individual accountant may be compared with the standards established for the profession as a whole. Finally, such a concept of responsibility determination must include a clear statement of the limited conditions under which it would be acceptable for a public accountant's actions to fall short of the generally accepted legal and professional standards. A discussion of some proposed ideas for each of these basic concepts of accountants' third party liability follows.
Although the members of the public accounting profession were initially free to establish the standards which would be used to judge the reasonableness of an individual accountant's audit activities, the courts have recently begun to create inroads into this once basic right of all skilled professionals. Yet, if public accounting is to continue to adequately serve the investing public, the courts must discontinue this policy of judicial infringement. The conduct of professional accountants must be regulated by, and judged in accordance with, standards which have been researched and developed by knowledgeable groups of individuals. While it is proper for the courts to espouse broad guidelines and possible goals for the accounting profession, the process of promulgating specific accounting standards must be left to the persons most capable of developing those specific standards—public accountants. Unless the courts again grant to the accounting profession the right which has been universally extended to all other skilled professionals—the right to develop their own standards of professional conduct and responsibility—the accounting profession, and therefore, all of economic society, will continue to be burdened with professional standards.

which have been promulgated by members of the judiciary who are uneducated in the intricacies of accounting practice.

Yet, the fact that public accountants should be allowed to establish the standards of professional conduct by which they will ultimately be judged does not mean that each individual accountant should be totally free to establish standards of professional conduct for each particular audit examination. If anything, the public accountant should be barred from using professional standards as a means of avoiding liability. The certified public accountant, above all, should be precluded from using general compliance with a set of isolated professional standards as a means of universally avoiding liability.3 Instead, the activities of members of the public accounting profession must be judged in relation to the entire set of standards of professional conduct and the way those standards relate to the particular audit situation. To accomplish this task, the courts must continue to use the concept of the "reasonably prudent man" as a basis for comparing the activities of the individual accountant to those which would be required by the profession's standards of conduct. This reasonably prudent public accountant

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possesses the professional skills of the normal practicing accountant. Yet, unlike the normal practicing accountant, the reasonably prudent accountant never is guilty of performing an unreasonable act. This accountant, in theory, reacts to all fact situations in a reasonable and prudent manner, and therefore, performs his audit function in a manner which has been determined by his profession, and economic society, to be acceptable. If the courts continue to apply the concept of the reasonable man to cases involving accountants and third party financial statement users, economic society can be sure that accounting standards will serve as guides to acceptable professional conduct, and not arbitrary rules for the avoidance of civil liability.

If the courts were willing to allow the public accounting profession to establish its own standards of conduct, and if the courts were to continue to use the concept of the reasonable man in determining whether an individual public accountant had performed his audit in accordance with those professional standards, the problem of closing the gap between the professional and legal interpretations of the accountant's responsibilities would be reduced significantly, but not yet completely solved. There would still exist certain situations in which an individual public accountant would find it

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impossible to comply with the profession's established
standards of conduct. Traditionally, such a situation
has caused the public accountant to add a disclaimer,
or qualification, to his audit opinion. While this
method of informing the statement using public of the
accountant's inability to conduct an adequate audit did
initially fulfill its purpose, some accountants have,
and most probably will, use one of these two mechanisms
as a means of avoiding their inherent legal responsi-
bilities. The courts must take two steps to preclude
the accountant from relying upon disclaimers and qualifica-
tions as a mode of liability avoidance. First, the courts
should refuse to recognize the validity of any overly
broad disclaimers or qualifications of opinions. By
taking this first step, the courts would bar members
of the accounting profession from using general disclaimers
or qualifications as a means of precluding third party
litigation. Second, the courts should require the public
accountant to state the specific reasons for any valid
disclaimer or qualification which is issued. Such a
step would provide for third party financial statement
users information regarding the circumstances which

5See Ryan v. Kanne, 170 N.W. 2d 395 (Iowa 1969);
and Rhode Island Hospital Trust National Bank v. Swartz,
Bresenoff, Yavner and Jacobs, 455 F. 2d 847 (4th Cir.
1972).

6"Torts—Professional Negligence—Accountants may
be Liable to Third Parties for Negligence," Texas Law
resulted in the accountant's inability to conduct an adequate audit examination. These two mechanisms would allow the public accountant a means of avoiding liability in certain uncontrollable situations, provide the third party with information concerning the specifics of these situations and prevent the public accountant from using the disclaimer or qualification as a universal means of liability avoidance.

It would therefore seem that three steps are necessary if the gap between the professional and legal interpretations of the public accountant's responsibilities is to be narrowed. First, the courts should again allow knowledgeable members of the accounting profession to establish the standards of conduct by which individual public accountants must abide. Second, the courts must continue to use the concept of the reasonable man in comparing the activities undertaken by an individual accountant to those activities required by professional standards and the individual fact situation. Finally, the courts must reject overly broad disclaimers and qualifications of the professional accountant's opinion. This three step approach to responsibility determination should have a significant, and advantageous, effect on the legal situation which currently plagues the accounting profession, the courts and third party financial statement users.
The Placement of Civil Liability

At several points in time, different members of the judiciary have advanced at least six separate doctrines of civil liability placement which are applicable to cases involving certified public accountants and third party financial statement users. Today, a particular court could possibly choose any of these concepts in determining the civil liability of a specific accountant to a specific third party statement user. This multiplicity of available legal doctrines has created substantial problems for both the courts and the accounting profession. In outlining any solution to this problem of liability placement, a two step approach must be taken. First, a doctrine of liability placement must be selected to deal with situations in which the certified public accountant is guilty of pure fraud. Second, a concept of liability placement must be selected to deal with situations in which the certified public accountant is guilty of something less the pure fraud (i.e., some form of negligence or gross negligence). If the courts were to take such an approach to the problem of liability placement, much of the uncertainty which is currently inherent in the law of accountants' third party liability would be eliminated.

Liability Placement in Cases of Pure Fraud

The earliest doctrine of liability placement which was applied by the courts to the accountant-third
party relationship was that of legal liability for pure fraud or deceit. Under such a concept of liability placement, the public accountant would be held responsible for the pecuniary losses suffered by third party financial statement users if that particular third party could prove the existence of three prerequisite conditions. To prove that the accountant is guilty of pure fraud, the third party must first prove the existence of scienter; that is, the third party must be able to prove that the public accountant knew that his financial representation was false or misleading. Beyond this basic proof of scienter, the third party must also prove the existence of intent on the part of the public accountant. In proving the existence of this element of intent, the third party need not prove that the public accountant specifically sought to deceive him, but instead, need only prove that the accountant realized that the class of persons to which the third party belonged would be influenced by his financial misrepresentation. Finally, the third party has an obligation to prove that his reliance was justified. To accomplish this task the third party must prove that the fact upon which he relied was significantly misleading, and yet, not so misleading as to be obviously false to an individual possessed of reasonable skill and knowledge (see chapters two and three). This basic concept of
liability for pure fraud was to be the first, and possibly only, concept of liability placement which was universally accepted by the courts.

While this threefold concept of legal liability for pure fraud should be retained by the courts, the courts must, for several reasons, progress beyond this initial doctrine if an equitable solution to the problem of accountants' civil liability placement is to be developed. First, the concept of third party liability for pure fraud is much too limited to represent a complete answer to the existing problems. The courts' requirements of the existence of scienter, intent and justifiable reliance preclude the imposition of civil liability in the vast majority of cases where the public accountant neither knows that his representation is misleading, nor intends the falsity of that representation to cause a third party to suffer financial injury. Second, some of the recent liberalizations which the courts have introduced into the law of fraud have added great amounts of confusion to the area of accountants' civil liability. The use of such concepts as gross negligence (i.e., fraud without proof of scienter and/or intent) as an inference of fraud have often forced judges and juries to attempt to draw an almost nonexistent distinction between gross and ordinary negligence. Thus, while

7Ibid.

8Ibid., pp. 417-418.
liability to third party financial statement users must continue to be imposed by the courts in cases involving pure fraud, the courts should abandon their attempts at expanding the fraud doctrines, and instead, progress to a more liberal concept of liability placement in situations where the failings of the public accountant are not sufficient to warrant a charge of pure fraud.

Liability Placement in Cases of Negligence

As the courts attempted to define the principles which would eventually limit the public accountant's liability for misrepresentations which were the result of faulty, yet not fraudulent, performances of the audit function, five doctrines of civil liability placement were developed (see chapter three). The earliest of these doctrines of liability placement consisted of the use of privity of contract as a bar to virtually all third party litigation. This privity rule was so strict as to almost totally eliminate third party recovery in situations where the accountant was guilty of an act less serious than fraud.

The first liberalization of the law of accountants' liability came when the courts allowed third parties to assert gross negligence as an inference of fraud. Yet, as has already been stated, the gross negligence rule was both too restrictive and too confusing for equitable judicial application. As the courts became
more liberal in their approach to accountants' civil liability, the primary benefit rule was used as a basic doctrine of liability placement. Although this rule did provide third parties with a means of recovering damages from a negligent accountant, the requirement that the third party be specifically known to the accountant prior to the performance of the audit function placed a much too restrictive interpretation on this law of negligence.\(^9\)

The most liberal step which has actually been taken by the common law courts in dealing with the accountant-third party relationship consists of the use of the foreseen class rule to determine the accountant's liability for ordinary negligence. Again, this doctrine of liability placement does not provide an adequate answer to the problems presently confronting third party statement users.

The foreseen class rule would tend to protect powerful and sophisticated statement users who are capable of making sure that the auditor is aware that they are relying upon the financial representation.\(^10\) Thus, such a concept of liability placement would necessarily exclude the vast group of third party financial statement users whose reliance cannot be specifically foreseen by the accountant.\(^11\)

\(^9\)Ibid., p. 418.


While it is quite clear that the public accountant must, at least to some extent, be held responsible for injuries suffered by third parties due to negligently prepared financial statements, none of the doctrines of liability placement which has been previously espoused by the courts offers an adequate mechanism for determining the scope of that liability. It would therefore seem that the most equitable approach to the situation must come from a doctrine beyond those which have already been developed by the courts. The concept of legal liability for negligent misrepresentation to all foreseeable persons provides such a doctrine. Under such a concept of liability placement, the negligent public accountant would be held legally responsible for the injuries suffered by all persons, or groups of persons, who he should have reasonably foreseen as users of the financial statements which he prepared. In the course of a normal audit, the accountant would be potentially liable to all present and future investors and creditors that would be normally expected to use the financial statements. Such a concept would substantially broaden the present scope of the public accountant's third party liability.

Yet, to say that the courts should hold the accountant liable for negligence to all foreseeable third parties is not to say that the accountant is legally responsible for the losses suffered by any of those third
parties. Several checks must be incorporated into the doctrine of foreseeability before it is applied by the courts. First, the concept of liability to all foreseeable third parties should not be used to grant recovery unless the accountant is truly negligent. The public accountant should be responsible for the losses of third party financial statement users only if it can be proven that the public accountant has failed to perform his audit function in accordance with generally accepted auditing standards. The processes undertaken by the specific public accountant must be compared to those which would have been undertaken by the reasonably prudent accountant in making the determination of the accountant's negligence. Second, the concept of liability to all foreseeable third parties should not be used to grant recovery unless the public accountant has expressed an unqualified opinion as to the fairness of the financial presentation. If the certified public accountant has supplemented his opinion with a legally valid disclaimer or qualification, the third party financial statement user should be barred from recovery. Finally, and most importantly, the concept of liability to all foreseeable third parties should not be interpreted by the courts to represent absolute liability for negligence. The third party financial statement user must be required to prove that his reliance on the public accountant's misrepresentation was the proximate cause of the injury
which he suffered. If the concept of liability to all foreseeable third parties is applied in a manner which incorporates these basic restrictions, the third party statement user and the public accountant will find the existence of a legal concept which guarantees adequate protection from misrepresentation for the third party and legal stability for the accounting profession.

In determining the scope of the public accountant's third party liability the courts have had several doctrines from which to choose. Yet, if an equitable and nonconfusing legal situation is to be arrived at, the courts must take two firm legal steps. First, the courts must hold the accountant liable to third parties when that accountant is guilty of pure fraud. The courts must consider intent, scienter and reliance to be indispensable elements of this fraud doctrine. Second, the courts must hold the accountant liable to all foreseeable third parties when that accountant is guilty of negligence in the performance of the audit function. A violation of accounting standards, an unqualified audit opinion and reliance on the part of the third party must be considered prerequisite elements of this form of recovery. If these concepts are employed universally by the courts, an equitable and determinate concept of liability placement shall be produced.

Summary

The legal problems currently facing the public accounting profession are twofold in nature, and therefore, must be approached from many different points of orientation. This chapter has proposed several concepts which could serve as the basis of a workable doctrine of accountants' liability. First, the courts must allow the accounting profession to establish the standards of conduct by which its members will be judged. Second, the courts should employ the concept of the reasonable man in comparing the function performed by an individual accountant to that required by professional standards. Third, the courts should reject overly general disclaimers and qualifications of the opinion advanced by the public accountant. Fourth, the courts must continue to hold public accountants liable to third parties when the accountant is guilty of pure fraud. Finally, the courts must begin to hold negligent accountants liable to all reasonably foreseeable third party statement users. This five step approach to accountants' civil liability both narrows the gap between the legal and professional interpretations of the accountant's duties and provides for an equitable and definitive distribution of the burden which results from financial misrepresentations.
CHAPTER VI

CONCLUSION

The public accounting profession is today confronted with two legal problems of major significance. The first of these legal problems is the result of the judiciary's recent infringement upon a set of rights which had traditionally been granted to the members of all skilled professions. This recent infringement has resulted in a judicial interpretation of the public accountant's responsibilities which differs substantially from the interpretation which has been advanced by the public accounting profession. The second of these legal problems is the result of the judiciary's espousal of six distinct concepts of civil liability placement. The espousal of these six applicable doctrines has left the public accountant in the middle of a confusing, and often stultifying, situation. This dissertation has presented a five step approach toward analyzing and solving these legal problems.

Chapter two of this dissertation undertook to provide an historical perspective of the development of accountants' civil liability. It was found that the English Courts produced the first significant legal
doctrines which were to be applied to the accountant-third party relationship. The American Courts were to later build upon these early concepts by proposing certain specific interpretations and applications of the British Doctrines. Yet, it was the New York Court, acting in the economically depressed thirties, that established the most lasting concept of accountants' third party liability. During the depression years, the New York Court sought to balance legal equity with social need, and in so doing, produced a restrictive concept of liability which was to be almost universally accepted by the courts for years to come.

As early legal doctrines began to intermingle with the complex societal and economic system of the sixties and seventies, a most perplexing situation began to develop. The first problem to confront the accounting profession resulted when the judiciary began to infringe upon the public accounting profession's right to establish the rules of conduct by which its members would be required to abide. This once universal right of all skilled professions was substantially reduced when the courts began to espouse standards of professional conduct with regard to the disclosure of subsequently acquired information, the detection of corporate fraud, the preparation of unaudited financial statements and the disclosure of current value financial information. As the judiciary's infringement upon the rights of public accounting grew,
the profession began to redirect its major efforts away from serving the economic sector and toward the avoidance of civil liability.

A second problem for the profession emerged in the form of a diverse set of doctrines of liability placement. As the modern courts reinterpreted and expanded the doctrines which had been developed by the early English and American Courts, the accountant found himself confronted with at least six distinct concepts of third party liability placement. In a given situation, a particular court could apply concepts of liability placement which ranged from a most conservative doctrine which was based upon a concept of pure fraud, to a most liberal doctrine which was based upon foreseeability and ordinary negligence. Thus, not only is the accountant today confronted with a discrepancy between legal and professional standards of conduct, but he is also confronted with a situation in which the determination of the scope of his liability is an almost impossible task.

Chapter four sought to analyze the balancing process through which a doctrine of accountants' liability could be developed. In so doing, this chapter sought to describe both the justifications for, and effects of an extension of the public accountant's third party liability. It was found that there were three legal justifications for an extension of the public accountant's civil
liability. First, it was argued that while the accounting profession has been eager to reap the benefits of the professional status which its members have achieved, public accountants have been unwilling to accept a concomitant degree of legal responsibility. Second, it was found that while the third party was virtually forced to rely upon the financial representations of public accountants, that third party had little legal recourse to an accountant who had performed his function improperly. Third, it was found that if the legal system is to treat all individuals in a fair and equitable manner, the accountant must assume a greater degree of third party liability. Thus, it would seem that there is substantial legal justification for an extension of the public accountant's third party civil liability.

Beyond these basic legal justifications, chapter four sought to analyze the effects that an extension of the accountant's liability would have on both the profession and economic society. It was found that an extension of the public accountant's third party liability would contribute to the quality of accounting services while not representing a significant threat to the economic stability of the accounting profession. Therefore, chapter four concluded that there were significant reasons for extending the third party civil liability of public accountants beyond its present limits.
Chapter five sought to implement the conclusions drawn in chapter four while solving the basic problems which were discussed in chapter three. To accomplish this task a five step approach was taken. First, it was proposed that the public accounting profession be allowed to implement its own standards of professional conduct. Second, it was proposed that the courts continue to use the reasonable man as a basis for comparing the activities of an individual accountant to the standards of the profession as a whole. Third, it was proposed that the courts preclude accountants from using disclaimers and qualifications as a means of liability avoidance. Fourth, it was proposed that the courts continue to hold accountants liable to third parties when the accountants are guilty of pure fraud. Finally, it was proposed that the courts hold accountants liable to all reasonably foreseeable third parties when the accountants are guilty of any form of negligence. Such an approach to accountants' third party liability would provide a more liberal concept of third party recovery while contributing to a sound system of law within which a solution to the problems confronting the accounting profession may be built.
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VITA

Jonathan J. Davies was born August 22, 1951, in New Orleans, Louisiana. In May, 1969, he graduated from Chalmette High School and proceeded to attend Northeast Louisiana University on a State Board of Education Scholarship. During a three year period at Northeast, he passed the Certified Public Accountants' Examination, was selected as the most outstanding graduate from the College of Business Administration, and graduated magna cum laude with a degree in accounting in May, 1972. In September, 1972, he entered the University of Florida on an Arthur Andersen Fellowship. Ten months later, in June, 1973, he received a master's degree in accounting. At the beginning of the next academic period, he entered Louisiana State University to pursue a doctorate in business administration.

While an undergraduate, Jonathan J. Davies participated in the intercollegiate debate program, attending over forty tournaments in a three year period. He also served as president of the local chapter of Pi Kappa Delta, national forensics fraternity, and was a member of Phi Kappa Phi and Omicron Delta Kappa. As a graduate student, he taught principles of accounting at Louisiana State University and worked part-time for the School of Banking of the South.
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