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Accountants' Scope of Liability
For Defective Financial Reports

By Lloyd Alan Levitin

If an accountant, in performing an audit for his client, negligently misrepresents his client's financial condition, can a third party lender or investor who suffers financial loss by his reliance upon that misrepresentation recover damages from the accountant? Until recently the answer has been no; privity of contract has been regarded as an absolute necessity to maintain an action for negligent misrepresentation.1 But in 1958 the California Supreme Court, in Biakanja v. Irving,2 repudiated the privity requirement in cases where the injury is to intangible economic interests:

The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm.3

This decision thus unleashes another "assault upon the citadel of privity"4 and is likely to have a substantial effect on the liability of

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4 "The assault upon the citadel of privity is proceeding in these days apace. How far the inroads shall extend is now a favorite subject of judicial discussion." Cardozo, C. J. in Ultramares Corp. v. Touche, 255 N.Y. 170, 180, 174 N.E. 441, 445 (1931).
accountants who heretofore have been insulated from third party liability for ordinary negligence. How will this decision be applied to accountants? What is the scope of an accountant’s liability?

Nature of Accounting Services

Public accountancy is a highly skilled and technical profession embracing many types of services. The primary service of the independent public accountant is to examine the financial statements of his client and to express an expert opinion—in the form of a report—on the fairness with which they present financial position and results of operations. Although the report is generally addressed to the client, in many instances it reaches innumerable interested parties in the investing and lending public, who place great weight on the opinion expressed. Difficult legal problems have arisen in defining the auditor’s responsibility to these parties.

Liability to Client

Accountants’ Duty

The contract of employment creates a relationship from which a duty arises to perform the promised services with due care. Accountants, as members of a skilled profession, are subject to the same rules of negligence in the practice of their profession as are members of other skilled professions. A recent California case states the duty of accountants as follows:

As members of a skilled profession they are experts. . . . “The services of experts are sought because of their special skill. They have a duty to exercise the ordinary skill and competence of members of their profession, and a failure to discharge that duty will subject them to liability for negligence. Those who hire such persons are not justified in expecting infallibility, but can expect only reasonable care and competence. They purchase service, not insurance . . . .”

If the accountant’s conduct falls below professional standards, he may be held liable to his client for breach of contract, or in tort for

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breach of the general duty to exercise due care, arising out of the contract relationship. 10

When the accountant undertakes to perform the usual audit which is to culminate in the expression of his expert opinion on the fairness of his client’s statement, it is implied that he will follow generally accepted auditing standards. 11 These standards are determined by reference to technical literature and expert testimony. 12 Auditing standards should be distinguished from auditing procedures. 13 The standards are the same for every audit whereas the procedures may differ. Auditing procedures adequate under one set of circumstances may not be adequate under another. Thus, any attempt at classifying various accounting procedures as legally acceptable or unacceptable would be fruitless. Similarly, cases involving alleged malpractice of accountants must be read with the understanding that failure to follow certain procedures may be negligence in one set of circumstances but not in another.

**Failure to Discover Defalcations**

Is the auditor’s failure to detect embezzlement negligence? The greatest number of reported cases in which the client sues his accountant arise out of the alleged failure of the accountant to discover fraud on the part of the client’s employees. 14 It should be pointed out that

10 For the general proposition of liability either in tort or contract for the negligent performance of a contractual duty, see 35 Cal. Jur. 2d Negligence 15; 2 Harper & James, Torts 1049-50 (1956); Prosser, Torts 478-86 (2d ed. 1955). For the rule that alternative remedies in tort or contract are available as applied to actions against accountants, see L. B. Labs., Inc. v. Mitchell, 39 Cal. 2d 56, 244 P.2d 385 (1952), Dantzler Lumber & Export Co. v. Columbia Cas. Co., 115 Fla. 541, 156 So. 116 (1934), Annot. 54 A.L.R.2d 324, 330 (1957).

The fact that alternative remedies may be available may be critical with respect to (1) statute of limitations, (2) application of contributory negligence and (3) damages. See Hawkins, Professional Negligence Liability of Public Accountants, 12 Vand. L. Rev. 797 (1959).


The accountant may limit his liability by expressly stating in his contract that he will not undertake the usual examination. See Levy, Accountants’ Legal Responsibility 15 (1954).

12 See Committee on Auditing Procedure, American Institute of Certified Public Accountants, Auditing Standards and Procedures 15-16 (1983) for a statement of the generally accepted auditing standards as approved and adopted by the membership of the American Institute of Certified Public Accountants.

13 Id. at 15.

the objective of the usual audit examination is to render an opinion on the financial statements and not to discover defalcations. However, if the defalcation went undiscovered because the accountant had not exercised reasonable care in the performance of this examination, he is liable.

**Liability to Third Parties for Negligence**

The third party bringing an action against an accountant for a negligent misrepresentation faces two major difficulties. The first is historical—the doctrine of privity. Under this doctrine a plaintiff cannot maintain an action in tort for harm caused by the defendant's negligent performance of a contract unless the plaintiff is in "privity of contract" (i.e., had contractual relations) with the defendant. This obstacle has now been removed at least in California by the decision in *Biakanja v. Irving*. The second obstacle is public policy. The scope of liability for a negligent misrepresentation causing only intangible economic loss is more limited than the scope of liability for negligent conduct causing personal injury or tangible harm to property.

**Privity Doctrine**

The "privity doctrine" was established in 1842 in the leading English case of *Winterbottom v. Wright*. The driver of a stagecoach brought an action against a contractor who had agreed with the postmaster general to provide and keep the stagecoach in repair. The coach collapsed, injuring the driver, who sought to recover against the contractor on account of its defective construction. The Court

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19 See *Prosser, Torts* 543 (2d ed. 1955); 1 *Harper & James, Torts* 545-51 (1956).

of Exchequer denied him any right of recovery on the ground that there was no privity of contract between the parties. Lord Abinger said:

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 operation 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.\textsuperscript{21}

In 1895 the California Supreme Court adopted this common law rule of non-liability to persons not in privity in the case of \textit{Buckley v. Gray}.\textsuperscript{22}

Public policy changed, and what would be "absurd and outrageous" to Lord Abinger was not so to Justice Cardozo who in 1916, in the leading case of \textit{MacPherson v. Buick Motor Co.},\textsuperscript{23} held a manufacturer liable to a third party, not in privity, who was injured by a negligently constructed automobile. The privity doctrine was thus repudiated in the area of manufacturers' liability.\textsuperscript{24} However, where the defendant's negligence did not cause tangible harm, but only harm to intangible economic interests (the usual result of negligent performance of services), the doctrine maintained its strength. The breakthrough came in the case of \textit{Glanzer v. Shepard},\textsuperscript{25} where the New York Court of Appeals repudiated the privity doctrine in the case of a negligent misrepresentation causing only pecuniary loss.\textsuperscript{26} In that case the defend-

\textsuperscript{21}Id. at 114, 152 Eng. Rep. at 405. The court held that no action could be maintained on the contract; however, an erroneous interpretation of Lord Abinger's dicta led lawyers and courts to suppose that there could be no action even in tort. See Prosser, \textit{Torts} 497-98 (2d ed. 1955); Labott, \textit{Negligence in Relation to Privity of Contract}, 16 L.Q. Rev. 168, 171 (1900); see Lord Atkin, in Donoghue v. Stevenson (1933), A.C. 592, 598-59; see dissenting opinion of Denning, L. J. in Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164, 176-77.

\textsuperscript{22}110 Cal. 339, 42 Pac. 900 (1895), disapproved in Biakanja v. Irving, 49 Cal. 2d 647, 320 P.2d 16 (1958), overruled in Lucas v. Hamm, 56 Cal. 2d 583, 15 Cal. Rptr. 685 (1961). In \textit{Buckley v. Gray}, it was held that legatees of a will could not sue an attorney for the negligent preparation of the will which caused injury to them, since there was no privity between the attorney and the legatees.

\textsuperscript{23}217 N.Y. 382, 111 N.E. 1050 (1916).

\textsuperscript{24}See Prosser, \textit{Torts} §§ 84-85 (2d ed. 1955); Prosser, \textit{The Assault Upon the Citadel (Strict Liability to the Consumer)} 69 Yale L.J. 1099 (1960); Seavey, \textit{Mr. Justice Cardozo and The Law of Torts}, 52 Harv. L. Rev. 372, 376-79 (1939). The \textit{MacPherson} doctrine has been adopted in California. See Kalash v. Los Angeles Ladder Co., 1 Cal. 2d 229, 231, 34 P.2d 461, 463 (1934).

\textsuperscript{25}233 N.Y. 236, 135 N.E. 275 (1922).

ant, a public weigher, was requested by a vendor to weigh beans which he had sold and to issue a certificate of weight to the buyer. Due to a negligent overstatement of weight, the buyer paid an excessive purchase price. The buyer sued the weigher to recover the amount of overpayment. The weigher argued no liability because he had no contractual relations with the buyer. Speaking through Justice Cardozo, the Court stated:

We think the law imposes a duty toward buyer as well as seller in the situation here disclosed. The plaintiff's use of the certificates was . . . a consequence, which to the weigher's knowledge, was the end and aim of the transaction . . . . 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. They sent a copy to the plaintiffs for the very purpose of inducing action. . . . In such circumstances, assumption of the task of weighing was the assumption of a duty to weigh carefully for the benefit of all whose conduct was to be governed. We do not need to state the duty in terms of contract or of privity. . . . Given the contract and the relation, the duty is imposed by law (cf. MacPherson v. Buick Motor Co., 217 N.Y. 382, 390).27

Recently the California Supreme Court followed this trend, and in the case of Biakanja v. Irving28 repudiated the privity doctrine as to intangible economic interests. In that case, a non-lawyer negligently drew up a will which proved to be invalid. The California Supreme Court held the non-lawyer liable to the intended legatee although they were not in privity of contract. Relying on the Glanzer (bean weigher) case, the Court stated:

Here, the "end and aim" of the transaction was to provide for the passing of Maroevich's estate to plaintiff. (See Glanzer v. Shepard. . . .) Defendant must have been aware from the terms of the will itself that, if faulty solemnization caused the will to be invalid, plaintiff would suffer the very loss which occurred.29

Scope of Liability—Intangible Economic Loss and Tangible Harm

Although the court in the Biakanja case declared that lack of privity is no longer a defense in an action for economic harm, it did not declare

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27 233 N.Y. 236, 238-39; 135 N.E. 275, 276 (1922).
28 49 Cal. 2d 647, 320 P.2d 16 (1958). The only California case in point prior to Biakanja expressly repudiated the Glanzer rule. Bilich v. Barnett, 103 Cal. App. 2d 921, 229 P.2d 492 (Super. Ct. 1951) (surveyors held not liable for negligently preparing grade sheets for a trucking company although they were furnished directly to plaintiff contractor with knowledge that he intended to rely thereon).
29 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (1958). There is a major distinction between the cases. Reliance of the plaintiff, an important factor in Glanzer, is absent in Biakanja. See 46 CALIF. L. REV., 851, 853 n.16. (1958).
that the defendant's scope of duty is unlimited so that any third person in the land who is harmed as a result of the defendant's negligence may recover. "The determination whether in a specific case the defendant will be liable to a third person not in privity is a matter of policy ...."

The leading American case with respect to the scope of duty of the negligent purveyor of business information is Ultramares Corp. v. Touche. In Ultramares the defendants were a firm of certified public accountants employed by Fred Stern & Co., Inc. to prepare and certify a balance sheet exhibiting the condition of its business as of December 31, 1923. To finance its operation, this company required extensive credit and borrowed large sums of money from banks and other lenders. All this was known to the defendants, who also knew that in the usual course of business the balance sheet, when certified, would be exhibited to banks, creditors, stockholders, purchasers and sellers, according to the needs of the occasion, as the basis of financial dealings. To satisfy this purpose, the defendants supplied the Stern Company with thirty-two copies of the certified balance sheet as counterpart originals. The defendants did not know the persons to whom these would be shown or the extent or number of the transactions in which they would be used; in particular the accountants did not know that the balance sheet would be submitted to the plaintiff. The balance sheet as certified showed a net worth of approximately 1,070,000 dollars. Attached to the balance sheet was the accountants' certificate reading as follows:

We have examined the accounts of Fred Stern & Co., Inc., for the year ending December 31, 1923, and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanations given us. We further certify that ... the said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern & Co., Inc., as at December 31, 1923. ... In the month following the defendant's certification of the balance sheet, Fred Stern & Co., Inc. approached the plaintiff for a loan. As

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31 255 N.Y. 170, 174 N.E. 441 (1931); Annot., 74 A.L.R. 1153 (1931). This decision has produced a great deal of writing. See Seavey, Mr. Justice Cardozo and the Law of Torts, 52 Harv. L. Rev. 372, 398-404 (1939); Seavey, Candler v. Crane, Christmas & Co.—Negligent Misrepresentations by Accountants, 67 L.Q. Rev. 465, 477-78, (1951); Meek, Liability of the Accountant to Parties Other Than His Client for Negligent Misrepresentation, Wis. L. Rev. 371, 380-83 (1942); Rouse, Legal Liability of the Public Accountant, 23 Ky. L.J. 3 (1934); MacMillan, Sources & Extent of Liability of a Public Accountant; 15 Chi.-Kent. L. Rev. 1 (1936); and the following notes and comments: 19 Calif. L. Rev. 454 (1931); 31 Colum. L. Rev. 858 (1931); 16 Cornell L.Q. 419 (1931); 33 Ill. L. Rev. 349 (1938); 26 Ill. L. Rev. 49 (1931); 30 Iowa L. Rev. 319, 322, (1951); 29 Mich. L. Rev. 648 (1931); 16 N.Y.U.L. Rev. 436 (1939); 13 St. John's L. Rev. 310 (1939); 6 U. Chi. L. Rev. 27 (1938).
a condition to any loan, plaintiff insisted that it receive a balance sheet certified by public accountants. The plaintiff was given one of the certified balance sheets. In reliance upon the balance sheet and the attached certificate signed by the defendants, the plaintiff advanced to Fred Stern & Co., Inc. some 165,000 dollars. About ten months thereafter, the company was declared bankrupt. It then appeared that the balance sheet made by the defendants, showing a net worth of approximately 1,070,000 dollars, was erroneous; the corporation at that time was, in fact, insolvent. The assets had been overstated by the defendants by the inclusion of over 706,000 dollars of fictitious and non-existing accounts receivable. Had the facts been accurately certified by the defendants, the plaintiff would not have made the loan.

The plaintiff alleged two causes of action, one based on fraud, the other on negligence. The trial judge dismissed the fraud action, but submitted the question of negligence to the jury.

On the question of negligence, the evidence was that the accountants had, prior to the actual audit, assigned a junior accountant the task of posting accounts receivable and sales to the general ledger from the sales journal. On the day the junior accountant finished posting the December sales, totaling some 644,000 dollars, an employee of the Stern Company posted additional December sales of some 706,000 dollars. These sales were entirely fictitious. When the junior accountant resumed his work, he saw the entry thus added, and included the 706,000 dollars of fictitious sales in his footings, resulting in an overstatement of over 706,000 dollars in the assets of the business. The auditors had failed to verify the 706,000 dollar ledger entry. An examination would have disclosed that the entry in the ledger was not supported by any entry in the sales journal. There were seventeen fictitious invoices supporting the entry, but scrutiny of these invoices would have disclosed that they were irregular. (They had no shipping number or customer's order number and varied in terms of credit and in other ways were unusual.) The defendants testified that they did not remember whether they had inspected these invoices. They conceded, however, that if they had looked, they would have discovered the irregularities.

The auditors had grounds to suspect irregularities. The inventory as it was given to the auditors totaled about 347,000 dollars. The defendants discovered that it had been overstated and that the actual inventory was but 44,000 dollars. Creditors had informed the defendants that the same accounts receivable had been pledged to several banks at the same time. The jury returned a verdict for the plaintiff in the amount of 187,576.32 dollars, whereupon the trial judge set aside
the verdict. Plaintiff appealed to the appellate division which found no fraud, but by a three to two decision reversed the dismissal of negligence and reinstated the jury's verdict. The majority reasoned that since it was customary for banks and merchants to require certified financial statements from independent accountants and to rely upon these in making loans, accountants should owe a duty to these banks and merchants to exercise due care. The court relied on the Glanzer (bean weigher) case in support of its decision. In a dissenting opinion, Judge Finch pointed out that the Glanzer case is inapplicable. In that case the identity of the person who was to be swayed by the defendant's conduct was known in advance. In the instant case, the defendants furnished the report without reference to any particular person and had no knowledge of the person or class of persons who might rely thereon, or of the specific purpose for which the report might be used. Judge Finch feared the practical effect of imposing liability on the accountants. Thus:

The professional man, be he accountant or otherwise, certifies for his client and not for all the world. If the client makes it clear to such a man that the statement is to be used in a particular transaction in which a third party is involved, such circumstance should create a duty from the professional man to such third party. If the accountant is to be held to an unlimited liability to all persons who may act on the faith of the certificate, the accountant would be obliged to protect himself by verification so rigid that its cost might well be prohibitive and a limited but useful field of service thus closed to him. The smallness of the compensation paid to the defendants for the services requested is in striking contrast to the enormity of the liability now sought to be imposed upon them. If in the case at bar the plaintiff had inquired of the accountants whether they might rely upon the certificate in making a loan, then the accountants would have the opportunity to gauge their responsibility and risk and determine with knowledge how thorough their verification of the account should be before assuming the responsibility of making the certificate run to the plaintiff.

The Ultramares case was then taken on cross appeals (plaintiff appealing the dismissal of fraud; defendant appealing the finding of negligence) to the New York Court of Appeals. This is the same court which had previously held the automobile manufacturer liable in the MacPherson case and the bean weigher liable in the Glanzer case. Justice Cardozo who wrote the opinions in those cases also spoke for

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32 229 App. Div. 581, 243 N.Y. Supp. 179 (1st Dep't 1930), rev'd 255 N.Y. 170, 174 N.E. 441 (1931); see the following note and comments. 30 Colum. L. Rev. 1066 (1930); 44 Harv. L. Rev. 134 (1930); 40 Yale L.J. 128 (1931).

the court in *Ultramares*. The court had no trouble in finding the defendants negligent, but the question was whether they owed a duty to this particular plaintiff. Appalled at the breadth of liability urged by the plaintiff, that any member of an indeterminate class of creditors or investors, present and prospective, known and unknown, may hold an accountant responsible for a negligent report, Justice Cardozo wrote:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.\(^{34}\)

*Glanzer* was not overruled but merely distinguished on its facts:

In *Glanzer v. Shepard*, the seller of beans requested the defendants, public weighers, to make return of the weight and furnish the buyer with a copy. This the defendants did. . . . The buyer paid the seller on the faith of the certificate which turned out to be erroneous. We held that the weighers were liable at the suit of the buyer for the moneys overpaid. Here 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 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” . . . . In a word, the service rendered by the defendant in *Glanzer v. Shepard* was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the benefit of the Stern company . . . and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it thereafter.\(^{35}\)

This distinction between the *Glanzer* and *Ultramares* cases, that the weigher’s service was primarily for the benefit of the third party, whereas in *Ultramares* the service was primarily for the benefit of the client and only collaterally for that of lenders, has been criticized as being artificial. The weight certificate in *Glanzer* was for the benefit of the seller as well as for the benefit of the buyer; the audit report in *Ultramares* of which there were thirty-two duplicate originals was intended for the benefit of third parties as well as for the client.\(^{36}\)

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\(^{34}\) 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931).

\(^{35}\) Id. 182-83, 174 N.E. at 445-46.

What is important is why recovery was denied in the *Ultramares* case. In *MacPherson* a manufacturer places into the channels of commerce a negligently made car. A third party uses the car, is physically harmed, and in an action against the manufacturer is granted recovery. In *Ultramares* an accountant places into the channels of commerce a negligently made audit report. A third party relies on the report, is economically harmed, and in an action against the accountant is denied recovery. In both cases the harm was foreseeable. Why is there a difference in rules as to liability for conduct causing physical harm and that causing only pecuniary harm? The answer rests on policy. Justice Cardozo feared that an extension of liability for negligent misrepresentation causing only pecuniary harm would subject persons to a great and indeterminate liability. Therefore, the potential liability of accountants was limited on the theory that liability would have such a crushing effect on their profession that either they could no longer offer such service, or their rates would be so high that people could not afford to use their services, and in either case, the result would be harmful to the economic interests of the community. It is this possibility of liability of unknown extent which distinguishes the *Ultramares* case from the *Glanzer* case, where the beans were misweighed. In *Ultramares*, the number and identity of persons who were likely to rely upon the defendant's audit report was unknown, whereas in *Glanzer* reliance on the weight certificate was known to be limited to one identified party. In *Glanzer* the upper limit of liability was the value of the beans. In *Ultramares*, the upper limit of liability was indeterminate.

Although the *Ultramares* case set forth the policy that the scope of liability should be more restricted in the case of economic loss than where there is tangible harm to person or property, the point of limitation has been a subject of considerable debate. The authors of the *Restatement of Torts* have squarely faced this problem. Section 552, apparently patterned after the New York cases of *Glanzer* and *Ultramares,* states:

One who in the course of his business or profession supplies information for the guidance of others in their business transactions is sub-

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38 Ibid.
39 Seavey, supra note 36 at 400.
40 Ibid. See also 36 LOWA L. Rev. 319, 326 (1951).
41 PROSSER, *TORTS* 543 (2d ed. 1955).
ject to liability for harm caused to them by their reliance upon the information if (a) he fails to exercise that care and competence in obtaining and communicating the information which its recipient is justified in expecting, and (b) the harm is suffered (i) by the person or one of the class of persons for whose guidance the information was supplied, and (ii) because of his justifiable reliance upon it in a transaction in which it was intended to influence his conduct or in a transaction substantially identical therewith.\textsuperscript{43}

Applying this section to accountants, it appears that the accountants' scope of duty extends to those persons for whose guidance the accountant prepares his report and for those transactions in which the report was intended to be used.

Although there are no cases reported in California involving a third party action against an accountant, a recent decision involving an abstractor of title approved section 552 of the Restatement as well as the rationale of the \textit{Ultramares} case.\textsuperscript{44}

Curiously, cases involving negligent misrepresentations by accountants arising after the \textit{Ultramares} case have ignored the \textit{Glanzer} case, and interpreted the \textit{Ultramares} case as ruling that accountants are not liable to third parties for ordinary negligence. Instead of analyzing the cases in terms of duty, that is whether the accountant's scope of duty extends to the particular plaintiff, the courts have accepted the \textit{Ultramares} decision as holding that accountants owe no duty to persons not in privity.\textsuperscript{45} This interpretation has even been applied in cases

\textsuperscript{43} \textit{Restatement}, Torts, § 552 (1938).

\textsuperscript{44} Hawkins v. Oakland Title Ins. & Guar. Co., 165 Cal. App. 2d 116, 331 P.2d 742 (1958). The case held that a title company which negligently searched title of A's property, owed no duty of care to B, a remote purchaser, not in privity, who purchased the property from A ten years later. In Howell v. Betts, 362 S.W.2d 924 (Tenn. 1962), the issue was whether the defendant, who negligently surveyed a lot for the then owner, owed a duty to a purchaser, not in privity, who purchased the lot 24 years later in reliance on his survey. The court recognized the \textit{Biakanja} case as repudiating the privity doctrine, but denied recovery under the rationale of the \textit{Ultramares} case, on the grounds that if the surveyor could be held liable to a remote purchaser 24 years after his survey, then with equal reason, he could be held liable to any and all purchasers to the end of time.

Although it may be necessary to confine title abstractors' and surveyors' scope of duty so that they will not be liable for an indeterminate time, this time factor would not be as important in accounting cases. Whereas a survey or title search made many years ago may be relied on today, financial statements lose their utility with the passage of time.

\textsuperscript{45} See also De Zemplen v. Home Federal Savings & Loan Assoc., 221 A.C.A. 236, 34 Cal. Rptr. 334, 339 (1963) (approving § 552 of the \textit{Restatement}, Torts).

\textsuperscript{45} In O'Connor v. Ludlam, 92 F.2d 50, 53 (1937), the court said "Since there was no contractual relationship between the plaintiffs and the defendants, liability could be imposed only for fraud ..."; in 54 A.L.R.2d 324, 345 (1957), the author of an annotation entitled \textit{Liability of Public Accountant}, states "public accountants may not be found liable upon the theory of ordinary negligence to parties with whom they are not
where the facts are similar to those of the Glanzer case, i.e., negligent misrepresentation to a known third party for a specific transaction.

Thus, in an English case, Candler v. Crane, Christmas & Co., the accountants, during the course of preparing a balance sheet for their client, were told by the client to exhibit it to a prospective investor when completed. This the accountants did. In reliance thereon, the investor purchased an interest in the company. The company became insolvent, and it was then learned the accountants were "extremely careless" in the preparation of the balance sheet. The plaintiff sued the accountants for negligence. Bound by English precedents, the court, in a two to one decision, held that the accountants were not liable for negligent misrepresentation to anyone other than their client. The English court did not consider the Glanzer case, but cited the Ultramares case to support its decision of no liability. Professor Seavey has stated that this is an erroneous use of the Ultramares decision, that if an American case was to be used, it should have been the Glanzer case where the reasoning would support liability.

Apparently the first American case involving a negligent misrepresentation by an accountant to a definite party for a definite purpose was Duro Sportswear, Inc. v. Cogen. A and B owned all the stock of a corporation. A agreed to purchase B's stock at a price dependent upon the results of an audit. The corporation employed a certified public accountant (B's brother-in-law) to make the audit. The accountant performed the audit negligently with the result that A overpaid for the shares. The court held that the accountant was negligent but found no liability, that under the rule of Ultramares, an accountant is not liable to a third party for ordinary negligence.

In the area of accountants' malpractice cases, some courts have thus shown a tendency to assume that the Ultramares case was intended to insulate accountants from third party liability. All that should be deduced from Ultramares is that in the particular circumstances of that in privity." There is one possible exception. In C.I.T. Financial Corp. v. Glover, 224 F.2d 44, 46 (1955), the court in dicta stated that it approved the jury instruction that "in order to establish a duty to the plaintiff for ordinary negligence in preparation of the . . . audits, the jury had to find that these reports had been made for the 'primary benefit' of the plaintiff."

case there was no duty owing the third party; the accountants' scope of duty was limited so that accountants would not be exposed to a potentially unlimited liability. The scope of the accountant's duty (which is limited) should not be confused with the basis of liability (i.e., negligence). A rule that accountants owe a duty to no one but their clients was criticized by Lord Denning in his dissenting opinion to Candler v. Crane, Christmas & Co. as not serving the best interests of the financial community. To illustrate, he posed an example where the client is dishonest and intentionally supplies the accountants with erroneous information hoping they accept it without verification. This they do. As a result the accountants negligently misrepresent their client's financial condition. The client will not complain. The creditors and investors who are harmed cannot complain because the law says auditors owe no duty to them. The auditor's opinion "which should be a safeguard, becomes a snare for those who rely on it."

Lord Denning concluded that the accountants' duty should extend to any third party to whom he has authorized his client to show the report but only for those transactions for which to the accountant's knowledge his report is required.

Some writers have argued that the duty of accountants should extend much farther. They have challenged the premise that the scope of liability for conduct causing economic loss should be more limited than the scope of liability for conduct causing tangible harm to person or property. It has been argued that the reckless writer should be held to as high a standard as the reckless driver, "for his pen may impoverish thousands, while his car can hurt but few." In reference to accountants, it has been argued that the duty of care should extend to the foreseeable plaintiff, as in negligence law generally, because (1) public accountancy by economic necessity amounts to a "public calling," (2) third parties are virtually forced to rely on the account-
ant's report because of the difficulty of independently checking his work, reliance by the third parties is justifiable. Finally, it has been pointed out that Justice Cardozo's fear of the solvency of the accounting profession is unwarranted. Under the Securities and Exchange Act, accountants have a broad liability to third parties. Further, accountants may (1) qualify their opinion, and thus limit responsibility, or (2) take out liability insurance. For an accountant to qualify his report, when he otherwise believes he has fairly stated it, is impractical. A qualification correspondingly reduces its utility. As to the purchase of liability insurance, how much should the accountant carry? It was the fear of a possible liability of unknown extent that led to a denial of negligence liability in the Ultramares case. If the upper limit of liability is indefinite, complete protection would appear unobtainable, or at least too costly.

**Liability to Third Parties for Deceit**

If an accountant, in performing an audit, is not merely negligent, but is also guilty of a fraudulent misrepresentation in respect to his clients' financial condition, can a third party who is injured by his reliance upon that misrepresentation (and unable to recover on a theory of negligence) recover on a theory of deceit? What is the accountants' scope of liability for deceit, and is it broader than that for negligence? But first, what constitutes deceit?

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56 Note, 36 Iowa L. Rev. 319, 326 (1951): "It would seem to be grossly unjust, even ridiculous, to exonerate a firm whose sole purpose in preparing a balance sheet was to provide prospective investors with information . . . because too many people placed too much trust and confidence in the quality of their service." Note, 31 Colum. L. Rev. 858, 869 (1931): "The accountant is left in a situation in which he requests reliance, demands a premium for his certification because of the reliance which it induces, and then seeks to avoid liability arising from the reliance."
57 After the passage of the Act it was said: "To say the least the Act goes as far in protection of purchasers of securities as plaintiff in Ultramares Corp. v. Touche unsuccessfully urged the New York Court of Appeals to go in the protection of a creditor. The change which that court thought so 'revolutionary' as to be 'wrought by legislation' has been made." Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171, 198 (1933).
58 Note, 31 Colum. L. Rev. 858, 869 (1931).
59 Note, 36 Iowa L. Rev. 319, 327 (1951).
60 See generally Prosser, Torts 536-50 (2d ed. 1955); 1 Harper & James, Torts 527-59 (1956); Smith, Liability for Negligent Language, 14 Harv. L. Rev. 184 (1900); Williston, Liability for Honest Misrepresentation, 24 Harv. L. Rev. 415 (1911); Bohlen, Misrepresentation as Deceit, Negligence or Warranty, 42 Harv. L. Rev. 733 (1929); Carpenter, Responsibility for Intentional, Negligent and Innocent Misrepresentation, 24 Ill. L. Rev. 749 (1930); Harper & McNealy, A Synthesis of the Law of Misrepresentation; 22 Minn. L. Rev. 939 (1938); Green, Deceit, 16 Va. L. Rev. 749 (1930); Keeton, The Ambit of a Fraudulent Representor's Responsibility, 17 Texas L. Rev. 1 (1938);
In the leading case on deceit, Derry v. Peek, the defendants, who were directors of a tramway corporation, issued a prospectus to induce the public to subscribe for stock, which contained the statement that the company had the right "to use steam or mechanical motive power, instead of horses . . . ." In fact the company had no such right. The trial judge found as a fact that the defendants honestly believed the truth of their statement and therefore held there was no deceit. The intermediate court reversed. It held that although the defendants might honestly have believed the truth of their statement, they had no reasonable ground for any such belief and since they ought to have known the statement was false, they are liable in deceit. The House of Lords reversed the intermediate court and held that an honest belief was a defense to an action in deceit, no matter how unreasonable the grounds for the belief. For deceit, the court stated there must be proof that a "false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false." The court suggested, however, that negligence, although not a substitute for deceit, may nevertheless be evidence that the defendant did not have an "honest belief" in the truth of his assertion.

This decision, which identified the deceit action with intentional misrepresentation, and excluded from the action a negligent or innocent misrepresentation, has been followed in the United States by a large number of courts.

A minority of American jurisdictions has modified the Derry v. Peek formula and has extended the action of deceit to (1) negligent misrepresentations, and/or (2) innocent misrepresentations.

In California, by statute, negligent misrepresentation is a form of deceit. Thus in California where the defendant makes false state-
ments, honestly believing they are true, but without reasonable grounds for such belief, he is liable in deceit. Some jurisdictions apply a rule that where the speaker makes a statement of fact true to his own knowledge, he warrants the accuracy of his statement. If the statement is false, he is liable in deceit, notwithstanding his belief in the truth of the statement is both honest and reasonable.67

How has the law of deceit been applied to accounting practice?

In Ultramares68 the court pointed out that the accountant's certificate consisted of two sentences. The first sentence contained statements of fact. The second sentence contained a statement of opinion. The first sentence read as follows:

We have examined the accounts of Fred Stern & Co., Inc. for the year ending December 31, 1923, and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanations given us.

The court stated in reference to this portion of the auditor's certificate:

The defendants certified as a fact, true to their own knowledge, that the balance sheet was in accordance with the books of account. If their statement was false, they are not to be exonerated because they believed it to be true. . . . [A]ccountants . . . by the very nature of their calling profess to speak with knowledge when certifying to an agreement between the audit and the entries.69

The court concluded that there was sufficient evidence from which the jury might hold such a statement to be false. Commentators are of the opinion that the court here applied the doctrine that one making a statement of fact true to his own knowledge warrants the accuracy of his statement, that neither honest belief in the truth nor reasonable care will constitute a defense.70 Admittedly, such expression that "they
are not to be exonerated because they believed it to be true" taken completely out of context supports the conclusion that the court intended to impose liability for an innocent misrepresentation. An entire reading of the opinion, however, suggests that the court merely held that there was sufficient evidence to entitle a jury to find that when the accountants made the positive and unqualified representation that the balance sheet corresponded with the accounts, they were doubtful about the truth of such statement because they consciously realized that their audit was not adequate to justify making such assertion with certainty.\textsuperscript{71} This is fraud within, not an exception, to the rule of 

The accounting profession, as a result of the \textit{Ultramares} case, has changed the wording of its certificates. Accountants no longer state as a fact the result of the examination (i.e., that the balance sheet is in accordance with the accounts), but state the results in the form of an opinion. The word "certify" is no longer used. The certificate now generally used by the profession reads as follows:

\begin{quote}
We have examined the balance sheet of X Company as of June 30, 19— and the related statement(s) of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying balance sheet and statement(s) of income and retained earnings present fairly the financial position of X Company at June 30, 19— and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

In the proper circumstances, California may impose liability for an innocent misrepresentation. California considered the warranty theory (but held it inapplicable under the circumstances) in the recent case of Cagne v. Bertran, 43 Cal. 2d 481, 486, 275 P.2d 15, 19 (1954): “Strict liability has also been imposed for innocent misrepresentation of facts that the maker purported to know, that the recipient relied on in matters affecting his economic interests, and that the maker positively affirmed under circumstances that justify the conclusion that he assumed responsibility for their accuracy.”
\end{quote}


\textsuperscript{72} 1 HARPER & JAMES, TORTS 534 (1956).
that he positively knows the thing to exist, he is really asserting what is false and thereby intentionally misleads him to whom the information is given.\(^7\)

It is not clear whether the court intended to apply the doctrine that one who positively states a fact as of his own knowledge is liable, if the statement is false, irrespective of an honest belief in its truth.\(^7\)

An accountant, however, to protect himself, should, whenever he relies upon sources of knowledge other than his own, so state in his report.\(^7\)

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\(^7\) Bohlen, supra note 64 at 738.

\(^7\) It has been observed that in this area of the law of fraud, there is considerable amount of confusion and that courts and commentators have given different interpretations to ambiguous statements which are found in many of the judicial opinions. See Keeton, supra note 71 at 583. Thus, the opinion in the Ultramarines case cited Hadcock v. Osmer, 153 N.Y. 604, 47 N.E. 923 (1897), as authority for the rule that one who makes an unqualified statement of fact as of his own knowledge is liable if the statement is false. The Hadcock case has been interpreted by Williston, supra note 71 at 433 n.51, for the proposition that making a statement as of actual knowledge may amount to fraud only when the defendant not only does not know the truth of what he asserts, but is conscious that he does not know it. Prosser op. cit. supra note 60 at 538 n.65 is in accord with Williston. However, 1 Harper & James op. cit. supra note 72 at 535 n.15, 552 n.3, cites the case as an example of innocent misrepresentation, that if the defendant makes a statement as true to his own knowledge, he is liable if it is false, irrespective of an honest belief in the truth of the statement.

\(^7\) Thus in Beardsley v. Ernst, 47 Ohio App. 241, 191 N.E. 808 (1934), the auditors' certificate stated: "We hereby certify that we have examined the books of account and record of International Match Corporation and its American Subsidiary . . . and have received statements from abroad with respect to the foreign constituent companies. . . . Based upon our examination and information submitted to us it is our opinion that the annexed Consolidated Balance Sheet sets forth the financial condition of the combined companies . . . ." It appeared that the plaintiff had purchased stocks and bonds of the International Match Corporation in reliance on the auditors' certified balance sheet. It was later discovered that the corporation was bankrupt at the time of plaintiff's purchase. The plaintiff brought an action against the accountant for fraudulent misrepresentations, which, however, were confined to the statements received from abroad. The court distinguished Ultramarines on the ground that there the accountants in certifying correspondence between the balance sheet and the books made a statement as true to their own knowledge when in fact they had no such knowledge. In the instant case, however, the accountants fully disclosed that their opinion was based on statements received from abroad, which gives rise to an indisputable inference that they had not examined the records of the foreign companies, and thus could not have known whether or not the statements were accurate. Accordingly there was no pretense of knowledge as to the information received which could make the defendants liable for fraud.

In C.I.T. Financial Corp. v. Glover, 224 F.2d 44 (1955), it was charged that the accountants overstated the value of receivables. It appeared that the valuation of the receivables was dependent on the valuation of the collateral securing them, which was extremely difficult to make due to the nature of the business. The accountants relied heavily on the valuation of the collateral made by their client and in their audit report disclosed this reliance by inserting a disclaimer of responsibility as to the valuation of the collateral and receivables. The jury's verdict exonerating the accountants was affirmed.
In the second sentence of their certificate, the auditors stated their opinion:

We further certify that . . . the said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern & Co., Inc., as at December 31, 1923.

As to an expert's opinion, the court held there is fraud if the grounds supporting the opinion "are so flimsy as to lead to the conclusion that there was no genuine belief back of it."76 Further, negligence, although not a substitute for fraud, "is none the less evidence to sustain an inference of fraud."77 The court concluded that the jury might find from the evidence presented that the accountants had not a "sincere or genuine belief when they certified to an opinion that the balance sheet faithfully reflected the condition of the business."78 The court reversed the dismissal of the cause of action in fraud and granted a new trial.

The Ultramares decision is significant in its enlargement of the scope of liability for deceit.79 Under the traditional and English view, adopted by the Restatement of Torts,80 liability is limited to only those persons in whom the defendant intended to induce reliance and then only to those who rely in the manner intended. In Ultramares a broader rule was applied; the plaintiff who relies on the misrepresentation does not have to show that the defendant intended to induce his reliance, it is enough that the defendant should reasonably have foreseen this possibility.82

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76 255 N.Y. at 186, 174 N.E. at 447.
77 Id. at 191, 174 N.E. at 449.
78 Id. at 193, 174 N.E. at 449.
80 Peek v. Gurney, [1873] L.R. 6 H.L. 377, is the leading case in the ambit of fraudulent representor's liability. The directors of a corporation issued a fraudulent prospectus for the purpose of inducing the public to purchase stock from the company. An investor who relied on the prospectus and purchased the shares, not from the company, but on the market from a stockholder, was denied recovery. The holding was based on a rule that a representor is liable only to those whom he had desired to influence, in the manner which had occasioned the injury. For a discussion of this rule, see Prosser, Torts 539 (2d ed. 1955), Keeton, The Ambit of a Fraudulent Representor's Liability, 17 Tex. L. Rev. 1, 5 (1938).
81 Section 531, with some limitations in §§ 532 (documents), 536 (information required by statute). Section 531, comment a, contains an illustration: "1. A is selling securities to B in the presence of C. A should but does not realize that C might rely upon A's statement to B and purchase some securities on his own account. This occurs. A is not liable to C." See also § 533.
82 Fidelity & Deposit Co. of Maryland v. Atherton, 47 N.M. 443, 449, 144 P.2d 157, 161 (1944); Prosser, Torts 541 (2d ed. 1955); Seavey, Caveat Emptor as of 1960, 38 Tex. L. Rev. 439, 440, n.6 (1960); 38 Iowa L. Rev. 319, 321 (1951).
In *Ultramares* the court thus drew a distinction between the scope of liability for negligence and for deceit. Liability for deceit (but not for negligence) was extended to any member of an indeterminate class whose reliance upon the accountants' report was foreseeable. The reason for this difference in scope of liability is a matter of policy: the liability of the intentional wrongdoer should be greater than that of the negligent wrongdoer.83

California, however, apparently does not follow this broad rule in defining the boundaries of liability for deceit, but follows the traditional and narrower English rule, as expressed in the *Restatement of Torts*.84 Under this narrower rule, if a firm of accountants employed to audit the books of a corporation gives a report fraudulently misrepresenting its assets, it is not liable in fraud to whomever the corporation may exhibit the report unless the accountants furnished the report with the *intent* that it be communicated to the plaintiff in order to influence his conduct in a particular transaction.85 This limitation of liability to those whom the defendant intended to influence appears too narrow,86 and can be defended only from a purely historical viewpoint.87 If a court were to apply this narrower view as to the scope of liability for deceit, a plaintiff, such as the one in *Ultramares*, would be entirely without a remedy.88

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83 Keeton, *supra* note 80 at 4; Seavey, *supra* note 79 at 404.
84 Cohen v. Citizens Nat'l Trust & Sav. Bank, 143 Cal. App. 2d 480, 484, 300 P.2d 14, 17-18 (1956): "A person uttering misrepresentations is liable only to those in whom he intended to induce reliance and who do rely in the manner intended. . . . Even though the misrepresentation has been made directly to the plaintiff, if the facts clearly indicate that the defendant when making such misstatements had no intention of inducing reliance by his listener, there is no actionable fraud even though the hearer in fact relies to his detriment . . . ." See also 2 Witkin, *Summary of California Law Torts* §§199-200, 207-08 (1960); *California Annotations to the Restatement of Torts*, §§531, 533 (1957).
85 See *Restatement, Torts* §533 (1938); *California Annotations to the Restatement of Torts* §533 (1957).
87 Historically, the conscious defrauder has been, and in many courts still is, treated more leniently than other wrongdoers. This negative attitude towards deceit is traceable to medieval England when the accepted standards of business morality could be expressed in two words: "caveat emptor." Seavey, *Caveat Emptor as of 1960*, 38 Texas L. Rev. 439 (1960); Seavey, *Mr. Justice Cardozo and the Law of Torts*, 52 Harv. L. Rev. 372, 402-04 (1939).
88 In California the scope of liability for a negligent misrepresentation causing economic harm appears to be coincident with the scope of liability for deceit (whether based upon intentional or negligent misrepresentations). This is attributable to the fact that California follows the *Restatement of Torts*, §§533 (scope of liability for deceit) and 552 (scope of liability for negligent supplier of business information), which are substantially the same with respect to scope of liability.
The principles stated in *Ultramares*, that an expression of opinion may be a fraudulent representation if there is not an honest belief in that opinion, that fraud may be inferred from negligence, are in accord with the *Derry v. Peek* rule. The decision indicates that if accountants are doubtful or skeptical of the validity of their opinion, because they realize it is based on insufficient or inadequate investigation of the underlying data, they do not entertain an "honest belief." An interesting application of these principles occurred in the case of *State Street Trust Co. v. Ernst*.\(^8^9\) On January 19, 1929, the president of Pelz-Greenstein applied to plaintiff, a trust company, for a line of credit and a time loan of 300,000 dollars. He presented an estimated balance sheet (unaudited) of the business as of December 31, 1928, and stated that defendants, a firm of accountants, were making an audit of the condition of the company as of that date and that a balance sheet certified by the defendants would be submitted to plaintiff when it had been prepared. The plaintiff refused to grant a time loan until it had received the certified financial statements and had found that it substantially corroborated the estimated balance sheet. However, pending the receipt of the certified financial statements, the plaintiff made a demand loan to Pelz-Greenstein of the requested 300,000 dollars. The certified balance sheet was prepared by the accountants and, with ten copies, was furnished to the client. Pelz-Greenstein forwarded one of the copies to the plaintiff. The accountants knew that the copies would be used to obtain credit. Having found that the certified balance sheet substantially corroborated the estimated balance sheet, the plaintiff cancelled the demand note and issued a three months' time note in its place. This note was renewed several times for like three month periods.

Thirty days after the plaintiff received the certified balance sheet (and after the time loan had been made), the accountants sent to their client—and only to their client—a long-form report containing comments and explanations of the balance sheet which did not appear on the condensed report previously distributed.

One year after the plaintiff made its loan the corporation was petitioned into bankruptcy. It was then discovered that the certified balance sheet prepared by the defendants, which showed assets of 8,000,000 dollars, liabilities of about 5,000,000 dollars, and net worth of about 3,000,000 dollars was erroneous. In fact the corporation was insolvent; its liabilities exceeded the fair value of its assets.

There was no question that the officers of the corporation had been deliberately dishonest; they made old and probably uncollectible ac-

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\(^{89}\) 278 N.Y. 104, 15 N.E.2d 416 (1938).
counts appear good by causing payments to be made to Pelz-Greenstein, Inc. by another corporation owned by themselves. (This made it appear as if the debtors had been paying their debts.) Plaintiff's complaint was based on allegations of fraud, alleging that many items in the balance sheet were fraudulently misrepresented. Basically it was claimed that the company's receivables were grossly overvalued. A block of receivables was valued at 2,000,000 dollars (representing 25 per cent of the company's assets) without disclosure that over 768,000 dollars of these accounts were stagnant. The accountants informed their client of the inactive condition of these accounts in their long-form report. Another block of receivables was valued at 215,125 dollars although the books showed on their face that many of these accounts had been inactive for years. The accountants also informed their client of the condition of these accounts in the long-form report. The accountants attempted to justify their action as to these latter accounts on the ground that the company's treasurer informed them that these accounts were amply secured.

At the conclusion of the plaintiff's case in the trial court, the defendants moved to dismiss. The judge reserved decision on this motion whereupon the defendants rested without calling any witnesses. The case was submitted to the jury which found for the plaintiff. The trial judge set aside the verdict, and directed a verdict for the defendants. The appellate division unanimously affirmed. The court of appeals in a four to two decision reversed and granted a new trial, holding that as a matter of law, the plaintiff's evidence was sufficient to enable the jury to find that the defendants were grossly negligent, from which they could infer fraud.

The court of appeals speaking through Judge Finch reiterated principles laid down in the Ultramares case, which it stated as follows:

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. . . . In other words, heedlessness and reckless disregard of consequences may take the place of deliberate intention.90

The court concluded that there was abundant evidence from which a jury could find that the defendants knew facts which vitally affected the financial worth of their client and which the defendants concealed

90 Id. at 112, 15 N.E.2d at 418-19.
on the condensed balance sheet, but disclosed to their client alone in the long-form report. From this evidence, the jury might reasonably have drawn the inference that the accountants had no genuine belief in the figures in the condensed balance sheet to which they certified.

The court was disturbed by the fact that the accountants accepted the client's statement that certain of the receivables were amply secured without any verification:

It appeared on the face of the books that there had been no realization upon this security for years . . . . If an accountant may disregard a situation which indicates substantial losses because he is informed by the person whose books are being examined that there is adequate security, the balance sheet issued by the accountant, by its failure to point this out, contains a misrepresentation. The very purpose of the bank in seeking the balance sheet prepared by the accountant is to check any possible fraud on the part of the person seeking the loan.\(^\text{91}\)

But the court seemed most disturbed by the fact that the accountants issued two reports, a condensed one for distribution to creditors containing an unqualified opinion, and a long-form one issued only to their client explaining the items in the condensed report.

These accountants . . . sent to Pelz-Greenstein the certified balance sheet, with ten additional copies, knowing that it was to be used to obtain credit . . . . Not until thirty days later did the accountants send to Pelz-Greenstein a letter of explanation of this balance sheet, and then apparently only one copy. So important was this covering letter in the minds of defendants that, although the balance sheet attached to the covering letter was in other respects substantially identical with the original balance sheet, it contained the following notation, which did not appear at all on the original balance sheet released thirty days earlier: "This balance sheet is subject to the comments contained in the letter attached to and made a part of this report." . . .

The above act of the accountants . . . was itself gross negligence and an important piece of evidence raising an inference of fraud.\(^\text{92}\)

The court also was unimpressed with the fact that the defendant did not call any witness "although there would naturally be available the men who prepared or supervised the preparation of the working papers or the certified balance sheet and experts to refute the testimony offered by the experts called by the plaintiff."\(^\text{93}\)

The State Street case demonstrates (1) the coexistence of a condensed report and long-form report is dangerous from an evidentiary standpoint; (2) information supplied by the client should be

\(^{91}\) Id. at 118-19, 15 N.E.2d at 421-22.

\(^{92}\) Id. at 113-14, 15 N.E.2d at 419-20.

\(^{93}\) Id. at 111, 15 N.E.2d at 418.
independently verified; (3) from an evidentiary standpoint, defendant-accountants should take the stand and defend their work.

Liability Under Federal and State Legislation

Federal Statutes

The common law liability of accountants to third parties for negligence has been substantially expanded by the enactment of the Federal Securities Act of 1933. This act regulates the offering of securities for sale to the public through the use of the mails or in interstate commerce. Its main purpose is to insure that significant facts about a security are made available to investors. The act requires the public filing of a registration statement with the Securities and Exchange Commission and the delivery to each prospective investor of a prospectus which contains most of the data incorporated in the registration statement. Included in the registration statements are the relevant financial statements of the issuer of the securities, which are required to be certified by independent public accountants (usually certified public accountants). The act provides that if any part of the financial statements contained in the registration statement (1) contains an untrue statement of a material fact or (2) omits a material fact required to be stated therein or necessary to make the statements therein not misleading, the purchaser of the security may sue the accountant. The plaintiff does not have to prove (1) that the accountant was negligent or fraudulent in certifying the financial statements involved, (2) or that he relied upon the statement (or even read it), (3) or that the loss suffered was the proximate result of the false statement. Once the plaintiff has established the falsity or misleading character of the financial statements, the burden of proving lack of negligence or fraud is shifted to the accountant. The accountant to escape liability must prove that he had, after reasonable investigation, reasonable ground to believe and did believe that the financial statements to which he certified, were true.

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These provisions have been justified by the assumption that the price of a security in the open market is affected by the contents of the registration statement, and that therefore in the event of a material error in the statement, any purchaser is at least indirectly damaged, whether or not he has read or relied upon the statement. Further, it would be difficult for a plaintiff to prove that the loss was attributable to the misrepresentation in the financial statement, to the exclusion of the innumerable causes of price fluctuation. See Douglas & Bates, Federal Securities Act of 1933, 43 Yale L.J. 171, 174 (1933).

The Securities Act of 1933 relates only to initial offerings of securities. A more recent statute, the Securities Exchange Act of 1934, relates generally to the regulation of securities traded on the securities exchanges. It provides for the filing of annual reports with the Securities and Exchange Commission, including financial statements certified by independent public accountants. The liability of the accountant for misleading or false statements is not as broad as in the 1933 Act. The plaintiff must prove his reliance upon the financial statement and prove damages that were caused by such reliance. The accountant is given the statutory defense "that he acted in good faith and had no knowledge that such statement was false or misleading." Thus, it appears that the plaintiff must prove "scienter."

The civil remedies under the Federal Securities Act do not apply to creditors other than bondholders. Very few cases against accountants have been reported under the Federal Securities Acts.

State Statute

Under the authority of the Business and Professions Code, the California State Board of Accountancy enacted a rule of professional conduct which provides in part:

58. Expressing Opinions. (a) Whenever a certified public accountant or public accountant allows his name to be associated with financial statements he shall do one of the following:

(1) Express an unqualified opinion;
(2) Express a qualified opinion;
(3) Disclaim an opinion on the statements taken as a whole;
(4) Disclose that the statements have been prepared without audit.

(b) In order to express an unqualified opinion a certified public accountant or public accountant shall acquire, by the application of the necessary auditing procedures, in accordance with generally accepted auditing standards, sufficient information to warrant such opinion.

If an accountant through carelessness violates rule 58, does this constitute negligence "per se" of the character that would permit an

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101 For detailed regulations relating to the accountants' certification of financial statements and their required form and content, see 17 C.F.R. § 210 (1949).
102 For a general discussion of accountants' liability under the federal securities acts, see RAPPAPORT, S.E.C. ACCOUNTING PRACTICE AND PROCEDURE, ch. 23 (1963); LOSS, SECURITIES REGULATIONS 1722-27, 1732-34, 1864-65 (1961).
103 CAL. BUS. & PROF. CODE §§ 5010, 5018.
104 16 CAL. ADM. CODE § 58 (as amended 1961).
injured third-party lender or investor to recover from the accountant? It is established law that the violation of a statute or ordinance constitutes negligence as a matter of law, or “per se,” if there is no legally sufficient justification, if the person harmed is a member of the class intended to be protected by the particular regulation and if the harm is of the kind the applicable regulation is designed to prevent. For whose benefit was rule 58 enacted? The statutory authority under which rule 58 was enacted provides that the California State Board of Accountancy may “by regulation, prescribe, amend or repeal rules of professional conduct appropriate to the establishment and maintenance of a high standard of integrity and dignity in the profession.”

Thus, it appears that the legislative intent was primarily to benefit the accountants as a professional class by establishing the highest standards of conduct for their members. There are indications, however, that the specific intent behind rule 58 may have been to benefit the lending or investing public. The State of California’s Department and Professional Standards has stated that:

The purpose of Rule 58 is to enable credit grantors, stockholders, and others who receive financial statements to determine the extent to which they may be relied upon.

And:

In addition to helping public readers of financial statements, compliance with Rule 58 will also aid the licensee. Such compliance will limit his civil liability because he will have given a clear-cut, definitive disclosure as to the scope of his examination.

The question remains: does rule 58 enlarge the scope of the accountants’ liability to third parties?

Conclusions

If an accountant, in performing an audit for his client, misrepresents the latter’s financial condition, a third party who is economically

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105 California Dep’t of Professional & Vocational Standards, Notice to Licensees Concerning Rule 58 of the Rules & Regulations of the State Board of Accountancy (1962).
106 Id. at 4.
107 Id. at 10.
108 In Biakanja v. Irving, 310 P.2d 63, 68, vacated, 49 Cal. 2d 647, 320 P.2d 16, the court stated “A regulatory statute is enacted for the benefit of those who might be injured in the absence of such regulation.” The court held that section 6125 of the Business and Professions Code (prohibiting practice of law without a license) was enacted to protect the public. See generally 44 Calif. L. Rev. 403 (1956).
harmed by his reliance upon that misrepresentation may recover dam-
age from the accountant, provided he falls within the category of those persons to whom an accountant owes a duty. The action may be based either on deceit or negligence. In an action for deceit, the modern rule as applied in the Ultramares and State Street cases, is that there is a duty to avoid making fraudulent statements which one might reasonably foresee will induce creditors or investors to act to their loss. In other jurisdictions, including California, the scope of liability for fraud appears limited to those persons in whom the accountant intended to induce reliance and who do rely in the manner intended. However, the Biakanja case, although in terms going no farther than to make a negligent performer of a contract liable to a third party, may lead to an expansion in the scope of liability of the fraudulent representor. The court’s discussion of the factors involved in imposing negligence liability indicates a liberal trend which should ultimately lead to an expansion of liability for the conscious wrongdoer.

In an action for negligence, lack of privity is no longer a valid defense. The old common law rule, that there is no duty of care upon a defendant to avoid economic loss to a plaintiff not in privity, was repudiated in New York by the Glanzer case and in California by the Biakanja case. Although there is a duty to avoid economic loss, its scope is narrow and uncertain. The duty of care to avoid negligent misrepresentation is not so broad as to extend to any persons who might foreseeably rely on the representation. The accountant’s duty does extend, however, to a specific person (or class of persons) for a specific transaction (or class of transactions). Because the test of duty is that the accountant know not only the person or class of persons who may rely on his report, but also the purpose for which the report is to be used, a third party should obtain the auditor’s report directly from the accountant, informing him of the purpose for which it is required. In this manner, the third party should come within the accountant’s scope of duty, and in the event he does not receive a competent report, he should be able to maintain an action in negligence.

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100 Supra note 82.
101 Supra note 84.
110 Supra note 84.
111 Seavey, Caveat Emptor as of 1960, 38 Texas L. Rev. 439, 440 n.7 (1960).
112 Supra note 43.