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Minn. L. Rev. Editorial Board

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successful. If a stronger restriction is placed on the present freedom to search without a warrant, the discarding of the Rule will be a small loss to criminal constitutional law.

Securities Regulation—Torts: Accountant's Liability for Nondisclosure

Early in 1964 Yale Express System, Inc. engaged defendant—accountants to audit the financial statements that the corporation intended to include in its annual stockholders' report. Shortly thereafter defendant also undertook to conduct "special studies" of the corporation's past and current income and expenses. On March 31, 1964, defendant, acting as an independent public accountant, certified the figures contained in the financial statements. On April 9, 1964, the corporation issued the annual report containing this certification, and shortly thereafter filed a report with the Securities and Exchange Commission (SEC) that also contained the certified figures. However, defendant subsequently discovered that the figures certified in the annual report were substantially false and misleading, but failed to disclose this discovery until the results of the "special studies" were released on May 5, 1965. Plaintiffs, who had purchased securities at a false and inflated price in reliance upon the corporation's annual report, brought suit for damages, alleging, inter alia, that defendant was liable for fraud and deceit both at


1. Yale was required to have its annual report certified by an independent public accountant since its securities were registered on a national stock exchange. Securities Exchange Act § 13(a)(2), 48 Stat. 894 (1934), as amended, 15 U.S.C. § 78m(a)(2) (1964).


3. In the capacity of an independent public accountant, an accountant has a primary obligation to the public investors. Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 670-71 (1957); McKesson & Robbins, SEC Accounting Release No. 19, at 30 (1940). However, in handling the corporation's special studies, defendant acted as a dependent public accountant whose primary obligation was to its employer. Defendant thus faced conflicting and mutually inconsistent obligations. 286 F. Supp. at 183.

common law and under section 10(b) of the Securities Exchange Act of 1934⁵ and Rule 10b-5⁶ promulgated thereunder for failure to immediately disclose the post-certification discovery of the report's falsity.⁷ Defendant moved to dismiss for failure to state a claim upon which relief could be granted. The Federal District Court for the Southern District of New York held that plaintiffs were entitled to prove their action either at common law or under section 10(b) and Rule 10b-5.⁸ Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

Although the common law action of deceit existed as early as 1201,⁹ the greater part of the law that has developed has not been particularly applicable to the relatively modern practices of public securities exchanges.

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5. Section 10(b) provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
   * * * * *
   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

6. Rule 10b-5 provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means of 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. 17 C.F.R. § 240.10b-5 (1967) [hereinafter cited as Rule 10b-5].

7. Plaintiffs also alleged that defendants were liable (1) under § 18 of the Exchange Act, 48 Stat. 897 (1934), as amended, 15 U.S.C. § 78r (1964), (2) under § 10(b) of the Exchange Act and Rule 10b-5 for failure to disclose the falsity contained in Yale's interim reports, and (3) under § 10(b) and Rule 10b-5 for "aiding and abetting" Yale by encouraging the use of Yale's own figures, allegedly known to be false.

8. The court summarily rejected the motion to dismiss the portion of the complaint alleging a § 18 violation because it involved purely a factual dispute. 266 F. Supp. at 189. The court also held that although it appeared that no cause of action existed as to the defendant's actions involving the interim statements, plaintiffs should have a chance to further develop the facts through discovery. 266 F. Supp. at 194-97.

accountancy and securities floatation. Rather than establishing a comprehensive treatment of fraud in these areas, the courts have applied general contract and tort law. The results have been an incorporation of uncertain subjective standards and common law limitations inappropriate to modern practices.

The original action of deceit was limited to direct parties to a transaction and required a showing of intent. Thus a merely negligent misrepresentation was not actionable. In addition, since the action of deceit developed at a time when business philosophy emphasized the individual's freedom of contract, the doctrine of caveat emptor was instrumental in curtailing liability for nondisclosure. Relief was limited to cases involving an affirmative misrepresentation. Finally, although common

11. One element of a deceit cause of action has traditionally been intent to defraud. See note 14 infra. In numerous situations proof of a defendant's intent is hardly possible with any degree of certainty. Similarly, whether plaintiff's reliance on defendant's statement was justified is determined partly by an examination of the individual's own mental capacity and knowledge. W. Prosser, supra note 9, at 732.
12. See Shulman, supra note 10, at 228-42, for a thorough discussion of the limitations of the common law.
13. See, e.g., Roswel v. Vaughan, 79 Eng. Rep. 171 (Ex. 1607). The best explanation for this limitation is that the earlier courts probably considered a deceit action to be appropriate only in cases involving contractual relations. W. Prosser, supra note 9, at 699.
14. Intent, in this sense, is an intent to induce reliance on a misleading impression. The crucial element is the state of the speaker's mind, and an honest belief in the truth of a representation was generally a good defense. See Derry v. Peek, 14 App. Cas. 337 (1889). See generally W. Prosser, supra note 9, at 715-19. The other elements of the cause of action include the defendant's false representation of a material fact, plaintiff's justifiable reliance, and damage to the plaintiff. See, e.g., C.W. Denning & Co. v. Suncrest Lumber Co., 51 F.2d 945 (4th Cir. 1931); Wishnick v. Frye, 111 Cal. App. 926, 245 P.2d 532 (1952).
17. See H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933). The President's demand to Congress then was "let the seller also beware."
18. See Crowell v. Jackson, 53 N.J.L. 656, 23 A. 426 (1891); Peek v. Gurney, [1873] L.R. 6 H.L. 377; Keates v. The Earl of Cadogan, 138 Eng. Rep. 234 (C.R. 1851). This treatment is similar to the distinctions made by the courts between nonfeasance and misfeasance. Thus, since no liability existed for a failure to act in normal circumstances, complete silence would not be actionable. But, just as liability could be imposed on an actor for action undertaken but not completed, so also would a
law remedies other than a deceit action presented promising alternatives,\textsuperscript{19} in practice, the remedies were greatly restricted.\textsuperscript{20} Faced with these precedents, the courts were forced either to leave wronged investors with inadequate remedies or to make exceptions to fit the new business practices of the twentieth century, often leaving the law in a confused state in the process.\textsuperscript{21}

In an attempt to fill the gap left by inadequate common law remedies\textsuperscript{22} and to give direction to the law, Congress passed the Securities Act\textsuperscript{23} and the Exchange Act.\textsuperscript{24} As a result of these Acts the duty in securities transactions of such experts as accountants, previously limited solely to the employer, was ex-


\textsuperscript{20} In a rescission action, plaintiff was required to be able to return the certificates, e.g., Sedden v. North E. Salt Co., [1905] 1 Ch. 326, and was subject to such defenses as waiver, e.g., Brennan v. National Equitable Inv. Co., 247 N.Y. 486, 160 N.E. 924 (1928), and laches, e.g., Maginess v. Western Sec. Corp., 38 Cal. App. 56, 175 P. 277 (1918), and was faced with problems of privity. See generally Shulman, supra note 10, at 231–32.

Similarly, in a warranty action, the remedy was strictly limited when applied to securities transactions. See Henderson v. Plymouth Oil Co., 13 F.2d 932 (W.D. Pa. 1926) (required to show intent to warrant); Goodwyn v. Folds, 30 Ga. App. 204, 112 S.E. 335 (1923); Burwash v. Ballou, 230 Ill. 34, 82 N.E. 355 (1907) (no warranty implied as to quality or value of stock); Heilbut v. Buckleton, [1913] A.C. 30.

\textsuperscript{21} The privity doctrine, for example, was first abandoned as to deceit in Pasley v. Freeman, 100 Eng. Rep. 450 (K.B. 1789). Confusion exists when courts attempt to extend the \textit{Pasley} rule to cases of merely negligent misrepresentation. Compare Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922), with Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164. Thus, an accountant was liable solely to his employer for a negligent misrepresentation. In the leading case of \textit{Ultramares} v. Touche, Niven & Co., 255 N.Y. 170, 194 N.E. 441 (1931), the court further confused the situation by ruling that negligence sufficiently gross would constitute actionable deceit, and the accountant, in this case, would then be liable to third parties.

\textsuperscript{22} See Shulman, supra note 10, at 227; \textit{Prospects}, supra note 19, at 1123.


tended to include the investing public as well.\textsuperscript{25} Defrauded investors were allowed to recover under specific statutory provisions\textsuperscript{26} rather than under the common law. However, these new remedies still did not provide investors with complete protection.\textsuperscript{27} Consequently, the SEC published rules pursuant to these Acts in an attempt to provide more complete protection. Included in this promulgation was Rule 10b-5 which was published in conformity with section 10 (b), the Exchange Act's general "antifraud" provision.\textsuperscript{28}

Although section 10 (b) does not specifically provide for civil liability, the courts have consistently construed it to contain an implied cause of action.\textsuperscript{29} In addition, the courts have imposed higher standards of disclosure in section 10 (b) and Rule 10b-5 actions than originally imposed by the common law.\textsuperscript{30} The greatest limitation still facing the defrauded investor has been the attempt by some courts to read into section 10 (b) a requirement of privity,\textsuperscript{31} but this view has increasingly been re-


\textsuperscript{26} See Securities Act §§ 11, 12(1)-(2); Exchange Act §§ 9(e), 18(a). Section 11(a)(4), for example, specifically provides that an accountant may be liable for any errors or omissions in a registration statement that he has certified. See also Prospects, supra note 19, at 1121.

\textsuperscript{27} See note 5 supra. See also Prospects, supra note 19, at 1121.


jected in modern actions.\textsuperscript{32}

Although the securities Acts thus made certain practices, including forms of nondisclosure,\textsuperscript{33} actionable, only a few cases have arisen involving nondisclosure of after-acquired information.\textsuperscript{34} Commentators have suggested that anyone who has made a statement which he knows others are relying on must disclose any after-acquired information showing the original statement to be false or misleading,\textsuperscript{35} but the courts have not uniformly accepted this view. One court held an accounting firm liable when, one month after issuing a report on a company's financial position, the accountants presented, to the company only, a detailed report which indicated that the original report did not present a true picture of the company's financial position.\textsuperscript{36} However, another court ruled that an accountant is under no duty to disclose developments occurring after certification.\textsuperscript{37}

In the instant case, the court rejected the accountant's claim that its duty to the investing public terminated once it certified the relevant balance sheets. Recognizing that in modern business practices the doctrine of\textit{caveat emptor} no longer justifies a defendant's nondisclosure of essential information, the court extended an accountant's potential liability in two ways. First, at common law,\textit{Fischer} dispensed with any requirement


\textsuperscript{34} E.g., Shonts v. Hirliman, 28 F. Supp. 478 (S.D. Cal. 1939).

\textsuperscript{35} S. Levy, supra note 25, at 48 (suggesting that an accountant should be under a duty to disclose events occurring after certification); W. Paosser, supra note 9, at 711.

\textsuperscript{36} State St. Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416 (1938).

\textsuperscript{37} Shonts v. Hirliman, 28 F. Supp. 478 (S.D. Cal. 1939). The decision has been severely criticized. 3 L. Loss, SECURITIES REGULATION 1731-34 (2d ed. 1981); Bradley, \textit{Auditor's Liability and the Need for Increased Accounting Uniformity}, 30 LAW & CONTEMP. PROB. 898, 914 (1965); Rappaport, \textit{Accountants' Responsibility for Events Occurring After the Statement Date}, 95 J. ACCOUNTANCY 332, 333 (1953); 38 MICH. L. REV. 1103 (1940); 50 YALE L.J. 98 (1940).
of privity or financial interest on the part of defendant and, more importantly, permitted the action to proceed without any allegations or proof of intent to defraud.\(^\text{38}\) Second, by allowing the statutory action, the court expanded the class of potential section 10(b) defendants,\(^\text{39}\) indicating the trend away from the older authority requiring an allegation of gain on the part of defendant\(^\text{40}\) or a "semblance of privity."\(^\text{41}\) The court did, however, recognize that at this stage of the litigation it would be improper to enunciate the exact extent of the accountant's expanded liability.\(^\text{42}\)

In ruling that a common law cause of action exists, the \textit{Fischer} court has shifted the emphasis from the inappropriate concept of privity and the traditional, though often fictional, search for "intent" to newer, more objective standards, namely, the impact of the nondisclosure on investors and the duty imposed by the demands of "good faith and common honesty."\(^\text{43}\) Under this impact test defendants will be held liable if the plaintiff's damage results from reliance on the misrepresentation, whether or not defendants were actually a party to the transaction from which the damage arose.\(^\text{44}\) Under the impact test the \textit{Fischer} facts are clearly actionable. The accountant made a representation that it knew others would rely on, and the subsequent nondisclosure of the after-acquired information made that reliance detrimental. But the adoption of this impact test in turn necessitates the abandonment of subjective considerations of intent. If the basis of responsibility is to be the impact of the misrepresentation, it should be irrelevant whether

\(^{38}\) Intent to defraud is one of the standard requirements of a deceit action. See note 14 supra.

\(^{39}\) 266 F. Supp. at 190.


\(^{41}\) See authorities cited note 31 supra.

\(^{42}\) Among the questions the court explicitly recognized but left unanswered were the length of time the duty to disclose after-acquired information lasts, to whom disclosure should be made, and how such disclosure should be made. 266 F. Supp. at 188-89.

\(^{43}\) \textit{Id.} at 186, 188.

\(^{44}\) Parties to a business transaction have long been under a common law duty to disclose information acquired subsequent to a representation but prior to the consumation of the transaction. \textit{See, e.g.}, Fitzgerald v. McFadden, 88 F.2d 639 (2d Cir. 1937); Loewer v. Harris, 57 F. 368 (2d Cir. 1935); \textit{Restatement (Second) of Torts} § 551(2)(e) (Tent. Draft No. 12, April 27, 1966). The \textit{Fischer} court found no reason for distinguishing between the two situations since the ultimate result of the misrepresentation is the same. 266 F. Supp. at 186.
or not defendant intended to convey a false impression. By requiring
the accountant to conform to the standard of "good faith and common
honesty," the court has provided a criterion capable of objective
determination and has taken a logical step toward expanding an
accountant's common law liability.

The similar extension of section 10 (b) and Rule 10b-5 liability is
also a logical expansion. It furthers the underlying theme in federal
securities regulation of full disclosure. The accountant's duty to
correct a mistaken impression is at least as great as that of an
attorney, and the SEC has ruled that an attorney's failure to
correct a report to the Commission that he knew to be false and
misleading constituted unethical and improper professional
duty. A requirement of privity, gain, or conspiracy would prevent
drawing the logical conclusion of this analogy and also unduly
constrict the broad protection desired. The rejection of this
requirement and imposition of liability on the accountant for
nondisclosure of after-acquired information will not only further
the contemplated statutory protection, but will also increase the
investing public's confidence in the accountant's representations in
general.

Although this case may never reach a final adjudication,
the court has nevertheless provided a foundation for the
extension of accountants' liability. In arriving at a final decision,
the court will have to balance the conflicting interest of the public
in protecting investors who rely on professional representations
against the possibility of disproportionately great liability for
accountants. Fischer seems to indicate that the balance is in
favor of the investors and, indeed, this has been the trend in

45. "Good faith and common honesty" is the standard long imposed
on parties to a contract in a normal business transaction. See, e.g.,
Loewer v. Harris, 57 F. 368, 373 (2d Cir. 1893).
46. Unfortunately, the court weakened its holding that intent need
not be shown by deciding that if that rationale were unacceptable intent
should alternatively be presumed. 266 F. Supp. at 188.
47. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186
(1963); Prospect, supra note 19, at 1120. See also Wilko v. Swan, 346
U.S. 427, 430–31 (1953); Columbia Gen. Inv. Corp. v. SEC, 285 F.2d 559
(5th Cir. 1959); Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir.
51. See S. Lev, supra note 25, at 4–5. See also Statement by Car-
man Blough, Research Director of the American Institute of Account-
ants, quoted in Carey, Editorial, 82 J. ACCOUNTANCY 449, 453 (1946).