CHAPTER 5A

Accountants' Liability Under the Federal Securities Laws

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Summary of this Chapter

The federal securities laws contain various provisions under which civil and criminal liability may potentially be imposed upon an accountant for professional misconduct, including Sections 11, 12(2) and 17(a) of the Securities Act of 1933 (the“Securities Act”) and Sections 10(b), 14 and 18 of the Securities Exchange Act of 1934 (the “Exchange Act”). Before the potential liability of accountants under each of these statutory provisions is analyzed, it is useful to provide an historical background concerning accountants’ liability under the federal securities law.

§ 5A.01 Introduction

[1] Prior to the 1960’s—Hints That Accountants Faced Potential Liability Under the Federal Securities Laws

The potential imposition of civil liability against accountants under the federal securities laws is a relatively new development. Until roughly the latter half of the twentieth century, private parties holding grievances against accountants were essentially relegated to whatever state law causes of action were available for “fraud,” “negligence” or “breach of contract.”

Even when private litigants relied on state law, they faced significant hurdles in bringing claims against accountants. The most significant hurdle for parties other than the accountant's client has been securing "standing" to sue, although this limitation has eased in more recent decades.

More particularly, prior to approximately the last 40 years, accountants were largely insulated from liability in lawsuits brought by parties other than their clients (*e.g.*, lenders, trade creditors and investors) who claimed injury due to the accountants' alleged negligent conduct. The issue of whether a non-client may sue an accountant for professional negligence was first addressed by the New York State Court of Appeals in 1931 in *Ultramares Corp. v. Touche, Niven & Co.*[1] The court in that case recognized that the risk to the profession of exposure to claims from anyone who could conceivably rely upon a financial statement, as to which an accounting firm has expressed an opinion, was potentially enormous.[2] Accordingly, the court determined to limit liability for professional negligence to only those in contractual privity with the firm or in a relationship closely approximating that of privity. *Ultramares* expressly noted that the defense of privity would be applicable only to negligence claims and not to claims where the firm's level of misconduct would support a claim of fraud.

Subsequently, commencing generally in the 1960's, various state courts (and federal courts applying state law) began to question the continued propriety of the "privity" defense. Since then, three standards (none of which require strict privity) have evolved as the courts continue to grapple with the issue:

(a) Based on continued adherence to the basic principles of *Ultramares*, the most demanding standard requires the existence of a relationship between the plaintiff and the accountant which is close to that of privity;[3]

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[1] 255 N.Y. 170, 174 N.E. 441 (N.Y. 1931).

[2] In this regard, the *Ultramares* court emphasized that lifting the shield of privity would unfairly "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class." 255 N.Y. at 179, 174 N.E. at 444.

[3] Since the *Ultramares* decision, courts which had adhered to its basic principles have refined the privity concept to further define the contours of an accountant's liability to third-parties. In Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 551, 483 N.E.2d 110, 188, 493 N.Y.S.2d 435, 443 (N.Y. 1985), the New York Court of Appeals held that a noncontractual party could not hold accountants liable for negligence unless three prerequisites are met:

(1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes;

(2) in the furtherance of which a known party or parties was intended to rely; and

(3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties reliance.

The third prong of the test raises the question of the nature and extent of the "conduct on the part

(b) "Foreseeability," the least restrictive standard, which permits claims to be asserted against an accounting firm by all reasonably foreseeable third-persons who might rely on reports prepared by it;[4] and

(c) The Restatement of Torts standard which permits a negligence claim against an accountant to be asserted by a third party who is one of a limited group of persons whom the accountant knew might rely on the accountant's report.[5]

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of the accountants" linking them to the third-party which would be sufficient to meet the test. This issue was addressed by the New York Court of Appeals in Security Pacific Bus. Credit, Inc. v. Peat Marwick Main & Co., 79 N.Y.2d 695, 586 N.Y.S.2d 87, 597 N.E.2d 1080 (N.Y. 1992), where the only linking "conduct" was a single telephone conversation between the accountant and the lender, initiated by the lender in which the lender announced its intended reliance and made certain inquiries regarding the audit then in progress. The court held that this was not sufficient to establish the necessary link and dismissed the claim.

Various courts outside New York have followed the general approach of *Credit Alliance*. *See, e.g.*, Toro Co. v. Krouse, Kern & Co., 827 F.2d 155 (7th Cir. 1987) (applying Indiana law); Colonial Bank of Alabama v. Ridley & Schweigert, 551 So. 2d 390 (Ala. 1989); Twin Mfg. Co. v. Blum Shapiro & Co., 602 A.2d 1079 (Conn. Super. Ct. 1991).

[4] The foreseeability standard abandons any notion of privity and exposes accountants to potential negligence liability to a spectrum of potential claimants limited only by the requirement that the claimant fall within a class of potential claimants who might reasonably be expected to rely on the financial statement in question. Only two states: (i) Wisconsin; *see* Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 335 N.W.2d 361 (1983); and (ii) Mississippi; *see* Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987); currently follow this approach. New Jersey which had been a leading proponent of the foreseeability standard; *see* H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 351, 461 A.2d 138, 153 (1983); statutorily reversed itself and adopted a near privity standard similar to that of New York; *see*, N.J. STAT. ANN. § 2A:53A-25 (West Pocket Part 1998) and E. Dickerson & Son, Inc. v. Ernst & Young, LLP, 179 N.J. 500, 846 A.2d 1237 (N.J. 2004) (interpreting New Jersey's "near privity" statute). In the case of banks, the statute requires as a predicate to standing that the accountant acknowledge the bank's intended reliance and the client's knowledge of that reliance in writing.

[5] The restatement standard provides that liability is limited to loss suffered "(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction." Restatement (Second) of Torts § 552 (ALI 1977). Thus, the Restatement approach does not require that the accountant be aware of a particular person's reliance, but rather permits liability if the person is part of a "limited group" of persons (whether or not specifically identified to the accountant) who the accountant intends or expects to be influenced by the information supplied. Unlike the test under *Credit Alliance*, the accountant need not be affirmatively linked to the third- party by its own specific conduct. California, previously a 'foreseeability" state, adopted the Restatement standard in Bily v. Arthur Young & Co., 3 Cal. 4th 370, 11 Cal. Rptr.2d 51, 834 P.2d 745 (1992), in connection with negligent misrepresentation claims. *See also, e.g.,* Scottish Heritable Trust, PLC v. Peat Marwick Main & Co., 81 F.3d 606 (5th Cir.) (applying Texas law), *cert. denied*, 519 U.S. 869 (1996); Nycal Corp. v. KPMG Peat Marwick LLP, 426 Mass. 491, 688 N.E.2d 1368 (1998); Boykin v. Arthur Andersen & Co., 639 So. 2d 504

Although private litigation against accountants was long subject to the type of limitations just discussed, the Securities and Exchange Commission (the "SEC" or "Commission") provided early hints of the substantial expansion of an accountant's potential liability to third parties (*i.e.*, parties other than his or her client), beyond the bounds set by *Ultramares*, which later began during the 1960's under the federal securities laws. For example, in 1939, only a few years after the enactment of the Securities Act and the Exchange Act, the public learned that the consolidated financial statements of McKesson Robbins ("McKesson"), a substantial pharmaceutical company, were fraudulent because millions of dollars of assets reported on McKesson's consolidated balance sheet were only traceable to a sham subsidiary which did not exist. The accountant who audited McKesson's consolidated financial statements did not discover the fraud. The SEC (which had just recently been established by the Exchange Act) conducted an investigation of the McKesson fiasco. Foreshadowing the future expansion of accountants' liability under the Securities Act and the Exchange Act, the SEC emphasized in its McKesson report that while McKesson's auditors satisfied their then existing professional responsibilities, the auditor "must now recognize fully his responsibility to *public investors* by including the activities of the management itself within the scope of his work and *by reporting thereon to investors*."[6]

In 1957, in *In re Touche, Niven, Bailey & Smart*[7] the SEC reiterated its position that the responsibility of an independent public accountant based on its certification of a company's financial statements "is not only to the client who pays his fee,

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(Ala. 1994); Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592 (Tenn. 1991); First Fla. Bank, N.A. v. Max Mitchell & Co., 558 So. 2d 9 (Fla. 1990); Badische Corp. v. Caylor, 257 Ga. 131, 356 S.E.2d 198 (1987); Nycal Corp. v. KPMG Peat Marwick LLP, 426 Mass. 491, 688 N.E.2d 1368 1998); Haddon View Inv. Co. v. Coopers & Lybrand, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982); Loop Corp. v. McIlroy, 2004 Minn. App. LEXIS 1146 (Minn. Ct. App., Oct. 5, 2004); Law Offices of Lawrence J. Stockler, P.C. v. Rose, 174 Mich. App. 14, 436 NW.2d 70 (1989); Blue Bell v. Peat Marwick, Mitchell & Co., 715 S.W.2d 408 (Tex. App. 1986).

Some states adhere to a variation of the Restatement approach through statutes that apply what is known as the "primary intent rule." *See, e.g.*, 225 ILL. COMP. STAT. 450/30.1 (2005); KAN. STAT. ANN § 1-402 (2005); MICH. COMP. LAWS § 600.2962 (2005). As a general matter, under these statutes, an accountant's liability to a non-client based on negligence may arise when the client has informed the accountant "in writing" that its "primary intent" in retaining the accountant was for the purpose of benefiting or influencing the non-client. Absent any writing, it may still be possible to establish an accountant's liability to a non-client if the plaintiff can otherwise show that the client's "primary intent" in retaining the accountant was to benefit or influence the non-client and that the accountant had knowledge of this intent. *See, e.g.,* Freeman, Freeman & Salzman, P.C. v. Lipper, 349 Ill. App. 3d 677, 812 N.E.2d 562 (Ill. App. Ct. 2004) (interpreting above Illinois statute and applying the "primary intent rule").

[6] *In re* McKesson & Robbins, 1940 S.E.C. LEXIS 1528, at * 10 (Dec. 5, 1940), 11 Fed. Reg. 10918 (Dec. 5, 1940) (emphasis supplied).

[7] 1957 SEC LEXIS 1014 (Mar. 25, 1957), 37 S.E.C. 629 (1957).

but also to investors, creditors and others who may rely on the financial statements which he certifies. . . . The public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. His duty is to safeguard the public interest, not that of his client."[8]

[2] The 1960's—The Birth of Accountants' Liability Under the Federal Securities Laws

The emergence of accountants' liability under the federal securities laws as a significant phenomenon began during the 1960's. The opening took hold with the acceptance by federal courts of an implied private right of action under Section 10(b) of the Exchange Act.[9] This section soon became the primary vehicle for the potential liability of accountants (and others) under the federal securities laws. Although the existence of a private cause of action under Section 10(b) became axiomatic,[10] the Supreme Court eliminated any doubt as to this question in 1971 in *Superintendent of Ins. v. Bankers Life & Casualty Co.*[11]

Initially, the newly established private right of action under Section 10(b) was mainly invoked against (i) corporations whose stock was purchased or sold by aggrieved investors, (ii) corporate insiders and (iii) broker-dealers. However, during the late 1960's the federal district court's decision in *Fischer v. Kletz*,[12] which was one of the earliest actions brought against accountants under the federal securities laws, received wide attention in the legal community. In that case the court, denying a motion to dismiss, held that an accounting firm which failed to disclose that it had discovered that a client's financial statements, which it had earlier certified, were, in fact, materially false and inaccurate, could potentially be liable under Section 10(b).

It is also noteworthy that the *Fischer* court expressly refused to dismiss the 10(b) claim on the ground that no privity existed between the plaintiffs and the accountants. In that regard, the court harkened back to the language from *In re Touche Niven Bailey & Smart*[13] which stated that the responsibility of an independent public accountant "is not only to the client who pays his fee, but also

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[8] 1957 S.E.C. LEXIS 1014, at * 89 - * 91, 37 S.E.C. at 670- 71.

[9] *See e.g*,, Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Estate Counseling Serv., Inc. v. Merrill, Lynch, Pierce Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962); Boone v. Baugh, 300 F.2d 711 (8th Cir. 1962); Hooper v. Mountain States Sec. Corp, 282 F.2d 195 (5th Cir. 1960); Connelly v. Balkwill, 279 F.2d 685 (6th Cir. 1960); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951).

[10] *See* Fischer v. Kletz, 266 F. Supp. 180, 190 (S.D.N.Y. 1967).

[11] 404 U.S. 6, 13 n. 9 (1971).

[12] 266 F. Supp. 180 (S.D.N.Y.1967).

[13] 1957 S.E.C. LEXIS 1014 (Mar. 25, 1957), 37 S.E.C. 629 (1957).

to investors, creditors and others who may rely on the financial statements which he certifies."[14]

On the heels of the *Fischer* decision, in 1968 the court in *Escott v. BarChris Construction Corp.*[15] provided further impetus for the coming explosion of litigation instituted against accountants under the federal securities laws. In *Escott*, the court found an accounting firm liable to various debenture holders under Section 11 of the Securities Act (subject to certain defenses such as statute of limitations) based on its certification of false financial statements of a client which were subsequently included in a registration statement the client filed with the SEC. In essence, the court concluded that the accounting firm had failed to satisfy its duty of "due diligence" when it audited its client's financial statements.[16]

[3] The 1970's Through the 1990's—Growth and Then Restriction of Accountants' Liability Under the Federal Securities Laws

Although the potential availability of federal securities claims against accountants was not generally recognized until the end of the 1960's, once the genie had escaped, it was impossible to put it back in the lamp. During approximately the last forty years, plaintiffs have instituted thousands of lawsuits against accountants under the Securities Act and the Exchange Act. This trend was reinforced because the plaintiffs' bar increasingly recognized that large national accounting firms were potential "deep pockets" both because of their size and the substantial amount of professional liability insurance they generally carry.

While the maintenance of securities claims against accountants has been a constant since the 1970's, there have been various significant judicial and legislative developments during this time period which either expanded (mostly during the 70's and 80's) or limited (mostly during the 90's) the reach of such claims against accountants. For example:

[a] Section 10(b) Claims Cannot Be Asserted Against Accountants (or Other Defendants) Based on Merely Negligent Conduct

(Text continued on page 5A-7)

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[14] 1957 S.E.C. LEXIS 1014, at * 89 - * 91, 37 S.E.C. at 1014.

[15] 283 F. Supp. 643 (S.D.N.Y. 1968)

[16] The court's decision in United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970), which upheld criminal convictions of three accountants for violations of the Exchange Act based on their certification of false financial statements, also heralded the expansion of accountants' liability under the federal securities laws.