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NEWLY REGISTERED SECURITIES AND ACCOUNTANTS' LIABILITY TO THIRD PARTY INVESTORS UNDER THE FEDERAL SECURITIES LAW

Timothy J. Murphy*

In recent years, a substantial increase in litigation concerning independent certified public accountants and the federal securities law has resulted in extensive court interpretation as to the accountant's liability under the Securities Act of 1933¹ and the Securities Exchange Act of 1934.² This article will explore the nature and extent of the civil liability of an independent³ certified public accountant (hereafter accountant) to third party investors when his or her work is utilized by an issuer in the registration and sale of a new security.

I. SECURITIES ACT OF 1933

The Securities Act of 1933 requires full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails. It is designed to prevent frauds in the sale thereof.⁴ Section 11 expressly imposes civil liability for specific actions contravening the purposes of the Act;⁵ criminal

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1. 48 Stat. 74-95 (1933), 15 U.S.C. § 77a *et seq.* (1971).

2. 48 Stat. 88-909 (1934), 15 U.S.C. § 78a *et seq.* (1971).

3. Schedule A, 48 Stat. 88(25)-(26) (1933), 15 U.S.C. § 77aa (1971) provides that financial statements included in a registration statement filed with the Commission be certified by an independent public accountant. 17 C.F.R. § 210.2-01(b) (1974). The principle accounting guideline issued by the SEC states that the Commission will not recognize any accountant as independent who is not in fact independent and describes examples of specific circumstances in which the accountant will not be recognized as independent. *See id.*

4. 48 Stat. 74 (1933).

5. 48 Stat. 82 (1933), 15 U.S.C. § 77k (1970).

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and implied civil liability may be imposed generally under section 17.⁶

Section 11

Section 11 expressly establishes the civil liability of an accountant to third party investors for misstatements or omissions of material⁷ facts in financial statements or reports prepared by the accountant and utilized in connection with a registration statement. The plaintiff-investor need not show reliance on the misstatement or omission or that the misstatement or omission caused the decline or loss in value of the security.⁸ Nor must the investor be in privity with the accountant or prove any intentional wrongdoing by the accountant. The mere fact that the material misstatement or omission occurred will make a case for the plaintiff.

The accountant has four basic statutory defenses to section 11 liability: (1) he or she resigned before the effective date of the registration statement from the capacity as accountant and gave written notice to the issuer and to the Commission of such action stating he or she would no longer be responsible for such part of the registration statement; (2) the registration statement became effective without his or her knowledge and upon learning of its effectiveness the accountant advised the Commission as provided in (1) above; (3) the registration statement did not fairly represent the accountant's statement as expert or was not a fair copy of or extract from his or her report as expert; or (4) after a reasonable investigation the accountant had reasonable grounds to believe, and did believe at the time the registration statement became effective, that his or her statements therein were true and there was no omission to state a material fact required to be stated or necessary to make the certified statements not misleading.⁹

The fourth defense, commonly referred to as that of "due diligence," is the most widely employed. It is the only available

6. 48 Stat. 84 (1933), 15 U.S.C. § 77q (1970). Other sections of the 1933 Act pertaining to limitations of actions, jurisdiction, damages and criminal penalties most assuredly affect the appropriateness of bringing a particular action under § 11 or § 17 of the 1933 Act, but are ancillary considerations to the main issue of the accountant's liability and will not be dealt with in this article.

7. 17 C.F.R. § 230.405(1) (1972). SEC regulations define "material facts" as information as to those matters which an average prudent investor ought reasonably to be informed before purchasing the security.

8. 48 Stat. 82 (1933), 15 U.S.C. § 77k(a)(4) (1971). See *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973); *Rudnick v. Franchard Corp.*, 237 F. Supp. 871 (S.D.N.Y. 1965). However, § 77k precludes relief if at the time of acquisition the purchaser knew of such untruth or omission.

9. 48 Stat. 82 (1933), 15 U.S.C. § 77k(b) (1971).

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defense when the accountant has examined the books and records of an enterprise, expressed an opinion on (*i.e.*, "certified") the financial statements and wilfully submitted them for inclusion in the prospectus and registration statement.¹⁰ The landmark decision of *Escott v. BarChris Construction Corp.*¹¹ is the most definitive judicial treatment of the accountant's due diligence defense. *BarChris* established a minimum standard for the successful assertion of due diligence. It held that the defense will fail if the accountant has not performed the audit in accordance with generally accepted auditing standards.¹²

BarChris concerned an action by purchasers of 5½ per cent convertible subordinated fifteen year debentures of BarChris Construction Corporation. The company was in the business of constructing and installing bowling alleys. In 1961 additional working capital was needed, and the company filed a registration statement for the sale of convertible debentures. During that year, the fortunes of the bowling industry declined, primarily as a result of overexpansion. In October, 1962, BarChris filed a petition in bankruptcy. An action was brought by the purchasers of the debentures against those potentially liable under section 11, including BarChris' accountants. The action alleged that the registration statement, which became effective on May 16, 1961, contained material false statements and omissions.

Plaintiff's claims of falsities and omissions pertained to certain financial information contained in the prospectus. The prospectus included consolidated financial statements as of December 31, 1960 (with attendant explanatory notes) as well as other financial data pertaining to the period between December 31, 1960 and May 16, 1961, the effective date of the registration statement. The accountants, Peat, Marwick, Mitchell & Co. (hereafter Peat, Marwick), had performed an audit and expressed an opinion on only the financial activities through December 31, 1960. Accordingly, Peat, Marwick was potentially liable only for errors or omissions in those statements on which an opinion was expressed and not for the financial data of the period subsequent to December 31, 1960.

10. 48 Stat. 88 (1933), 15 U.S.C. § 77aa (1971) requires inclusion of certified financial statements in registration statements, and 48 Stat. 81 (1933), 15 U.S.C. § 77j (1971) requires certified financial statements in prospectuses.

11. *Escott v. BarChris Const. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

12. Professional approved standards of audit are found in AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, *CODIFICATION OF AUDITING STANDARDS AND PROCEDURES* (1972) (commonly known as "generally accepted auditing standards").

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After a detailed review of the financial facts and the financial data as presented in the prospectus, the court found there were falsities and omissions with respect to the December 31, 1960 consolidated financial statements certified by Peat, Marwick, and summarized them as follows:¹³

1. 1960 Earnings

(a) Sales

Per prospectus	\$9,165,320
Correct figure	8,511,420
Overstatement	\$ 653,900

(b) Net Operating Income

Per prospectus	\$1,742,801
Correct figure	1,496,196
Overstatement	\$ 246,605

(c) Earnings per Share

Per prospectus	\$.75
Correct figure	.65
Overstatement	\$.10

2. 1960 Balance Sheet

Current Assets

Per prospectus	\$4,524,021
Correct figure	3,914,332
Overstatement	\$ 609,689

3. Contingent Liabilities as of December

31, 1960 on Alternative
Method of Financing

Per prospectus	\$ 750,000
Correct figure	1,125,795
Understatement	\$ 375,795

Capitol Lanes should have been shown as a direct liability	\$ 325,000
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After determination and delineation of the falsities and omissions, the court proceeded to determine whether such errors were material. The average prudent investor is not, the court said, concerned with minor inaccuracies. Material facts are those which, if known by the investor, would tend to deter him from purchasing a security.¹⁴ Based on this test of materiality, the errors in the 1960 balance sheet figures, which resulted in an overstatement of current assets by \$609,689 (affecting the current ratio) and a \$325,000 understatement of lia-

13. 283 F. Supp. at 679.

14. *Id.* at 681.

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bilities (approximately \$65,000 of which should have been treated as current), were considered material. On the other hand, the misstatement of the 1960 earnings figures resulting in an earnings per share of 75 cents rather than a proper 65 cents did not, in the court's opinion, result in a material misstatement, given the speculative nature of the debentures.¹⁵ The court also felt the \$375,795 understatement of contingent liabilities as to the alternative method of financing was not material since investors would not have been deterred from buying the debentures had they known the correct amount of contingent liabilities.

Because there were falsities and omissions in the financial statements certified by Peat, Marwick, and because at least some of these errors were material, Peat, Marwick was potentially liable under section 11 of the Act. Peat, Marwick sought exoneration by asserting the statutory "due diligence" defense as provided in section 11(b)(3)(B)(i) of the Act. It alleged it had, after reasonable investigation, reasonable grounds to believe, and did believe at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

The question of "due diligence" is one that depends on the facts of each particular case. In *BarChris* the court weighed such factors as: (1) the age and experience of the senior accountant who performed the majority of the field work; (2) the failure of that senior accountant to relate conflicting or ambiguous nomenclature for the various bowling alley projects—in particular, his failure to realize that Heavenly Lanes and Capitol Lanes were two names for the same bowling alley when a review of the accounts receivable cards, corporate minutes, and job cost ledger cards should have, at least, put him on inquiry; (3) the failure of the accountant to provide an adequate allowance (reserve) for the potential uncollectibility of a \$125,000 account receivable when the age, arrearages in payments, and other such factors clearly cast doubt as to the potential collectibility of the receivable; (4) the miscomputation of contingent liabilities due to the accountant's failure to examine the

15. Bradley, *The Public Auditor*, in ACCOUNTANTS' LIABILITY 68 (J. McCord ed. 1969). Bradley suggests that the basis for the court's conclusion was that BarChris was a growth company; investors were interested in its percentage of growth which, even disregarding the overstatement, was over 200 per cent. Accordingly, the overstatement was not material to the type of investor interested in the security.

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documents which established the percentage potential liability on certain factoring transactions involving leasebacks; and (5) the insufficiency of the S-1 audit review,¹⁶ *i.e.*, the short period of time for the review (20½ hours) in relation to the overall complexity of financial activities of BarChris for the period involved, the failure of the accountant to verify answers supplied to him, his satisfaction with glib answers to his inquiries and his failure to properly perform steps of the S-1 audit program. The court concluded that Peat, Marwick had not met the burden of proof to satisfy its "due diligence" defense.¹⁷

In making its decision, the court stated that accountants should not be held to a standard higher than that recognized in their profession.¹⁸ The certifying accountants in *BarChris* were held liable because they had not performed to the auditing standards established by their own profession, *i.e.*, some auditing steps which should have been performed were not; and some auditing steps which apparently were performed did not culminate in proper adjustment or reporting of the information intended to be discovered by such auditing procedures.

Today, however, it is at least arguable that a court might no longer allow the performance of an audit in accordance with generally accepted auditing standards to be an absolute defense to section 11 liability (even assuming that the accountant did believe that the certified financial statements were true and that there was no omission to disclose a material fact). For example, in the anti-fraud areas of federal securities law litigation involving the accountant's liability, recent court decisions have held accountants to a standard higher than that of their profession.¹⁹ The professional standard challenged by the courts in these anti-fraud cases has been the American Institute of Certified Public Accountants' (hereafter AICPA) generally accepted accounting principles,²⁰ which deal with

16. 17 C.F.R. § 239.11 (1974) prescribes Form S-1 as the basic registration form under the 1933 Act. The form requires inclusion of financial information certified by independent accountants. Since the accountant's responsibility continues under 15 U.S.C. § 77k (1971) up to the effective date of the registration statement, the accountant is liable for failure to correct the data to show any adverse changes between the filing date and the effective date of the registration statement. The final review of the data is commonly referred to as the S-1 review.

17. 283 F. Supp. at 703.

18. *Id.*

19. *See, e.g.*, *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (2d Cir. 1974).

20. Professionally approved standards of accounting are contained in several publication series of the American Institute of Certified Public Accountants including Fi-

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the method of recording and reporting financial transactions. The professional standard at issue in *BarChris* and under section 11 actions dealing with the "reasonable investigation" by the certifying accountant is the AICPA's generally accepted auditing standards,²¹ which encompass the technical requirements of performing an audit and expressing an opinion on the financial information audited. Both sets of standards were established by the AICPA and are recognized by members of the accounting profession.

It has been stated that although the adequacy of generally accepted accounting principles as an absolute defense to a securities law violation has been challenged through the courts, the adequacy of generally accepted auditing standards has not and will not be challenged.²² The profession, however, cannot afford to be comforted by such a statement. The courts have already violated any inherent "sanctity" of the accounting profession's standards by finding the self-regulation of the accounting profession inadequate with respect to generally accepted accounting principles. Given an "attractive" plaintiff, it would not be surprising for a modern court to similarly reject compliance with generally accepted auditing standards as a complete defense.

In summary, the accountant's liability to third party investors under section 11 of the 1933 Act is based on an action in simple negligence against the independent accountant who misstates or omits to state a material fact. Under *BarChris*, if the accountant can meet the statutory criteria for pleading the due diligence defense by showing he or she conducted a good faith audit in accordance with generally accepted auditing standards, and, based on such audit, believed that the statements in the registration statement purporting to be made upon his or her authority as an expert were true and that there was no omission to state a material fact, the accountant can probably avoid section 11 liability. However, if a future court should feel that an otherwise properly conducted audit should have yielded information leading to the auditor's discovery of the misstatement or omission, the fact that the audit was performed in accordance with generally accepted auditing standards may be in-

financial Accounting Standards Board Statements, Accounting Principles Board Opinions and Accounting Research Bulletins.

21. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, *supra* note 12.

22. Liggio, *Expanding Concepts of Accountant's Liability*, 42 CALIF. C.P.A.Q. 18 (1974).

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sufficient to meet the burden of the accountant's due diligence defense.

Section 17

Section 17 is the general anti-fraud provision of the 1933 Act under which criminal and injunctive actions can be brought by the SEC and under which there is an implied right to civil remedy. The fraud provisions of section 17 embrace any scheme to defraud. Hence, anyone who contributes to the effectuation of a scheme with knowledge of its existence is a participant—including independent certifying accountants. Section 17 was also the model for Rule 10b-5²⁴ promulgated pursuant to section 10b of the Securities Exchange Act of 1934.

A major distinction between a section 17 fraud action and a Rule 10b-5 action is that section 17 does not apply to fraud by a purchaser of securities. Thus Rule 10b-5 can be applicable to a broader range of situations than section 17. Additionally, Rule 10b-5 has other procedural advantages over section 17 actions.²⁵ Because of the advantages of a Rule 10b-5 action the body of the law surrounding anti-fraud actions has primarily developed with regard to Rule 10b-5. Accordingly, if an action by third party investors against the accountant is brought under section 17's general anti-fraud provisions, the question and elements of fraud will be primarily guided and influenced by the case decisions which have developed under the virtually identically worded general anti-fraud provisions of Rule 10b-5 of the Securities Exchange Act of 1934.²⁶

Section 17 was the statutory basis for relief in perhaps one of the most significant cases relating to accountant's liability. The decision in *United States v. Simon*²⁷ (commonly known as the Continental Vending case) affirmed an accountant's conviction for criminal conspiracy and established that the adherence to generally accepted principles will not necessarily insulate the certifying accountant from liability for a misstatement or an omission to state a material fact if the resulting certified information does not also result in a de facto

23. 48 Stat. 84 (1933), 15 U.S.C. § 77q (1970).

24. 17 C.F.R. 240.10b-5 (1972).

25. For example, 15 U.S.C. § 77m (1970) sets a one year limitation on actions under § 17 of the 1933 Act. No statute of limitations on actions exists in the 1934 Act.

26. See text accompanying notes 32-52, *infra*, for a discussion of § 10b and Rule 10b-5.

27. *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

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fair presentation and full disclosure of the facts.²⁸ The issue confronting the court in *Simon* was whether the footnotes to the certified financial statements were designed to conceal the diversion of corporate funds by the president of the company. The court found from the facts that the accountants actually knew of the inadequate disclosure, and liability was thus imposed notwithstanding the fact that the financial statements were in accordance with generally accepted accounting principles.

II. SECURITIES EXCHANGE ACT OF 1934

The Securities Exchange Act of 1934 has registration requirements entirely distinct from those of the Securities Act of 1933. An accountant certifying financial statements in connection with a newly registered security may find himself or herself potentially liable under the 1934 Act without regard to any potential liability under the 1933 Act.²⁹

Section 10b, Rule 10b-5

The accountant's liability to third party investors has most commonly been established in the 1934 Exchange Act under section 10b,³⁰ and more specifically under Rule 10b-5³¹ promulgated pursuant to that section. Rule 10b-5, although broadly and literally covering fraud in both the purchase and sale of securities, was initially adopted to close a possible gap in the failure of the securities laws to protect the defrauded seller.³² In practice, Rule 10b-5 has been employed in fraud actions by both buyers and sellers.³³ Rule 10b-5 expressly provides for criminal and civil sanctions by the SEC (the administrator of the Exchange Act of 1934) and im-

28. See *Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresneoff, Yavner & Jacobs*, 455 F.2d 847 (4th Cir. 1973).

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

30. 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1970). Although accountant's liability to third party investors in newly registered securities may also exist under Security Exchange Act of 1934, § 18, 48 Stat. 897 (1934), 15 U.S.C. § 78r (1970), application of § 78r is limited and to date no liability of accountants has been established under this section.

31. 17 C.F.R. 240.10b-5 (1972). Section 10b makes it unlawful to use or employ, in connection with the purchase or sale of any security, any manipulative or deceptive device. Rule 10b-5 elaborates on the employment of manipulative or deceptive devices by making it unlawful: (1) to employ any device, scheme, or artifice to defraud; (2) to make any untrue statement of 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 (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

32. 3 H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* 8-64 (1974).

33. *Id.*

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pliedly provides for a right of action by third party investors and any other injured parties.³⁴

Rule 10b-5 is modeled after section 17(a) of the 1933 Act. It provides that it is unlawful for any person directly or indirectly to participate in a scheme to defraud, or make untrue or misleading statements, in connection with the purchase or sale of any security. Unlike a section 11 action under the 1933 Act, which is predicated on negligent conduct, *i.e.*, the misstatement or omission of a material fact without the exercise of due diligence, imposition of liability under the provisions of Rule 10b-5 is based on fraud.³⁵

Fraud under the common law generally requires that the defendant make a representation that is: (1) material; (2) false; (3) known by defendant to be false at the time it is made; (4) made with the intention that it should be acted on by plaintiff; (5) relied upon by plaintiff; and (6) the cause of the plaintiff's injury.³⁶ There is some question as to exactly what type of conduct must be present to constitute fraud under Rule 10b-5. For example, in *Fischman v. Ratheon Manufacturing Corp.*³⁷ the Second Circuit held, in accord with the traditional rule, that, among other things, the maker of a false statement in a Rule 10b-5 action is required to have knowledge that the statement is false. On the other hand, the Ninth Circuit has held that knowledge by the maker of a false statement as to its falsity is not essential—the mere existence of a manipulative device or contrivance is enough to generate potential 10b-5 liability.³⁸

There is also a question as to whether the person to whom the statement is made must detrimentally (and reasonably) rely on it before he or she can recover for fraud. In *List v. Fashion Park, Inc.*³⁹ the Second Circuit required, among other things, that plaintiff show he would not have acted as he did had he known the truth. In a subsequent case, the same court decided “there

34. *Sargent v. Genesco, Inc.*, 492 F.2d 750 (5th Cir. 1974); *Jordan Bldg. Corp. v. Doyle, O'Connor & Co.*, 401 F.2d 47 (7th Cir. 1968); *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956); *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967); *Kardon v. National Gypsum*, 73 F. Supp. 798 (E.D. Pa. 1947).

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

36. *See, e.g.*, *Clements Auto Co. v. Service Bureau Corp.*, 444 F.2d 169 (8th Cir. 1971); *E.M. Fleischmann Lumber Corp. v. Resources Corp. Int'l*, 105 F. Supp. 681 (D. Del. 1952). With respect to accountant's liability in particular see *Ultramares Corp. v. Touch*, 255 N.Y. 170, 174 N.E. 441 (1931).

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

38. *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).

39. *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965).

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need be no showing that the plaintiff himself relied upon the deception."⁴⁰ What must be shown, the court held, is that there is deception which misleads some stockholders and that this is in fact the cause of plaintiff's injury.⁴¹

From these examples it can be seen that the burden for proving fraud under Rule 10b-5 can be less stringent than for a common law fraud action since elements such as reliance and knowledge of falsity may not be required in order to prove fraud in a Rule 10b-5 action. A faulty but honest exercise of judgment by an accountant is potentially subject to Rule 10b-5 liability. It should be clear from this that liability under Rule 10b-5 may encompass the accountant's negligence as well as traditional (common law) fraud. While the courts have generally avoided imposing Rule 10b-5 liability for patently negligent acts which are covered by section 11 of the 1933 Act (so as not to infer a redundancy in purpose of the subsequently codified Rule 10b-5), acts which fall between section 11 negligence and strict common law fraud will be potentially "fraudulent" for purposes of Rule 10b-5 liability.⁴²

In *Drake v. Thor Power Tool Co.*,⁴³ for example, accountants certified financial statements containing management's falsification of both inventory and sales figures. The accountants were charged with applying inappropriate auditing procedures, thereby failing to uncover the falseness of these figures, and with making untrue certification as to Thor's financial condition. The most significant item in the case with respect to accountant's liability under Rule 10b-5 is the very last paragraph of the opinion which says, in effect, the

40. *Crane v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1961).

41. *Id.* The *Crane* court distinguished the issue of reliance in *Crane* from that in *List* on the basis that *Crane* involved non-disclosure whereas *List* involved misstatement. The court stated that "reliance is an element of causation which plays little role in non-disclosure cases." In the case of an (affirmative and intentional) misstatement by the accountant, for example, no cause of action will apparently exist if the plaintiff cannot prove reliance, *i.e.*, if it appears that the plaintiff made the purchase notwithstanding the accountant's misstatement. However, with respect to non-disclosure, the courts have put the onus on the defendant-accountant to establish that the plaintiff would not have acted differently if the omitted facts had been disclosed. This distinction as to reliance might result in an effect unintended by the anti-fraud statute since an independent accountant who intentionally misstates a material fact is effectively made less culpable for a fraudulent act under Rule 10b-5 than the accountant who omits to state a material fact or who fails to correct an earlier innocently made false representation.

42. *See, e.g., Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961) where the court, commenting on the scope of § 10b and SEC regulations pursuant to it, stated that "[h]ad Congress intended to limit this [SEC] authority to regulations proscribing common law fraud, it would probably have said so."

43. *Drake v. Thor Power Co.*, 282 F. Supp. 94 (7th Cir. 1967).

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complaint stated a cause of action because it alleged the accountants knew or should have known about the falsity of the statements.⁴⁴ Of course, if they knew of the falsities of the inventory and sales figures, then they were parties to a misrepresentation of a kind which typically would constitute common law fraud; *i.e.*, the accountants knew of the falsity of the statement and that investors would rely on such statements to their detriment. Such fraudulent action would unmistakably be in violation of the provisions of Rule 10b-5. But when the court said that the accountants would be liable if they should have known of the falsities, even if in fact they did not, then the court was imputing potential Rule 10b-5 liability to an act of negligent misrepresentation; *i.e.*, the accountants were potentially liable for fraud under Rule 10b-5 if they should have known that the statements were false. Imputation of fraud on such a basis clearly extends Rule 10b-5 liability to acts not considered fraudulent or deceitful under common law.

Following the trend toward imposition of fraud under 10b-5 through relaxed common law fraud standards, the 1974 Second Circuit decision in *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*⁴⁵ found accountants liable for fraud under Rule 10b-5 even though the certified financial statements were in accord with generally accepted accounting principles and the court had to *infer* that the accountants knew the financial statements were misleading and had to *presume* reliance on the part of the plaintiff.⁴⁶ For the purposes of understanding the various factors influencing the court's decision, this case should be examined in detail.

Firestone Group Ltd. (FGL) was attempting to raise money in a private placement. Laventhol (the accounting firm) was retained to perform an audit and issue a report on the audited financial statements for the eleven month period ending November 30, 1969. Laventhol knew that its report and the audited financial statements would be relied upon by prospective investors. Laventhol issued its report on the audited financial statements on December 6, 1969. The plaintiff Herzfeld alleged that the certified financial

44. *Id.* at 105.

45. *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (2d Cir. 1974).

46. *See United States v. Simon*, 425 F.2d 796 (2d Cir. 1969) (reliance on generally accepted accounting principles no defense where accountant had actual knowledge of the inadequacy of the disclosure); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (2d Cir. 1974) (actual knowledge inferred by court).

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statements were materially misleading due to improper accounting treatment accorded by Laventhol to the buy-then-sell arrangement by FGL of certain nursing home properties in November 1969. In the audited report Laventhol treated this transaction as an acquisition and sale in which FGL first purchased the nursing homes from Monterey Nursing Inns, Inc. (Monterey) for \$13,362,500, on November 22, 1969, and then, four days later, on November 26, 1969, sold them to Continental Recreation Company, Ltd. (Continental) for \$15,393,000. In the certified income statement Laventhol treated \$235,000 of the projected profit for the transaction as current income and \$1,795,000 as deferred gross profit. (Consider the contrast between this financial treatment and FGL's original unaudited figures which reflected the entire gain of \$2,030,000 as current income.) Herzfeld contended that the Monterey transaction was "phony" and intended solely to give support to the private placement and that Laventhol knew or should have known it was "phony" or, alternatively, that the transaction involved nothing more than an option to buy the properties at the buyer's discretion and that Laventhol knew or should have known it to be an option.⁴⁷

The purchase and sale of the nursing homes was the largest single transaction in the history of FGL. The magnitude and importance of the Monterey transaction can be shown by a comparison of the financial condition of FGL, with and without the Monterey transaction, as in the table used by the court:⁴⁸

	Monterey included	Monterey excluded	
Sales	22,132,607	6,739,607	
Total Current Assets	6,290,987	1,300,737	
Net Income	66,000	-169,000	(loss)
Deferred Profit	1,795,000	None	
Earnings per share	10¢	-25¢	(loss)

Thus, to the eye of a prospective investor, whether FGL appeared to be a profitable or unprofitable, a healthy or ailing company, depended on the recognition of the sales proceeds and the profits from the Monterey transaction in the company's financial statements.

During the audit, Lipkin, the Laventhol partner in charge of

47. 378 F. Supp. at 118.

48. *Id.*

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the audit, met with Richard Firestone, president of FGL, and asked him about the details of the Monterey transaction. Firestone told Lipkin that the agreement was a legitimate, arms-length contract, made in the normal course of FGL's business. Lipkin also verified the financial references of Max Ruderian, president and controlling stockholder of Continental (the intended buyer of the nursing homes from FGL), and found Ruderian to be "a very legitimate, outstanding, substantial business person." Lipkin also had another Laventhol partner (Boyer) who knew Ruderian personally verify the transaction with Ruderian by phone. In the phone conversation Ruderian stated that he had executed the FGL-Continental contract, regarded it as binding on Continental, and intended to comply with its terms. Lipkin then consulted with Chazen, Laventhol's national partner for auditing and accounting, who told Lipkin that the proper way to reflect the transactions in the financial statements (*i.e.*, in accordance with generally accepted accounting principles) was to take into current income the two \$25,000 cash payments and the \$185,000 in liquidated damages payable under the Continental contract.

Due to the magnitude of the transactions, Chazen felt it wise to further verify the accounting treatment and the enforceability of the contracts with someone more experienced in real estate matters. Chazen, therefore, consulted a Laventhol partner named Zeman, who suggested that an attorney be called. With Lipkin and Zeman present, Chazen telephoned Julius Borah, a Los Angeles attorney. In a short conversation, Chazen told Borah that the contract provided for the sale of interests in land and described selected parts of the contract to Borah, such as the amounts involved and the fact that the agreement provided for a non-recourse note and a liquidated damages clause. Chazen then asked Borah if the contract was legally enforceable, "within its terms." Borah replied that the contract was valid and enforceable.

Satisfied that the transaction was bona fide and legally binding, Chazen and Lipkin met with Firestone on December 4, 1969, and told Firestone that only a portion of the \$2,030,000 profit from the Monterey transaction would be reported as current income for the period ending November 30. Firestone disagreed strongly, arguing that the entire profit should be recorded as current income. Scharf, Firestone's investment advisor, threatened Laventhol with a lawsuit if the private placement fell through.

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The Laventhol people remained adamant, however, and refused to alter their treatment of the profit on the Monterey transactions. Thus, when the report was issued on December 6, 1969, the Monterey transaction was recorded as a purchase from Monterey and a sale to Continental, the \$1,795,000 portion of the profit and the \$235,000 portion of the profit being reflected as deferred income and current income respectively. In addition, Laventhol issued its report with a qualified opinion; *i.e.*, Laventhol's report stated, in effect, that the financial statements fairly reflected FGL's financial condition *subject to* the collectibility of the balance receivable on the contract of sale to Continental.

Neither the purchase from Monterey nor the sale to Continental was ever consummated because Monterey was unable to provide clear title to the property. The transaction folded in late December. FGL never received the second \$25,000 down payment or the liquidated damages, or any other sum of money from Continental on the transaction. The court stated that the essential facts necessary to establish a civil claim for relief under section 10b and Rule 10b-5 were: (1) that Laventhol's report was materially misleading; (2) that Laventhol knew that the report was misleading; and (3) that plaintiffs relied upon the report and suffered damages as a result of such reliance.

In discussing whether Laventhol's report was materially misleading, Judge McMahon prefaced the court's finding by stating:

The policy underlying the securities laws of providing investors with all the facts needed to make intelligent investment decisions can only be accomplished if financial statements fully and fairly portray the actual financial condition of the company. In those cases where application of generally accepted accounting principles fulfills the duty of full and fair disclosure, the accountant need go no further. But if application of accounting principles alone will not adequately inform investors, accountants as well as insiders must take pains to lay bare all the facts needed by investors to interpret the financial statements accurately.⁴⁹

The court found that it was incumbent on Laventhol to reveal to

49. *Id.* at 122.

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investors its reservations and doubts about the ability of FGL to collect the balance due on the Continental contract and the facts upon which its reservations were based. Laventhol claimed that its qualification that the report was "subject to the collectibility of the balance receivable on the contract of sale," along with Note 4 to the financial statements (discussing details of the buy-then-sell nursing home transaction) constituted full disclosure of its reservations. The court did not agree, for Note 4 was considered misleading in several respects. First, neither the company from whom FGL bought the properties, nor the company to whom the properties were sold, was mentioned in the note. Nor did the note mention the fact that Continental, the buyer, had a net worth of only \$100,000. Second, the note said that FGL "acquired" the nursing homes; yet at no time did FGL ever acquire title to these properties. Third, the note stated that "the deferred income of \$1,795,000 will be considered realized when the January 30, 1970 payment is received." This statement at least implied that the payment would be received on the due date and there was no suggestion of the possibility that Continental would not carry out the contract or that payment would not be made. In fact, the court said, Laventhol had had real doubts that such a payment would be made. Fourth, the note stated that the properties were leased back to their former owners. Laventhol had no proof that the leasing back ever occurred, except for the statement of the parties' intention to do so in the Monterey-FGL contract. This statement was therefore considered improper.

In addition to the court's conclusion that Note 4 itself was misleading, the court found that the inclusion of the Monterey transaction in sales and income was misleading without a full disclosure by Laventhol of all the material facts about the transaction. The court stated that the full disclosure mandated by the 1934 Act required Laventhol to include in its report at least the following: (1) Continental's net worth; (2) the ambiguity of the language in the contract which might have suggested to some that it was an option; (3) the fact that Ruderian, on whose reputation and representations Laventhol was depending, was not personally liable on the contract; (4) Ruderian's practice of reselling property before he paid for it; (5) the fact that neither the purchase of the Monterey property by FGL or its resale to Continental was recorded in FGL's books of original entry or corporate minute books; (6) the fact that FGL would show a loss if the income from the Monterey transactions was not realized; (7) the fact that this transaction was the largest in

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which FGL had ever participated; (8) the fact that FGL had not acquired title to the nursing home properties from Monterey; (9) the fact that no deed, title search or title insurance on the properties had ever been obtained by FGL; and (10) the fact that the legal opinion sought by Laventhol, on which it relied in treating the transaction as an enforceable purchase and sale, had been obtained over the telephone from an attorney who not only never saw the contract, but who never even had it read to him (in its entirety) on the telephone. The court also stated that "each investor was entitled to decide for himself, on the basis of the stark facts, whether the transaction had a realistic prospect of being completed."⁵⁰ The information needed to make that judgment, which was known to Laventhol, was not disclosed in the Laventhol report. In discussing the issue of fraud under Rule 10b-5, the *Herzfeld* court reaffirmed the Second Circuit requirement that proof of the maker's knowledge of the falsity of the statement is an essential element of a civil claim under Rule 10b-5. It stated that the plaintiffs must prove that Laventhol had actual knowledge of any misrepresentations and omissions it made. However, on the basis that Laventhol omitted facts which should have been revealed to the investors and which were discovered by Laventhol during the course of its audit, the court inferred Laventhol's knowledge of existing misrepresentations and omissions in the financial statements and held that the requisite element of scienter was therefore present.⁵¹

As to reliance, the court required that the plaintiff show a nexus between the misrepresentations in the Laventhol report and the damage he sustained. Herzfeld's initial interest in the securities was generated by sources other than Laventhol and he actually purchased the securities before seeing the audited financial statements. However, because FGL offered to refund Herzfeld's subscription payment if the report indicated that the securities were not a good investment, and because a true statement of the financial condition of the company could, in the court's opinion, have shaken that belief and possibly caused Herzfeld to change his mind and demand a refund of his payment, the court held that the report's false picture of FGL's financial condition

50. *Id.* at 125.

51. The court made no distinction between two very different kinds of knowledge which an accountant may possess: (1) knowledge of facts subsequently found to have been essential to an understanding of the report; and (2) knowledge of those facts together with a realization that the report will be misleading without their inclusion.

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was a substantial, even crucial, factor in convincing Herzfeld that his investment decision to purchase the securities was prudent. The court therefore held that the plaintiff had shown sufficient reliance on the Laventhol report (note, however, that the court took a totally theoretical approach to the reliance issue, since Herzfeld testified that, in fact, he never looked at the financial statements certified by Laventhol). Satisfied that the requisite elements of scienter and reliance were present, the court held Laventhol liable for violations of the anti-fraud provisions of Rule 10b-5, even though the certified financial statements as prepared by Laventhol were in accordance with generally accepted accounting principles.

Section 18

If any document (including a registration statement with attendant certified financial statements) containing a false or misleading statement is filed with the SEC, that document can be used, under section 18 of the 1934 Act,⁵² as a basis for civil liabilities, prosecution for criminal or civil violations, or injunctions. While to date there are no court decisions assessing the accountant's liability under section 18 (presumably because the majority of the investing public does not physically review, and therefore rely on, the documents filed at SEC headquarters in Washington, D.C.), the section remains a viable means of relief to suitors of certifying accountants. The accountant's defense to a false or misleading statement of a material fact made by him or her and upon which an investor relied must rest on a showing that he or she acted in good faith and had no knowledge that such statement was false or misleading. Any action under section 18 must be brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued.

CONCLUSION

Decisions with respect to the accountant's liabilities under the securities laws have based liability on the fact that the accountant has not performed up to the standards of the accounting profession (*e.g.*, the *BarChris* case), or that the accountant had knowledge of facts which, while not required to be disclosed to the investor under generally accepted accounting principles, were so significant in impact to a potential investor that failure to disclose

52. 48 Stat. 897 (1934), 15 U.S.C. § 78r (1971).

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such information was at least potentially misleading (*e.g.*, the *Simon* case). These decisions appear to take the approach that the accountant either did shoddy work or that the work, even though well performed and in accordance with the accounting profession's standards, did not result in a full and fair disclosure to the investor based on information known to the certifying accountant. The imposition of liability in such cases to insure that accountants, under an obligation of honesty and good faith, take steps to preclude faulty information from being transmitted to the investor, clearly seems appropriate. Weighing the good faith of the accountant in such an approach also respects the obvious intention of Congress to provide accountants with a due diligence defense and for fraud under the securities laws to be something more than imputed negligence. However, some decisions (primarily under Rule 10b-5) imply that the accountant is a guarantor of all financial information related to a newly registered security. Although the question of adequate and proper auditing standards and accounting principles is of continuing concern to the AICPA and the SEC as they attempt to obtain full and fair disclosure of accounting information for the investor, the proper role of the certifying accountant is not appreciated by those courts which, to some degree, apparently impose a duty of investigation or disclosure on accountants primarily for the purpose of indemnifying the investor when there is no other solvent defendant available. Such decisions seem to set up a standard of disclosure and performance which will force the accountant interested in avoiding liability to substitute a hopeless morass of data from which logical conclusions cannot be readily drawn for the cohesive summaries of financial data most accountants now associate with competent auditor's reports and financial statements. The literal application of the court's decision in such cases (*e.g.*, the *Herzfeld* case) requires the disclosure of every fact about almost all transactions as to which there is the slightest doubt. It is easy in the light of hindsight to single out a specific transaction which requires greater disclosure, but looking at the transactions prospectively, it is impossible to determine which transactions will, because of doubt, require the presentation of a myriad of facts.⁵³

In this author's opinion, what some courts overlook is that financial statements are, and must be, primarily the responsibility of management. Corporate management is in charge of day to day

53. Liggio, *supra* note 22, at 22.

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operations and has control over the safeguarding of company assets, the originating and recording of financial transactions, and the preparation of the company's financial statements in the first place. The independent accountant's principal function is to examine and report on those company financial statements. Because the accountant's examination is necessarily based on sampling techniques, he cannot absolutely guarantee that his findings will detect any or all errors in the client's financial statements. Likewise, because the accountant *must* rely on the information provided by management and others (for example, client's legal counsel with respect to contingent liabilities), when there is no feasible method by which the accountant can independently determine certain information, the accountant cannot always be sure that no deceit on the part of management or others has occurred. The accountant has, of course, an obligation to exercise skill and due care in the conducting of his audit; and any material information coming to his attention during or outside the scope of the audit or after the audit has been completed should be appropriately reflected or reported. But holding independent accountants liable to the investor in the absence of truly blameworthy conduct excessively enlarges the accountant's duty and ignores the legislative intent animating the securities laws.