Legal liability of certified public accountants

Legal liability of certified public accountants (from Wikipedia)

Legal liability of Certified Public Accountants (CPAs) is the “responsibility of the accountant to the client and third parties relying on the accountant's work. Accountants can be sued for fraud and negligence in performance of duties”.[1] Certified Public Accountants (CPAs) opinions affect their clients and their judgments can further affect investors, stockholders, firm creditors, or even partners. Large public accounting firms perform thousands of audits annually. Ultimately they will find unmodified reports on financial statements that could appear to be misleading. If CPAs fail to modify the audit report on financial statements that are materially misstated, investors and firm creditors may experience substantial losses. As a result of litigation against public accounting firms, amounts in excess of $300 million have been awarded to these parties.[2] Even with professional liability insurance to cover such loses, occasionally the total amounts granted to plaintiffs have surpassed the maximum amounts the insurance can or will cover. If investors sustain losses they will attempt to recover them as long as the price to bring suit is low and there is a chance for recovery. Any public accounting firm may find itself in litigation no matter how careful the CPAs were. CPAs are often required to make further payments for investors and creditors uninsured losses. The firm itself can make these payments, as can personnel who have worked on the engagement.

Sources of CPAs' liability

In the United States, CPAs have common law liability and statutory law liability. Common law liability arises from negligence, breach of contract, and fraud. Statutory law liability is the obligation that comes from a certain statute or a law, which is applied, to society. Recoveries from these liabilities vary by their source or “theory”. Some of these theories are:

- **Privity**: CPAs and their clients enter into a contract with an agreement to perform certain services. Liability occurs when there is a breach of contract.[3] This applies to the CPA if they don’t perform what they stated in the engagement letter and the client suffers damages.

- **Negligence**: Negligence may be viewed as "failure to exercise due professional care".[4] Both clients and third parties can sue CPAs for the tort of negligence, which is a wrongful act, injury, or damage for which a civil action can be brought. Negligence can be referred to as ordinary negligence and gross negligence. Ordinary negligence is defined as failure of duty in accordance with applicable standards, and gross negligence is the lack of concern for the likelihood that injuries will result.[5]

- **Fraud**: Fraud is defined to be a misrepresentation of a material fact by a person who is aware of his or her actions, with the intention of misleading the other party with the other party injured as a result.

- Statutory liability: CPAs have statutory liability under both federal and state securities laws. Statutory liability provides cover for defense costs, fines and penalties charged against the firm. Under statutory law, an auditor can be held civilly or criminally liable.[6]
CPAs’ liability to their clients under common law

CPAs have an obligation to their clients to exercise due professional care. With an engagement letter, it provides the client and other third parties with rights of recovery. Therefore if the CPAs are not performing within the agreement set forth in the contract this will be considered a breach of contract. The clients may also claim negligence against the CPAs if the work was performed but contained errors or was not done professionally. This is considered a tort action. **In order to recover from an auditor under common law, the client must prove:**[7]

- Duty
- Breach of Duty
- Losses
- Causation

CPAs may defend against a breach of contract if they can prove that the client’s loss occurred because of factors other than negligence by the auditors. If the auditor proves the loss resulted from causes other than the auditor’s negligence, a client may be accused of contributory negligence. If a state follows the doctrine of contributory negligence, the auditor may eliminate their liability to the client based on contributory negligence by the client. Many states do not follow this doctrine.[8] Most states permit a jury to assess the fault and apply the correct percentage of fault to the parties involved. This is called comparative negligence.


Legal liability of CPAs under common law

**From the opinion of Judge Lucas in Robert R. Bily v. Arthur Young & Co.**

**III. Approaches to the Problem of Auditor Liability to Third Persons**

The complex nature of the audit function and its economic implications has resulted in different approaches to the question whether CPA auditors should be subjected to liability to third parties who read and rely on audit reports. Although three schools of thought are commonly recognized, there are some variations within each school and recent case law suggests a possible trend toward merger of two of the three approaches.

A substantial number of jurisdictions follow the lead of Chief Judge Cardozo’s 1931 opinion for the New York Court of Appeals in Ultramares, supra, 174 N.E. 441, by denying recovery to third parties for auditor negligence in the absence of a third party relationship to the auditor that is "akin to privity." (See pt. III(A), post.) In contrast, a handful of jurisdictions, spurred by law review commentary, have recently allowed recovery based on auditor negligence to third parties whose reliance on the audit report was "foreseeable." (See pt. III(B), post.)

Most jurisdictions, supported by the weight of commentary and the modern English common law decisions cited by the parties, have steered a middle course based in varying degrees on Restatement Second of Torts section 552, which generally imposes liability on suppliers of commercial information to third persons who are intended beneficiaries of the information. (See pt. III(C), post.) Finally, the federal securities laws have also dealt with the problem by imposing auditor liability for negligence-related conduct only in connection with misstatements in publicly filed and distributed offering documents. (See pt. III(D), post.)
In this section we will review and briefly analyze each of the recognized approaches to the problem before us.

A. Privity of Relationship

In Ultramares, supra, 174 N.E. 441, plaintiff made three unsecured loans totalling $165,000 to a company that went bankrupt. Plaintiff sued the company's auditors, claiming reliance on their audit opinion that the company's balance sheet "present[ed] a true and correct view of the financial condition of [the company]." (at p. 442.) Although the balance sheet showed a net worth of $1 million, the company was actually insolvent. The company's management attempted to mask its financial condition; the auditors failed to follow paper trails to "off-the-books" transactions that, if properly analyzed, would have revealed the company's impecunious situation.

The jury, precluded by the trial judge from considering a fraud cause of action, returned a verdict in plaintiff's favor based on the auditor's negligence in conducting the audit. The New York Court of Appeals, speaking through Chief Judge Cardozo, reinstated the fraud cause of action but set aside the negligence verdict.

The auditor in Ultramares knew the company was in need of capital and that its audit opinion would be displayed to third parties "as the basis of financial dealings." (Ultramares, supra, 174 N.E. at p. 442.) In this regard, it supplied to the company 32 copies of the opinion "with serial numbers as counterpart originals." (Ibid.) Plaintiff's name, however, was not mentioned to the auditor nor was the auditor told about any actual or proposed credit or investment transactions in which its audit opinion would be presented to a third party.

With respect to the negligence claim, the court found the auditor owed no duty to the third party creditor for an "erroneous opinion." In an often quoted passage, it observed: "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." (Ultramares, supra, 174 N.E. at p. 444.) (Opinion issued by judge Benjamin Cardozo)

.....

In summarizing its holding, the court emphasized that it was not releasing auditors from liability to third parties for fraud but merely for "honest blunder." (Glanzer v. Shepherd, supra, 174 N.E. at p. 448.) It questioned "whether the average business man receiving a certificate without paying for it, and receiving it as one of a multitude of possible investors, would look for anything more." (Ibid.)

.....

Distinguishing Ultramares, the court commented that the "services of the accountant were not extended to a faceless or unresolved class of persons, but rather to a known group possessed of vested rights, marked by a definable limit and made up of certain components."

.....

The New York Court of Appeals restated the law in light of Ultramares, White v. Guarante, and other cases in Credit Alliance v. Arthur Andersen & Co. (1985) 65 N.Y.2d 536 [493 N.Y.S.2d 435, 483 N.E.2d 110]. Credit Alliance subsumed two cases with different factual postures: in the first case, plaintiff alleged it loaned funds to the auditor's client in reliance on
audited financial statements overstating the client's assets and net worth; in the second, the same scenario occurred, but plaintiff also alleged the auditor knew plaintiff was the client's principal lender and communicated directly and frequently with plaintiff regarding its continuing audit reports. The court dismissed plaintiff's negligence claim in the first case, but sustained the claim in the second.

The New York court promulgated the following rule for determining auditor liability to third parties for negligence: "Before accountants may be held liable in negligence to noncontractual parties who rely to their detriment on inaccurate financial reports, certain prerequisites must be satisfied: (1) the accountant 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." (Credit Alliance v. Arthur Andersen & Co., supra, 483 N.E.2d at p. 118.)

Discussing the application of its rule to the cases at hand, the court observed the primary, if not exclusive, "end and aim" of the audits in the second case was to satisfy the lender. The auditor's "direct communications and personal meetings [with the lender] result[ed] in a nexus between them sufficiently approaching privity." (Credit Alliance v. Arthur Andersen & Co., supra, 483 N.E.2d at p. 120.) In contrast, in the first case, although the complaint did allege the auditor knew or should have known of the lender's reliance on its reports: "There was no allegation of either a particular purpose for the reports' preparation or the prerequisite conduct on the part of the accountants ... [nor] any allegation [the auditor] had any direct dealings with plaintiffs, had agreed with [the client] to prepare the report for plaintiffs' use or according to plaintiffs' requirements, or had specifically agreed with [the client] to provide plaintiffs with a copy [of the report] or actually did so." (Credit Alliance v. Arthur Andersen & Co., supra, 483 N.E.2d at p. 119.)

B. Foreseeability Arguing that accountants should be subject to liability to third persons on the same basis as other tortfeasors, Justice Howard Wiener advocated rejection of the rule of Ultramares in a 1983 law review article. (Wiener, Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation (1983) 20 San Diego L.Rev. 233 [hereafter Wiener].) In its place, he proposed a rule based on foreseeability of injury to third persons. Criticizing what he called the "anachronistic protection" given to accountants by the traditional rules limiting third person liability, he concluded: "Accountant liability based on foreseeable injury would serve the dual functions of compensation for injury and deterrence of negligent conduct. Moreover, it is a just and rational judicial policy that the same criteria govern the imposition of negligence liability, regardless of the context in which it arises. The accountant, the investor, and the general public will in the long run benefit when the liability of the certified public accountant for negligent misrepresentation is measured by the foreseeability standard." ( at p. 260.) Under the rule proposed by Justice Wiener, "[f]oreseeability of the risk would be a question of fact for the jury to be disturbed on appeal only where there is insufficient evidence to support the finding." ( at pp. 256-257.)

Following in part Justice Wiener's approach, the New Jersey Supreme Court upheld a claim for negligent misrepresentation asserted by stock purchasers against an auditor who had rendered an unqualified audit report approving fraudulently prepared financial statements. (Rosenblum v. Adler (1983) 93 N.J. 324 [461 A.2d 138, 35 A.L.R.4th 199].) The court
found no reason to distinguish accountants from other suppliers of products or services to the public and no reason to deny to third party users of financial statements recovery for economic loss resulting from negligent misrepresentation. (at pp. 142-146.) From its review of the purpose and history of the audit function, it concluded: "The auditor's function has expanded from that of a watchdog for management to an independent evaluator of the adequacy and fairness of financial statements issued by management to stockholders, creditors, and others." (at p. 149.) Noting the apparent ability of accounting firms to obtain insurance against third party claims under the federal securities laws, the court posited the same or similar protection would be available for common law negligent misrepresentation claims. (Ibid.)

From a public policy standpoint, the court emphasized the potential deterrent effect of a liability-imposing rule on the conduct and cost of audits: "The imposition of a duty to foreseeable users may cause accounting firms to engage in more thorough reviews. This might entail setting up stricter standards and applying closer supervision, which should tend to reduce the number of instances in which liability would ensue. Much of the additional cost incurred either because of more thorough auditing review or increased insurance premiums would be borne by the business entity and its stockholders or its customers." (Rosenblum v. Adler, supra, 461 A.2d at p. 152.)

Notwithstanding its broad pronouncements about the public role of auditors and the importance of deterring negligence by imposing liability, when the New Jersey court formulated a rule of liability it restricted the auditor's duty to "all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes." (Rosenblum v. Adler, supra, 461 A.2d at p. 153, italics added.) …

Two other state high courts--those of Wisconsin and Mississippi--have endorsed foreseeability rules. …

…

In addition to these out-of-state cases, the Court of Appeal in International Mortgage Co. v. John Butler Accountancy Corp., supra, 177 Cal.App.3d 806, also adopted, with certain variations, a foreseeability approach. That decision will be discussed in the next part of this opinion.

…

C. The Restatement: Intent to Benefit Third Persons

Section 552 of the Restatement Second of Torts covers "Information Negligently Supplied for the Guidance of Others." It states a general principle that one who negligently supplies false information "for the guidance of others in their business transactions" is liable for economic loss suffered by the recipients in justifiable reliance on the information. (Id., subd. (1).) But the liability created by the general principle is expressly limited to loss suffered: 

"(a) [B]y 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." (Id., subd. (2).)

To paraphrase, a supplier of information is liable for negligence to a third party only if he or she
intends to supply the information for the benefit of one or more third parties in a specific transaction or type of transaction identified to the supplier.

Comment (h) to subdivision (2) of section 552, Restatement Second of Torts, observes that the liability of a negligent supplier of information is appropriately more narrowly restricted than that of an intentionally fraudulent supplier. It also notes that a commercial supplier of information has a legitimate concern as to the nature and scope of the client's transactions that may expand the supplier's exposure liability. As the comment states: "In many situations the identity of the person for whose guidance the information is supplied is of no moment to the person who supplies it, although the number and character of the persons to be reached and influenced, and the nature and extent of the transaction for which guidance is furnished may be vitally important. This is true because the risk of liability to which the supplier subjects himself by undertaking to give the information, while it may not be affected by the identity of the person for whose guidance the information is given, is vitally affected by the number and character of the persons, and particularly the nature and the extent of the proposed transaction." (Ibid., italics added.)

To offer a simple illustration of comment (h) to subdivision (2) of section 552, Restatement Second of Torts, an auditor engaged to perform an audit and render a report to a third person whom the auditor knows is considering a $10 million investment in the client's business is on notice of a specific potential liability. It may then act to encounter, limit or avoid the risk. In contrast, an auditor who is simply asked for a generic audit and report to the client has no comparable notice.

The authors of the Restatement Second of Torts offer several variations on the problem before us as illustrations of section 552. For example, the auditor may be held liable to a third party lender if the auditor is informed by the client that the audit will be used to obtain a $50,000 loan, even if the specific lender remains unnamed or the client names one lender and then borrows from another. (Com. (h), illus. 6, 7.) However, there is no liability where the auditor agrees to conduct the audit with the express understanding the report will be transmitted only to a specified bank and it is then transmitted to other lenders. (Com. (h), illus. 5.) Similarly, there is no liability when the client's transaction (as represented to the auditor) changes so as to increase materially the audit risk, e.g., a third person originally considers selling goods to the client on credit and later buys a controlling interest in the client's stock, both in reliance on the auditor's report. (Com. (j) and illus. 14.)

Under the Restatement rule, an auditor retained to conduct an annual audit and to furnish an opinion for no particular purpose generally undertakes no duty to third parties. Such an auditor is not informed "of any intended use of the financial statements; but ... knows that the financial statements, accompanied by an auditor's opinion, are customarily used in a wide variety of financial transactions by the [client] corporation and that they may be relied upon by lenders, investors, shareholders, creditors, purchasers and the like, in numerous possible kinds of transactions. [The client corporation] uses the financial statements and accompanying auditor's opinion to obtain a loan from [a particular] bank. Because of [the auditor's] negligence, he issues an unqualifiedly favorable opinion upon a balance sheet that materially misstates the financial position of [the corporation] and through reliance upon it [the bank] suffers pecuniary loss." (Rest.2d Torts, § 552, com. (h), illus. 10.) Consistent with the text of section 552, the authors conclude: "[The auditor] is not liable to [the bank]." (Ibid.)

This is a diversity action, pursuant to 28 U.S.C. § 1332, commenced by the plaintiff (Rusch Factors, Inc. added), a New York commercial banking and factoring corporation, against the defendant (Leonard M. Levine, CPA added), a resident of Rhode Island.

The facts are as follows. In late 1963 and early 1964 a Rhode Island corporation sought financing from the plaintiff. To measure the financial stability of the corporation the plaintiff requested certified financial statements. The defendant accountant prepared the statements which represented the corporation to be solvent by a substantial amount. In fact, the corporation was insolvent. On or before February 10, 1964, the corporation submitted the statements to the plaintiff. The plaintiff relied upon the statements and loaned the corporation a sum in excess of $337,000.00. Subsequently, the corporation went into receivership, and the plaintiff has been able to recover only a portion of the amount loaned to the corporation.

The plaintiff complains that it has been injured in an amount in excess of $121,000.00 as a result of its reliance upon the fraudulent or negligent misrepresentations in the financial statements certified by the defendant accountant.

The Privity Defense

As the Court noted, supra, a federal court whose jurisdiction is predicated upon diversity of citizenship must apply the substantive law of the state in which it sits. For the purposes of the Erie doctrine, state choice of laws principles are substantive, and thus must be applied. If, then, there were a conflict between the law of Rhode Island, the place of the making of the misrepresentation by the defendant, and New York, the place of the plaintiff's reliance and consequent loss, it would be necessary for the Court to determine, under Rhode Island choice of laws principles whether the law of Rhode Island or that of New York, relating to the scope of an accountant's responsibilities, should be applied. But there is no such conflict of laws. New York law relating to the scope of liability for intentional or negligent wrongdoing is grounded on the same theory of risk distribution as is Rhode Island law.

Privity of contract is clearly no defense in a fraud action. An intentionally misrepresenting accountant is liable to all those persons whom he should reasonably have foreseen would be injured by his misrepresentation. Ultramares v. Touche & Co., 255 N.Y. 170, 174 N.E. 441, 74 A.L.R. 1139. Neither actual knowledge by the accountant of the third person's reliance nor quantitative limitation of the class of reliant persons is requisite to recovery for fraud.

...The reluctance of the courts to hold the accounting profession to an obligation of care which extends to all reasonably foreseeable reliant parties is predicated upon the social utility rationale first articulated by Judge Cardozo in the Ultramares case. In that case the defendant accountants were employed by a company to perform the company's yearly audit. The defendants negligently overvalued the company's assets in the balance sheet upon which the plaintiffs, creditors of the company, subsequently relied. In holding the defendant accountants free from liability for their negligence, Judge Cardozo stated at...

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 one to these consequences.
The wisdom of the decision in *Ultramares* has been doubted, …, and this Court shares the doubt. Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional malpractice? Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming public? …

.. the plaintiff (*in Ultramares, added*) was a member of an undefined, unlimited class of remote lenders and potential equity holders not actually foreseen but only foreseeable. Here the plaintiff is a single party whose reliance was actually foreseen by the defendant. The case at bar is, in fact, far more akin to the case of *Glanzer v. Shephard, 233 N.Y. 236, 135 N.E. 275, 23 A.L.R. 1425*, another Cardozo opinion and the first case to extend to persons not in privity, liability for negligent misrepresentation causing pecuniary loss. In *Glanzer* a professional weigher contracted with a bean seller to weigh a shipment of beans and certify the weight to the bean buyer. The plaintiff bean buyer paid his seller for the beans in accordance with their weight as represented by the defendant's certificate. When it turned out that the weigher had overweighed, and hence that the buyer had overpaid, the Court allowed the buyer to recover the difference from the misrepresenting weigher. The Court stated …

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. Growing out of a contract, it has nonetheless an origin not exclusively contractual. Given the contract and the relation, the duty is imposed by law. * * *

… The tentative drafts of the Restatement (Second) of Torts § 552 states the rule of law as follows:

(1) One who, in the course of his business, profession or employment, or in a transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in subsection (3), the liability stated in subsection (1) is limited to loss suffered

(a) by the person or one of the 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 which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

The same tentative draft includes the following hypothetical illustration of the above-stated rule of law:

A is negotiating with a bank for a credit of $50,000. The bank requires an audit by certified public accountants. A employs B & Company, a firm of accountants, to make the audit, telling them he is going to negotiate a bank loan. A does not get his loan from the first bank but does negotiate a loan with another bank, which relies upon B & Company's certified
statements. The audit carelessly overstates the financial resources of A, and in consequence the second bank suffers pecuniary loss. B & Company is subject to liability to the second bank.

…. With respect, then to the plaintiff's negligence theory, this Court holds that an accountant should be liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons. According to the plaintiff's complaint in the instant case, the defendant knew that his certification was to be used for, and had as its very aim and purpose, the reliance of potential financiers of the Rhode Island corporation. The defendant's motion is, therefore, denied. The Court does not rule upon, but leaves open for reconsideration in the light of trial development, the question of whether an accountant's liability for negligent misrepresentation ought to extend to the full limits of foreseeability. Rusch Factors, Inc. v. Levin. U.S. District Court D RI. 284 F.Supp. 85 (1968)

Legal liability of CPAs under statutory law

U.S. Supreme Court

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)

Federal regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929.

The Securities Act of 1933 (1933 Act), 48 Stat. 74, as amended, 15 U.S.C. § 77a et seq., was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing. See H.R.Rep. No. 85, 73d Cong., 1st Sess., 1-5 (1933). The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.

U.S. Supreme Court. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)

Securities Act of 1933

CIVIL LIABILITIES ON ACCOUNT OF FALSE REGISTRATION STATEMENT

SEC. 11. (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue-

(1) every person who signed the registration statement;
(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the
registration statement with respect to which his liability is asserted;
(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions or partner;
(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(e) The suit authorized under subsection (a) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought:

Securities Exchange Act of 1934

2. 17 C.F.R. § 240.10b-5 (1979) 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, (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." Rule 105 was promulgated under § 10b of the 1934 Act which provides that it is unlawful "to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, 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." 15 U.S.C. § 78j(b) (1976). Throughout this Note, "rule 105" will be used to refer to either the rule or to § 10(b).


U.S. Supreme Court. Ernst & Ernst v. Hochfelder. 425 U.S. 185 (1976)

The issue in this case is whether an action for civil damages may lie under § 10(b) of the Securities Exchange Act of 1934 (1934 Act), 48 Stat. 891, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 105, 17 CFR § 240.10b-5 (1975), in the absence of an allegation of intent to deceive, manipulate, or defraud on the part of the defendant.

Petitioner, Ernst & Ernst, is an accounting firm. From 1946 through 1967, it was retained by First Securities Company of Chicago (First Securities), a small brokerage firm and member of the Midwest Stock Exchange and of the National Association of Securities Dealers, to perform periodic audits of the firm's books and records. …

Respondents were customers of First Securities who invested in a fraudulent securities scheme perpetrated by Leston B. Nay, president of the firm and owner of 92% of its stock. Nay induced the respondents to invest funds in "escrow" accounts that he represented would yield a high rate of return. Respondents did so from 1942 through 1966, with the majority of the transactions occurring in the 1950's. In fact, there were no escrow accounts, as Nay converted respondents' funds to his own use immediately upon receipt. These transactions were not in the customary form of dealings between First Securities and its customers. The respondents drew their personal checks payable to Nay or a designated bank for his account. No such escrow accounts were reflected on the books and records of First Securities, and none was shown on its periodic accounting to respondents in connection with their other investments. Nor were they included in First Securities' filings with the Commission or the Exchange.

This fraud came to light in 1968 when Nay committed suicide, leaving a note that described First Securities as bankrupt and the escrow accounts as "spurious." Respondents subsequently filed this action [Footnote 2] for damages against Ernst & Ernst [Footnote 3] in the United States District Court for the Northern District of Illinois under § 10(b) of the 1934 Act. The complaint charged that Nay's escrow scheme violated § 10(b) and Commission Rule 10b-5, [Footnote 4] and that Ernst & Ernst had "aided and abetted" Nay's violations by its "failure" to conduct proper audits of First Securities. As revealed through discovery, respondents' cause of action rested on a theory of negligent nonfeasance. The premise was that Ernst & Ernst had failed to utilize "appropriate auditing procedures" in its audits of First Securities, thereby failing to discover internal practices of the firm said to prevent an effective audit. The practice principally relied on was Nay's rule that only he could open mail addressed to him at First Securities or addressed to First Securities to his attention, even if it arrived in his absence. Respondents contended that, if Ernst & Ernst had conducted a proper audit, it would have discovered this "mail rule." The existence of the rule then would have been disclosed in reports to the Exchange and to the Commission by Ernst & Ernst as an irregular procedure that prevented an effective audit. This would have led to an investigation of Nay that would have revealed the fraudulent scheme. Respondents specifically disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst. [Footnote 5]
After extensive discovery, the District Court granted Ernst & Ernst's motion for summary judgment and dismissed the action. The court rejected Ernst & Ernst's contention that a cause of action for aiding and abetting a securities fraud could not be maintained under §10(b) and Rule 10b-5 merely on allegations of negligence. It concluded, however, that there was no genuine issue of material fact with respect to whether Ernst & Ernst had conducted its audits in accordance with generally accepted auditing standards. [Footnote 6]

The Court of Appeals for the Seventh Circuit reversed and remanded, holding that one who breaches a duty of inquiry and disclosure owed another is liable in damages for aiding and abetting a third party's violation of Rule 10b-5 if the fraud would have been discovered or prevented but for the breach. 503 F.2d 1100 (1974). [Footnote 7]

The Supreme Court's opinion delivered by Justice Powell stated the following.

When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances -- the commonly understood terminology of intentional wrongdoing -- and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct. [Footnote 33]

Recognizing that 10(b) and Rule 10b-5 might be held to require proof of more than negligent nonfeasance by Ernst & Ernst as a precondition to the imposition of civil liability, respondents further contend that the case should be remanded for trial under whatever standard is adopted. Throughout the lengthy history of this case, respondents have proceeded on a theory of liability premised on negligence, specifically disclaiming that Ernst & Ernst had engaged in fraud or intentional misconduct. [Footnote 34] In these circumstances, we think it inappropriate to remand the action for further proceedings.

The judgment of the Court of Appeals is Reversed.

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (opinion delivered by Justice Powell)

Definitions of terms used in this section

Recklessness differs from negligence in several respects, although breach of duty is implicit in both concepts. 42 Negligence is comprised of the actor's failure to perceive a risk that the reasonable man "should have known" in light of community standards. 43 Recklessness, however, involves the actor's disregard of a risk that he "must have known" in light of the actual circumstances. 44 T
breach of contract n. failing to perform any term of a contract, written or oral, without a legitimate legal excuse. This may include not completing a job, not paying in full or on time, failure to deliver all the goods, substituting inferior or significantly different goods, not providing a bond when required, being late without excuse, or any act which shows the party will not complete the work ("anticipatory breach.") Breach of contract is one of the most common causes of law suits for damages and/or court-ordered "specific performance" of the contract.

**Common Law.** The ancient law of England based upon societal customs and recognized and enforced by the judgments and decrees of the courts. The general body of statutes and case law that governed England and the American colonies prior to the American Revolution.

The principles and rules of action, embodied in case law rather than legislative enactments, applicable to the government and protection of persons and property that derive their authority from the community customs and traditions that evolved over the centuries as interpreted by judicial tribunals.

**Joint and several liability.** A designation of liability by which members of a group are either individually or mutually responsible to a party in whose favor a judgment has been awarded.

**Negligence.** Conduct that falls below the standards of behavior established by law for the protection of others against unreasonable risk of harm. A person has acted negligently if he or she has departed from the conduct expected of a reasonably prudent person acting under similar circumstances.

In order to establish negligence as a **Cause of Action** under the law of TORTS, a plaintiff must prove that the defendant had a duty to the plaintiff, the defendant breached that duty by failing to conform to the required standard of conduct, the defendant's negligent conduct was the cause of the harm to the plaintiff, and the plaintiff was, in fact, harmed or damaged.

**PRIVITY OF CONTRACT.** The relation which subsists between two contracting parties.

**Punitive damages.** Monetary compensation awarded to an injured party that goes beyond that which is necessary to compensate the individual for losses and that is intended to punish the wrongdoer.

**Recklessness.** Rashness; heedlessness; wanton conduct. The state of mind accompanying an act that either pays no regard to its probably or possibly injurious consequences, or which, though foreseeing such consequences, persists in spite of such knowledge.

**standard of care** n. the watchfulness, attention, caution and prudence that a reasonable person in the circumstances would exercise. If a person's actions do not meet this standard of care, then his/her acts fail to meet the duty of care which all people (supposedly) have toward others. Failure to meet the standard is negligence, and any damages resulting therefrom may be claimed in a lawsuit by the injured party. The problem is that the "standard" is often a subjective issue upon which reasonable people can differ.

**Statutory.** Created, defined, or relating to a statute; required by statute; conforming to a statute.

**THIRD PARTIES.** This term includes all persons who are not parties to the contract, agreement or instrument of writing, by which their interest in the thing conveyed is sought to be affected.
tort n. French for wrong, a civil wrong, or wrongful act, whether intentional or accidental, from which injury occurs to another. Torts include all negligence cases as well as intentional wrongs which result in harm. Therefore tort law is one of the major areas of law (along with contract, real property and criminal law), and results in more civil litigation than any other category. Some intentional torts may also be crimes such as assault, battery, wrongful death, fraud, conversion (a euphemism for theft), and trespass on property and form the basis for a lawsuit for damages by the injured party. Defamation, including intentionally telling harmful untruths about another, either by print or broadcast (libel) or orally (slander), is a tort and used to be a crime as well


THERE ARE FOUR BASIC SYSTRUST STANDARDS, ranging from most restrictive (least likelihood of a successful third-party lawsuit) to least restrictive. Different states follow different standards.

- Privity requires that a direct connection or contractual relationship exist between an accountant and a third party for the latter to be able to sue a practitioner.
- Near-privity requires the plaintiff to prove he or she was an intended third-party beneficiary.
- The restatement rule, in general, says a CPA owes a duty to a client (or others) whom the client or accountant intends the information to benefit.
- Reasonable foreseeability says accountants have a duty to all whom they could reasonably foresee as receiving and relying on their work product.


(A) Joint and several liability.--Any covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws.

(B) Proportionate liability.--

(i) In general.--Except as provided in paragraph (1), a covered person against whom a final judgment is entered in a private action shall be liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that covered person, as determined ...

(ii) the percentage of responsibility of such person, measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff; and

Proportionate Liability. Private Securities Litigation Reform Act of 1995. Section 201