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Robert Stern

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THE LEGAL RELATIONSHIPS within the accounting profession are currently in a state of uncertainty caused by both internal and external forces. Due to fairly recent developments of the law widening the breadth and scope of its potential liability, the accounting profession, in an effort to more precisely define and clarify its moral and legal duties, "is deeply involved in a great debate over how precisely accounting principles should be defined and how rigidly enforced." [1] Some spectacular lawsuits recently ". . . tend to reflect the growing responsibilities and hazards of the accounting profession in an age of increasingly complex international business." [2]

Duty to the Client for Misfeasance

The common law duty of care has been relatively well established in the area of misfeasance to clients. The same standards of due care which apply to the various other professions such as doctors, lawyers, architects, engineers and others engaged in furnishing skilled services for compensation are also applied to the accounting profession.[3]

These professional men have a duty to exercise reasonable care in the performance of their work.[4] This necessarily implies that they possess the minimum standards commonly possessed by other members of the profession.[5] More specifically, accountants have a duty to their employer to perform their work with the care and caution proper to their calling.[6] While the imposition of such standards may appear rather harsh, further analysis reveals that liability would only arise where lack of reasonable care, fraud, or bad faith are indicated since they are entitled to a wide discretion in the selection of such methods and in determining which of several practices or principles is most sound or best suited for the work undertaken by them.[7] It can be seen that where an accountant has been negligent in his work he may well be liable for damages caused to his client.

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* B.S., Ohio State University; C.P.A., Ohio; Fourth-year student at Cleveland-Marshall Law School.

1 Wise, The Very Private World of Peat, Marwick, Mitchell, in Fortune Magazine, July, 1966, at 129.

2 *Id.* at 128. See, for typical trial questions to an accountant in a negligence claim, 1 Encyc. of Negl., 15 (Form No. 9) (1962).

3 Gammel v. Ernst & Ernst, 245 Minn. 249, 252, 72 N.W. 2d 364, 367 (1955).

4 Prosser, Torts § 32 at 164 (3rd ed. 1964).

5 *Id.*

6 Ultramares Corporation v. Touche, 255 N.Y. 170, 173, 174 N.E. 441, 444 (1931).

7 *Supra* note 3.

Duty to Third Parties for Misfeasance

More difficult problems arise where third parties, who have relied on the work of accountants, are attempting to recover from the latter, asserting there was a breach of their duty of care.

Judge Cardozo wrote the opinion in the landmark case in this area.[8] Plaintiffs were a factor and had lent money to defendants' client, relying on the financial statements certified by the defendants, an accounting firm. The defendants had not verified an entry of over $700,000 to accounts receivable, which subsequently was discovered as false. It was held that defendants not only owed a duty to their client to render their opinion without fraud, but also to creditors and investors to whom the certificate was exhibited.[9] The defendants had notice in the circumstances that the certificate would not be used exclusively by the employer.[10]

Later it was stated that an inference of fraud may be drawn where negligence or blindness is present, at least where there is gross negligence.[11] While this appears rather harsh taken literally, the rule was qualified earlier in the text of the decision. Realizing the ramifications of such a broad position not only to accountants but to the other professions, Cardozo definitely ruled out third-party liability where only negligence could be shown.[12] He felt that extending the rule so far would "enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." [13]

This decision was later followed in *State Street Trust Co. v. Ernst.*[14] Again, a creditor was trying to recover from an accounting firm for losses sustained by relying on an allegedly fraudulent financial statement prepared by the accountants. Judge Finch, speaking for the majority of the court, held that liability would attach where a representation was made with no foundation.[15]

> A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an

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[8] *Supra* note 6.

[9] *Id.*

[10] *Id.*

[11] *Supra* note 6 at 178, 174 N.E. at 449.

[12] *Supra* note 6 at 173, 174 N.E. at 444.

[13] *Supra* note 6 at 173, 174 N.E. at 444:

"A different question develops when we ask whether they [defendants] owed a duty to these [third parties] to make it without negligence. 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 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."

[14] State Street Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E. 2d 416 (1938).

[15] *Id.* at 112, 15 N.E. 2d at 419.

> opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability.

Gross negligence would lead to an inference of fraud where there was a heedlessness and a reckless disregard of consequence.[16]

The scope of accountants' liability was again limited. Unless a contractual relationship or its equivalent can be shown, accountants will not be held liable for ordinary negligence.[17]

It is clear then, that where the accountant performs his duties fraudulently or where he is grossly negligent and knows or reasonably expects third parties to rely on his opinion, he may well be liable for any damages caused by his conduct.

Duty to Third Parties for Nonfeasance

One of the most intriguing questions currently under discussion in this area is concerned with the liability of accountants where they have rendered an opinion on the financial statements of their clients and, assuming that due care in the original opinion is not being disputed, what are their duties when they later learn that their financial statements are materially in error? Some of the difficult questions raised are:

> How long, for instance, does the duty to disclose after-acquired information last? To whom and how long should disclosure be made? Does liability exist if the after-acquired knowledge is obtained from a source other than the original supplier of information? Is there a duty to disclose if an associate or employee of the accounting firm discovers that the financial statements are false but fails to report it to the firm members?[18]

While wrongful acts are usually construed in terms of misfeasance, an omission or failure to act can be as equally damaging. This proposition has had a labored development in the common law and was slow to receive recognition.[19] There was a tendency in the common law to only give relief for active misfeasance. Liability for omissions to act belonged to a later period.[20]

Liability for nonfeasance first was imposed on those engaged in "public" callings on the theory that they undertook a duty by holding themselves out to the public.[21] Later this was extended to all contractual relationships.[22]

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16 *Id.*

17 *Supra* note 14 at 111, 15 N.E. 2d at 418.

18 Fischer v. Kletz, 266 F. Supp. 180, 189 (S.D. N.Y. 1967).

19 Prosser, *supra* note 4 at 334.

20 McNiece and Thornton, Affirmative Duties in Tort, 58 Yale L. J. 1272, 1289 (1949).

21 Prosser, *supra* note 4 at 334.

22 *Id.*

Obviously, before liability could lie for not disclosing after-acquired information, there must first be a duty by the person making the original representation to disclose to those relying on it.[23] Where an accountant renders a written opinion on the financial statements of his client, he knows that various third parties will likely be in a position of reliance on his word.[24] In fact, the purpose of many audits is for the use of government agencies, investors, creditors, unions, and other interested parties.[25]

In one of its publications, the American Institute of Certified Public Accountants stated that:

> Most audit reports are prepared for "general" purposes; that is, they are intended to be useful to management, and stockholders and others, as well as to creditors.[26]

Rarely will an accountant be allowed to assert that he didn't know that his client intended to exhibit his opinion to third parties.

Under the circumstances in question, accountants are in a position of trust of confidence, one that assumes the position of a fiduciary. A fiduciary relationship is not subject to absolute definition. It implies a position of trust and confidence contemplating fair dealing and good faith between parties.[27] Such a relationship is based on the personal confidence reposed by one person in another[28] and includes informal relations when one person trusts and relies on another, as well as technical fiduciary relations.[29] Some of the more obvious examples of what are generally held to be fiduciary relationships are principal and agent, attorney and client, parent and child, and guardian and ward.[30]

The duty of care of one occupying the position of a fiduciary is higher than one acting at arms length. "A trustee is held to something stricter than the morals of the market place." [31] "Only thus has the level of con-

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23 Loewer v. Harris, 57 F. 368 (C.A. 2d 1893).

24 Duro Sportswear, Inc. v. Cogen, 131 N.Y.S. 2d 20, 25 (1954).

25 Touche, Niven, Baily & Smart, S.E.C. Accounting Ser. Rel. No. 78, 3 CCH Fed. Sec. L. Rep. ¶ 72,100, 62,236 (1957). "The responsibility of a public accountant is not only to the client who pays his fee, but also investors, creditors, and others who may rely on the financial statements which he certifies."

26 American Institute of Certified Public Accountants, *Questions & Answers About Audit Reports* 15 (1955-1956) (published by American Institute of Certified Public Accountants, New York, N. Y.).

27 Kinzbach Tool Co., Inc. v. Corbett-Wallace Corp., 13 Tex. 565, 566, 160 S.W. 2d 509, 512 (1942).

28 Moffatt v. Fulton, 132 N.Y. 507, 509, 30 N.E. 992, 994 (1892).

29 Glover v. National Bank of Commerce, 156 App. Div. 247, 253, 141 N.Y.S. 409, 415 (1913).

30 Curtis v. Armagast, 158 Iowa 507, 512, 138 N.W. 873, 878 (1912); O'Brien v. Stoneman, 227 Iowa 389, 390, 288 N.W. 447, 448 (1939).

31 Meinhard v. Salmon, 249 N.Y. 464, 164 N.E. 545, 546 (1928).

duct for fiduciaries been kept at a level higher than that trodden by the crowd." [32]

With the confidential relationship and the correlative duty established, what should the law expect of the accountant after he discovers an error? Earlier it was pointed out that at first the courts would only give relief for misfeasance, but later imposed liability for nonfeasance on those engaged in "public" callings and further extended this to all contractual relations.[33] Prosser states that:

> During the last century, liability for "nonfeasance" has been extended still further to a limited group of relations, in which custom, public sentiment and views of social policy have led the courts to find a duty of affirmative action. It is not likely that this process of extension has ended.[34]

The general law on this question is summarized in the *Restatement of Torts* which states that where there is a duty to exercise reasonable care, one has a duty to disclose matters which he knows may justifiably induce a party to act or refrain from acting.[35]

Extending this basic principle, which has been so held in a number of decisions, a party has the same duty to disclose

> Any subsequently acquired information which he recognizes as making untrue or misleading a previous representation which when made was true or believed to be so.[36]

In the case of *Loewer v. Harris*,[37] negotiations were made for the sale of a brewery. One of the primary factors in the negotiations was the profits of the company. Plaintiffs had been given various information by the defendants showing the profits and were told that since the information was prepared "the business was showing a gradual increase." Later the defendants discovered that the profits were not increasing but had actually decreased. Addressing themselves to the question, the court stated that when a party has held out the existence of a state of facts which are material and, knowing the other party is acting upon them, when he later learns of a change which the other party is not aware of:

> [G]ood faith and common honesty require him to correct the misapprehension which he has created. It becomes his duty to make disclosure of the changed state of facts, because he has put the other party off his guard.[38]

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32 *Id.*

33 Prosser, *supra* note 4 at 334.

34 *Id.* at 335.

35 Restatement of Torts, § 551 (1) (1938).

36 *Id.* § 551 (2) (b).

37 *Supra* note 23 at 373.

38 *Id.*

The Restatement of the Law, Restitution, also takes the same position:

> [O]ne who makes a statement which was true at the time of speaking discovers that it is untrue with reference to present facts or if he discovers that a statement which was immaterial when made has become material, he is under a duty of disclosure.[39]

Another case in point is *Hush et ux. v. Reaugh.*[40] Here it was said that:

> [I]f one has made a statement which was true when made and a material change takes place in financial condition, in value, or in health, he is guilty of fraud in not disclosing such change when he knows or should know that the other party relies on such original representation.[41]

Summary and Conclusion

Accountants, like those in the other professions, have a duty to their clients to perform their work with due care. That is, they must possess the minimum standards of their calling and must exercise reasonable care in their endeavors. Negligent conduct may subject them to liability.

Certain duties are often owed to third parties. They exist where it is reasonably expected that various interested groups, other than clients, will be relying on their work. This situation can be expected to increase as accounting information is understood and is being used by a wider audience as the business world grows increasingly complex and sophisticated. In this situation accountants assume the role of a fiduciary and must act accordingly.

Where a duty to third parties exists, mere negligence will usually not create liability for misfeasance. However, where it can be shown that they were grossly negligent or even fraudulent in their work, third parties should be able to recover for damages caused by such conduct.

The development of common law liability for nonfeasance has had a retarded development and more difficult problems are unfortunately encountered. However, the courts have been more willing to grant relief in this area in recent times. When a duty exists and damages have been incurred, the courts will be less likely to find a difference in an original misstatement and a failure to correct a prior statement that had been originally made "bona fide."

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39 Restatement of Restitution, § 8b. (1937).

40 Hush v. Reaugh, 23 F. Supp. 646 (Ill. 1938).

41 *Id.* at 652.