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Liability of Accountants to Third Parties for Negligence and Deceit

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Notes

LIABILITY OF ACCOUNTANTS TO THIRD PARTIES FOR NEGLIGENCE AND DECEIT

An attempt to extend further the asserted proposition that one who negligently performs a contractual duty owed another is liable for injuries resulting to a stranger to the contract was frustrated recently by the New York Court of Appeals in the case of *Ultramares Corporation v. Touche.*[1] The Supreme Court, basing its decision on the case of *Glanzer v. Shepard,*[2] had held that a firm of accountants, who had negligently certified a balance sheet for an insolvent corporation, were liable to a third party who had lent money to the corporation in reliance upon the balance sheet.[3] The Court of Appeals, however, was not willing to allow a verdict on the ground of negligence, but held that liability could be predicated only on the ground of deceit, inasmuch as there were entries in the accounts of so suspicious a nature as to make representations based thereon in the absence of further investigation such gross negligence as is equivalent to deceit upon those creditors who relied upon the statement in making advances. It therefore reversed the decision of the Supreme Court.

The case is interesting and important from two angles, the judicial treatment by the Court speaking through Chief Judge Cardozo,[4] and the effect of the decision upon a profession, fast growing in importance.[5]

A further consideration of the facts in the instant case shows that the defendants, Touche, Niven and Company, a firm of public accountants, were employed by Fred Stern and Company to prepare and certify a balance sheet exhibiting the condition of its business in December 31, 1923. They had been employed at the end of each of three years preceding to render a like service. Knowing that such a statement would be exhibited to banks, creditors, stockholders, purchasers and sellers, they made up and supplied the Stern Company with thirty-two copies certified with serial numbers as counterpart originals. The certificate was as follows: "We have examined the accounts of the Fred

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

[2] (1922) 233 N. Y. 236, 135 N. E. 275.

[3] Ultramares Corp v. Touche (1930) 229 App. Div. 581, 243 N. Y. S. 179.

[4] Green, *The Judicial Process—Ultramares Corp. v. Touche* (1931) 26 ILL. L. REV. 49.

[5] Lay, *Business Policy as Related to Accounting* (1929) 4 ACC. REV. 121; Davies, *The Changing Objectives of Accounting* (1929) 4 ACC. REV. 94, 106.

Stern and Co., Inc., for the year ending December 31, 1923, and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanation given us. We further certify that, subject to provision for federal taxes on income, the said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern and Co., Inc., as at December 31, 1923."[6]

The plaintiff, a corporation engaged in business as a factor, was approached by Stern in March, 1924, with a request for loans of money to finance the sales of rubber. Since the previous dealings between the two houses had been slight, the plaintiff requested a balance sheet certified by public accountants. One of the thirty-two certified by the defendant was given by the Stern Company to the plaintiff, and in reliance thereon, the latter extended the Stern Company a large line of credit, which amounted to the sum of $165,000 in the month of December alone. In January, 1925, the Stern Company was declared bankrupt.

The balance sheet had shown a net worth of $1,070,715.26, while, as a matter of fact, the Stern Company was insolvent at the time. The assets included many spurious items, especially a suspicious entry of about $700,000, which were not verified by the defendant's accountant.

The New York Supreme Court dealt with the case rather superficially in allowing a verdict on the negligence count and not on the deceit count. It brought the above facts within the general dictum of *Glanzer v. Shepard,* saying that "here is an act performed carelessly, intended to influence the actions of third parties, and one that reasonably might be expected, when carelessly performed, to cause substantial loss."[7]

In *Glanzer v. Shepard,* a seller of beans requested the defendants, public weighers, to make return of the weight and furnish the buyer with a copy. This the defendants did. Their return, which was one made out in duplicate, one copy to the seller and the other to the buyer, recited that it was made by order of the former for the use of the latter. The buyer paid the seller on faith of the certificate which turned out to be erroneous. The weighers were held liable at the suit of the buyer for moneys overpaid. The opinion in that case was also rendered by Chief Judge Cardozo. In distinguishing that case from the instant case, he said: "Here [*Glanzer* case] was something more than the rendition of a service in the expectation that the one who ordered the certificate would use it thereafter in the operations of his business as occasion would require. Here was a case

[6] N. 1 above, 442.
[7] N. 3 above, 184.

where the transmission of the certificate to another was not merely one possibility among many, but the 'end and aim of the transaction' . . ."[8]

Hence, it was conceded in the present case that the accountants were negligent, that is, there was a violation of duty, if any duty to be careful existed, and that there was the damage and causal relation. That a duty existed, however, in the same sense that one was recognized in *Glanzer v. Shepard* was denied. Reasons for holding thus were found in both business and administrative policies.[9]

From the business standpoint:

> 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 inkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.[10]

The necessity for a limit somewhere is recognized. Yet it would seem that in the case of a profession in which special skill is an inherent characteristic and which fact is recognized by statutes in the various states, licensing certified public accountants, such a limit should be extended to include that class—regardless of size—which might reasonably be expected to rely on the professional statements. The fact that the class is large, and hence the extent of injury vast, are reasons for recognizing such a further duty, rather than for limiting the scope of liability, because of the admittedly widespread danger.

From the administrative standpoint:

> The extension, if made, will so expand the field of liability for negligent speech as to make it nearly, if not quite coterminous with that of liability for fraud. . . We have said that the duty to refrain from negligent misrepresentation would become coincident or nearly so with the duty to refrain from fraud if this action could be maintained.[11]

It is true that there is a need for securing the integrity of both networks of the deceit and negligence theories so as not to render the handling of cases difficult by confusing many points of conflicting formulae.[12] But it should not be deduced as a necessary consequence that parties in the same class such as ac-

[8] N. 1 above, 445.
[9] *Op. cit.* n. 4 above, 50, 51.
[10] N. 1 above, 444.
[11] *Ibid.* 447.
[12] *Op. cit.* n. 4 above, 51.

countants, may not fall into either one of the two classes, depending upon the particular circumstances. The need for distinct separation of the two legal theories does not require nor justify the labeling of all accountants in such an exclusive manner that, in relation to third parties who rely upon certified statements prepared by them for debtors, only the deceit theory may operate and not the other.[13]

In distinguishing the negligence theory in reference to liability to third parties, Judge Cardozo points out:

> . . . the duty to speak with care does not arise unless the words are the culmination of a service . . . and unless the service is rendered in the pursuit of an independent calling, characterized as public. . . Public accountants are public only in the sense that their services are offered to any one who chooses to employ them. This is far from saying that those who do not employ them are in the same position as those who do.[14]

In the *Glanzer* case the words were the culmination of the service. The statement of weight and nothing more was to be the final outcome of the whole transaction. That statement was intended to be and actually was a basis for the transaction between the buyer and seller. In *International Products Co. v. Erie R. R. Co.*,[15] the defendant carrier, which was bailee of plaintiff's goods, upon the request of the plaintiff, named the place where the goods were stored, but did so incorrectly. The consequence was that an insurance policy which plaintiff had procured upon the goods did not attach. The goods were destroyed by fire. The defendant was held liable. In that case, it was said that there was such a relationship between the parties, so that a duty existed "if one speaks at all, to give the correct information."[16] The giving of the information by the Erie was not the basic service, but was rather incidental. Chief Judge Cardozo reconciles this latter fact to the above rule wherein the words are necessarily the culmination of a service, by pointing out that the Erie was not held for negligence in the rendition of a service, but "it was held for words and nothing more."[17] As a matter of good business practice, the decision is creditable, since the risk should fall on him who has the information at hand and upon whose word reliance is placed.

Furthermore, the certification by a trustee that assets are in

[13] N. 1 above, 447-8.
[14] *Ibid.* 448.
[15] (1927) 244 N. Y. 331, 155 N. E. 662.
[16] *Ibid.* 664.
[17] N. 1 above, 446.

his possession allows no latitude.[18] When his certificate induces another to become a beneficiary of the trust, he must certify truly or become responsible to those who invest their moneys upon the faith of his certificate. Honesty of purpose is no excuse.[19]

It is therefore indicated that the incidental use by the plaintiffs of the balance sheet certified by the defendants in the present case was not such a culmination of the service as to create a duty between the parties sufficient to render defendants liable for carelessness. The bringing of accountancy within the class of "public calling" so that such a duty would arise, furthermore, would be such an extension that in many analogous situations, the liability for negligent speech would become nearly, if not quite, coterminous with fraud. For instance, lawyers who certify their opinions as to the validity of municipal or corporate bonds, title companies insuring titles to land, newspapers reporting market quotations,[20] and other such unlimited number of examples, would be kept with difficulty from the operation of the extended doctrine.

There is some precedent for the proposition that, as between a party to a contract to perform a service and a third party stranger, a sufficiently direct relationship may be deemed to exist as will give rise to a duty not to be negligent. Those engaged in "common callings," such as the practice of medicine, have been brought within the scope of such liability.[21] There has been a split of authority on the question of liability when the contract involves a supposed public duty in addition to the contractual duty, as in cases where a property owner attempts to hold one who has contracted with a municipality to supply it with water for fire protection and such contract has been breached.[22] The majority of the courts hold, however, that there is no liability.

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[18] Doyle v. Chatam & Phenix Nat. Bank (1930) 253 N. Y. 369, 171 N. E. 574.

[19] *Op. cit.* n. 4 above, 52.

[20] See Jaillet v. Cashman (1923) 235 N. Y. 511, 139 N. E. 714. In that case the defendant supplying ticker service to brokers was held not liable in damages to one of the broker's customers for the consequences of reliance upon a report negligently published on the ticker.

[21] Pippin and Wife v. Sheppard (1822) 11 Price 400, 147 Eng. Repr. 512. See Bohlen, *Affirmative Obligations in the Law of Torts* (1905) 53 AM. L. REG. 209, 219.

[22] Moch Co. v. Rensselaer Water Co. (1928) 247 N. Y. 160, 159 N. E. 896; German Alliance Insurance Co. v. Home Water Co. (1912) 226 U. S. 220, 33 Sup. Ct. 32. *Contra,* Woodbury v. Trampa Water Works Co. (1909) 57 Fla. 243, 49 So. 556 (minority view). See comprehensive note in (1928) 62 A. L. R. 1199, 1205.

Under the "dangerous instrumentality" doctrine, manufacturers, contractors and vendors have been held liable where their negligence has resulted in injuries to life or limb.[23] The liability of telegraph companies in this country to the recipients of messages negligently transmitted has been long settled.[24] Some jurisdictions hold a title abstractor liable to third parties expected to rely on the certificate,[25] while others make him liable by statute.[26]

On the fraud doctrine, the court in the instant case finds little difficulty in showing that there were sufficient grounds to infer deceit. It said:

> Fraud includes the pretense of knowledge when knowledge there is none. To creditors and investors to whom the employer exhibited the certificate, the defendants owed a . . . duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself. . .[27] The defendants certified as a fact, true to their own knowledge, that the balance sheet was in accordance with the books of account. If their statement was false, they are not to be exonerated because they believed it to be true. . .[28] The plaintiff does not need the invention of a novel doctrine to help it out in such conditions.[29]

This conclusion on the basis of fraud has but one disturbing element in it. It is denied that there is a sufficient relationship between the plaintiffs and accountants in the present case to permit reliance on the balance sheet so as to predicate liability for negligence. Nevertheless, it is asserted that there is such a relationship between the defendant and plaintiff for purposes of imposing liability for fraud. The Court speaks of a duty "to creditors and investors to whom the employer exhibited the certificate." It is settled that only those whose actions were intended to be influenced have a right to accept and rely upon the

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[23] MacPherson v. Buick Motor Co. (1919) 217 N. Y. 382, 111 N. E. 1050; American Law Institute, RESTATEMENT OF LAW OF TORTS, 262. For comprehensive discussion see, Bohlen, *Liability of Manufacturers to Persons Other Than Their Immediate Vendees* (1929) 45 L. Q. REV. 343.

[24] Western Union Telegraph Co. v. Dubois (1889) 128 Ill. 248, 21 N. E. 4. English rule is *contra.* But see Pollock, LAW OF TORTS (11th ed. 1920) 560.

[25] Anderson v. Spriesterbach (1912) 69 Wash. 393, 125 Pac. 166. Compare a recent case, Cole v. Vincent (1930) 242 N. Y. S. 644, where knowledge in the abstractor of the third person's identity was held immaterial.

[26] (1930) 40 YALE L. J. 128, n. 14. See note (1925) 34 A. L. R. 67, 73.

[27] N. 1 above, 444.

[28] *Ibid.* 448.

[29] *Ibid.* 444.

representation of others.[30] In fact, one may even be the person to whom the false representations are made, and yet be entitled to no remedy, if they were made to him as agent for another and to affect the action of the other, and were not intended to influence his own action.[31]

Where one person, however, makes a false representation to another for the purpose of being communicated to a third party, then there will be liability to the latter for fraud.[32] Upon this principle, therefore, where fraudulent statements are made to mercantile agencies by persons regarding the status of their business, they are held liable to all parties relying upon such statements.[33] Also in cases where projectors of corporate undertakings publish prospectuses containing misrepresentations calculated to influence others to invest moneys in their projects, liability for fraud to third parties has been sustained.[34] It is within such a class of third persons that the *Ultramares* case attempts to bring creditors who rely upon balance sheets fraudulently prepared for employers by public accountants.

It is not suggested that the public is not within a sufficiently close relationship in the case of creditors relying upon statements given to mercantile agencies, or in the case of persons relying upon false prospectuses, to show fraud on the part of those issuing such statements to themselves. It is suggested, however, that the public, among whom are creditors, are not in a position so analogous to the third parties above, that a sufficient privity as to public accountants certifying balance sheets for employers to whom said public has extended credit in reliance thereon may be deemed to exist for purposes of fraud. This suggestion is made in light of facts pointed out by Judge Cardozo in dismissing the negligence theory, wherein he states that "the service was primarily for the benefit of the Stern Company, a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit thereafter."[35]

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[30] Throckmorton's, COOLEY ON TORTS (1930) 601; Henry v. Dennis (1902) 92 Me. 24, 219 Atl. 58; Hindman v. First Nat. Bank (C. C. A. 8, 1902) 112 F. 931.

[31] Wells v. Cook (1865) 160 Ohio St. 67; McCracken v. West (1848) 17 Ohio 16.

[32] Waston v. Crandall (1883) 78 Mo. 583; Baker v. Crandall (1883) 78 Mo. 584; Commonwealth v. Call (Mass. 1839) 21 Pick. 515, 523.

[33] Eaton, Cole & Burnham Co. v. Avery (1880) 83 N. Y. 31; Tindle v. Birkett (1902) 171 N. Y. 520, 64 N. E. 210.

[34] *Op. cit.* n. 30 above, 602; Paddock v. Fletcher (1869) 42 Vt. 389; Terwillinger v. Grt. West. Tel. Co. (1871) 59 Ill. 249. See also Derry v. Peek (1889) 14 A. C. 337.

[35] N. 1 above, 446.

Prospectuses and statements to mercantile agencies, on the other hand, are made with the sole intention of obtaining credit or investment. The basis of the distinction laid down with reference to the negligence theory between the *Ultramares* case and the *Glanzer* case was that in the latter case, the statement of weight for use by both buyer and seller was said to be the "end and aim of the transaction."[36] Consistency demands that a similar distinction be made in dealing with the fraud theory in the *Ultramares* case.

Judge Cardozo, however, disposes of this "logic" by pointing out that "foresight of these possibilities [incidental use of certified balance sheet by creditors] may charge with liability for fraud," but "The conclusion does not follow that it will charge with liability for negligence."[37] This explanation seems somewhat inadequate. The logical inconsistencies in reconciling and distinguishing relationships or privities necessary to maintain an action for negligence on the one hand and an action for deceit on the other leave one seeking an understanding of the law with a feeling of dissatisfaction.[38]

The decision in the *Ultramares* case has, apart from this disconcerting effect upon legal theories, redeeming features from the practical standpoint of the judicial process. Professor Green remarks:

> The fraud formula as a moral solvent is at the same time consistent with good business and easy administration. Under it the judge may exercise a maximum of power. . . The accountant is not placed under less responsibility, but more. If he unqualifiedly certifies to facts which are not true, he is not merely under a duty to be *diligent*, but he is under a duty to be correct. . .
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> The latitude allowed by permitting the jury to infer fraud from negligence leaves all to the jury and gives every ad-

[36] *Ibid.* 445.

[37] *Ibid.* 446.

[38] See Cardozo, THE NATURE OF THE JUDICIAL PROCESS (1928) 28. "I own that it is a good deal of mystery to me how judges, of all persons in the world, should put their faith in dicta. A brief experience on the bench was enough to reveal to me all sorts of cracks and crevices and loopholes in my own opinions when picked up a few months after delivery and reread with contrition." Later the author says, "The directive force of logic does not always exert itself, however, along a single and unobstructed path. One principle or precedent, pushed to the limit of its logic, may point to one conclusion; another principle or precedent, followed with like logic, may point with equal certainty to another. In this conflict, we must choose between the two paths, selecting one or other, or perhaps striking out upon a third which will be the resultant of the two forces in combination, or will represent the mean between two extremes." *Ibid.* 40.

> vantage afforded by the negligence formula. In addition, in its psychological effects the fraud formula is more sobering upon the jury than a formula requiring less moral culpability. . . In these cases, therefore, the fraud formula, permitting at one moment the most decisive use of judicial power, at another the wide variation of law verdicts, serves the purpose of consistent administration far better than the negligence formula which allows the judge the minimum and the jury the maximum of power in nearly all cases.[39]

There is some general truth in Professor Green's conclusion, although there is room for question in regard to the statement that more responsibility is placed upon the accountant by the fraud theory alone in the *Ultramares* case. It is not suggested that the fraud theory be abandoned in the least, but rather that it should not preclude the negligence theory. Cases are conceivable wherein accountants may be found to be negligent to third parties and yet not fraudulent.[40]

Conceding that the certification of a balance sheet for credit purposes is not its only use, yet there is much evidence in everyday business practice that such use is recognized as one of the most important if not the most important use.[41] It is true that the creditor can find other means of protecting his interests without reliance upon the debtor's balance sheet prepared by the debtor's own accountant.[42] But the fact remains that he does not seek such other means for practical reasons, and of this fact the accountant must be aware. Moreover, the increasing complexity of business and of methods of handling business will increase the need for authoritative data and accurate statements[43] so that eventually the scope of relationship sufficient to show liability of a public accountant to third parties will of necessity be drawn closer to include negligence.[44]

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[39] *Op. cit.* n. 4 above, 55.

[40] See lower court decision in Ultramares Corp. v. Touche, n. 3 above. Also the appellate court decision, n. 1 above, 448.

[41] Eggleston, AUDITING PROCEDURE (1926) 15.

[42] *Op. cit.* n. 4 above, 55.

[43] Baldwin, *Liability of Accountants to Third Parties* (1931) 52 J. OF ACC. 342 (dealing with Ultramares case).

[44] See further (1919) 29 YALE L. J. 234, commenting on Landell v. Lybrand (1919) 264 Pa. 406, 107 Atl. 783, which held in accord with Ultramares case that a certified public accountant is not liable to purchasers of stock who relied upon balance sheet negligently prepared for insolvent corporation. The comment criticizes the decision in the case.