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Within the context of the general trend toward expanding legal liability which permeates our society,[1] the accounting profession has certainly not escaped unscathed. The days when professions were largely autonomous, self-regulated and immune from significant external legal influences are over,[2] and some legal commentators interpret this change as a threat to the accounting profession.[3] While the profession has strengthened its standards and is considering even more rigorous educational requirements,[4] the liability explosion and the increasing disciplinary activity of administrative agencies such as the Securities Exchange Commission[5] have created an environment which necessitates an assessment of the law's treatment of accountants.

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1. If increased litigiousness is any measure, a virtual explosion of liability is taking place. There were 206,193 civil lawsuits filed in federal court in 1982, *twice* as many as in 1974, and *triple* the number filed in 1960. There was a sevenfold increase in federal appeals between 1960 and 1982, and the number of state suits increased by 22 percent between 1977 and 1982, while state appeals increased by 32 percent in the same period. Minow, *Accountants' Liability and the Litigation Explosion*, 10 J. ACCT. 75 (1984).

2. The liability of *all* the professions is expanding at an unprecedented pace, as legal theories that would have been unthinkable twenty years ago are pursued with relish.

> Architects, doctors, lawyers . . . all face a steady stream of lawsuits. The suits seem premised on the view that the professional's responsibilities extend to every possible occurrence. The cases appear to reflect a rejection of the notion that a professional may be living up to his or her best professional ability and yet still be unable to prevent risk or the misfortunes of patients or clients.

Id. at n.1. Such a view would have been unacceptable twenty years ago.

3. *See* Minow, *supra* note 1, at 75, 81 for portentious statements regarding the effects of accountants' increased liability exposure.

4. *See* Nelson, *Accounting in a Decade—Trade or Profession*, 48 C.P.A.J. 6, 11 (1978); Ellyson, *A 5-Year Education Requirement?*, 52 C.P.A.J. 12, 39 (1983).

5. *See infra* notes 36-46 and accompanying text.

A. *Accountants' Liability at Common Law*

Traditionally, accountants' liability at common law has involved three principal theories: breach of contract; fraud; and negligence. Most of the expansion of common law liability, however, has involved the latter theory, customarily manifested by a general expansion of the "duty" concept as applied to the accountant in negligence actions.[6]

The traditional common law rule governing the extent of auditors' liability for negligence was for fifty years the principle enunciated by Judge Cardozo in the classic case of *Ultramares Company v. Touche.*[7] *Ultramares* involved a suit against an accounting firm for negligently preparing a balance sheet utilized by the plaintiff as a basis for issuing a loan to the defendant's client.[8] Since the balance sheet showed assets exceeding $1 million, plaintiff loaned defendant's client the money. However, defendant's client was in fact insolvent, and in subsequent bankruptcy proceedings, plaintiff sustained losses on the loans it had made.[9] While taking judicial notice of the fact that the assault upon the "citadel of privity" was proceeding apace, Judge Cardozo nevertheless held that accountants could not be held liable to third parties for negligence.[10] Such a rule would expose accountants to liability "for an indeterminate amount for an indeterminate time to an indeterminate class."[11]

Until 1968, the requirement of privity enunciated in *Ultramares* enjoyed an absolute reign.[12] Thus, it was universally the law that

6. Compared with the flux in the negligence "duty of care" area, accountants' liability under common law fraud and contract theories have remained rather stable. Plaintiffs in contractual privity with defendant accountants enjoy all the traditional contract theories and remedies, but third parties apparently have not been successful under contract theory, although a "third party beneficiary" model of liability may be emerging. *See* Nortek, Inc. v. Alexander Grant & Co., 532 F.2d 1013 (5th Cir. 1976). Most of the fraud cases today are brought under the aegis of the federal securities laws, discussed *infra.*

7. 255 N.Y. 170, 174 N.E. 441 (1931). *Ultramares* remains the law in New York. *See also* Dworman v. Lee, 83 A.D.2d 507, 441 N.Y.S.2d 90 (1981), *aff'd*, 56 N.Y.2d 816, 438 N.E.2d 103, 452 N.Y.S.2d 570 (1982) (no liability where plaintiffs alleged that they became sureties under a contract in reliance on financial statements defendant accountants had prepared). The wisdom of its principles, however, has recently been questioned at the intermediate appellate level. *See* Credit Alliance Corp. v. Arthur Andersen & Co., 101 A.D.2d 231, 476 N.Y.S.2d 539 (1984), *rev'd* in part, 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985).

8. 255 N.Y. 170, 174 N.E. 441 (1931).

9. *Id.*

10. *Id.* at 178.

11. *Id.* at 179.

12. *See* Brodsky and Swanson, *The Expanded Liability of Accountants for Negligence*, 12 SEC. REG. L. J. 252, 258 (1984).

where an "honest blunder" was involved, the ensuing liability for negligence was bounded by the contract and limited to the parties bargaining therein.[13] It was not until *Rusch Factors, Inc. v. Levin*[14] that the wisdom of *Ultramares* was first seriously questioned. *Rusch* involved a negligence suit against an accountant by a factor who had lent money to an insolvent borrower on the basis of financial statements negligently prepared by defendant accountant. Before upholding liability based upon the accountant's knowledge that the plaintiff was the single party to whom the financial statements would be provided,[15] the court noted:

> 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 on to its customers, who can in turn pass the cost on to the entire consuming public? Finally, wouldn't a rule of forseeability elevate the cautionary techniques of the accounting profession? For these reasons it appears . . . that the decision in *Ultramares* constitutes an unwarranted inroad upon the principle that "[t]he risk reasonably to be perceived defines the duty to be obeyed."[16]

The *Rusch* expansion of *Ultramares* to encompass a "reasonable foreseeability" rule was echoed a year later by the Iowa Supreme Court in *Ryan v. Kanne*,[17] which involved a fact situation virtually identical to that in *Rusch*. The Iowa court ruled that accountants may be held liable to third parties not in privity who reasonably rely upon financial statements negligently prepared by accountants.[18] While *Rusch*, *Ryan* and recent New York cases[19] all employ

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13. The two well-recognized exceptions to *Ultramares* are where the accountant fraudulently prepared a financial statement and where the accountant negligently prepared a financial statement primarily for the benefit of a third party known to the accountant. 255 N.Y. at 189, 174 N.E. at 448. The latter exception in particular has been used by courts to circumvent the rule, and may have the potential for swallowing it. *See* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968). Its essence was expressed by Judge Cardozo in *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 393, 111 N.E. 1050, 1054 (1916):

> The contractor who builds the scaffold invites the owner's workmen to use it. The manufacturer who sells the automobile to the retail dealer invites the dealer's customer to use it. The invitation is addressed in the one case to determinate persons and in the other to an indeterminate class, but in each case it is equally plain, and in each its consequences must be the same.

Id.

14. 284 F. Supp. 85 (D.R.I. 1968).

15. *Id.* at 91. Such reasoning, of course, does not require the *Rusch* court to disturb the authority of the *Ultramares* holding. *See supra* note 13.

16. 284 F. Supp. at 91.

17. 170 N.W.2d 395 (Iowa 1969).

18. *Id.* at 401. *See also* 999 Corporation v. Cox & Co., slip op. (E.D. Mo. Nov. 23, 1983); Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Civ. App. 1971); Rhode

reasoning to distinguish *Ultramares* without departing from its holding, the extent to which such recent cases can be harmonized with *Ultramares* is open to serious question.[20]

The trend toward expanding common law liability may have been accelerated by the decision of the United States Supreme Court in *Ernst & Ernst v. Hochfelder*,[21] a case which did not involve common law negligence. In *Ernst & Ernst*, the Court held that Rule 10(b) of the Securities Act requires proof of intent to defraud before liability will attach, a standard of proof more rigorous than that which had previously obtained in the courts.[22] Prior to *Ernst & Ernst*, Rule 10(b) had been a major avenue for accountants' liability claims, at least in part because Rule 10(b) does not incorporate a privity requirement.[23] One effect of the Supreme Court's enunciation of a more rigorous proof requirement for 10(b) cases in *Ernst & Ernst* may have been to channel more accountants' liability claims through the traditional common law theories.

Three recent cases have flatly rejected *Ultramares* and its holding, perhaps indicating a future trend. In *Rosenbloom v. Adler*,[24] the New Jersey Supreme Court held that an accountant may be liable for negligence to a stock purchaser not known specifically to the accountant, even though the purchaser was not in privity with the accountant. In *Rosenbloom*, defendant Touche Ross had certified materially false financial statements for its client Giant Stores Corporation. The financials were subsequently relied upon by the plaintiff in selling his business for Giant stock. The court stated that lack of privity did not prevent recovery, but that the duty

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Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847 (4th Cir. 1972); Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. Ct. App. 1973).

19. In *White v. Guarente*, 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977), the New York Court of Appeals read its *Ultramares* decision as protecting an accountant from liability to the indeterminate investing public at large, but held that where the accountants' services are 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" a duty will lie. *Id.* at 361.

20. *Cf.* cases discussed *infra* notes 24-27 and accompanying text.

21. 425 U.S. 185 (1976).

22. *See* 3 BROMBERG & LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 8.5 (1983).

23. Section 10(b) of the Act, which is implemented by S.E.C. Rule 10(b)-5, S.E.C. Securities Exchange Act Release No. 3230 (May 21, 1942), makes unlawful any deceptive practice in connection with the purchase or sale of any security. Civil liability may ensue from non-disclosure of a material fact or affirmative misrepresentation, and proof of reliance and privity is unnecessary. *See* H. HENN AND J. ALEXANDER, LAW OF CORPORATIONS 826-27, (1983).

24. 93 N.J. 324, 461 A.2d 138 (1983).

should be defined by the reasonably foreseeable consequences of the negligent act.[25]

Less than one month later, the Wisconsin Supreme Court followed New Jersey's lead in *Citizens State Bank v. Timm, Schmidt & Co., S.C.*,[26] holding an accountant liable to a third party bank not in privity for negligent preparation of financial statements. The case involved a loan made by plaintiff bank to defendant's client, on the basis of the negligently prepared financial statements. When the accountants' client defaulted, the bank sued the accounting firm for negligence. The court ruled that an accountant, like any other tortfeasor, is fully liable for all the foreseeable consequences of his or her act.[27]

The California Court of Appeals recently ruled on claims of negligence and misrepresentation asserted against an accounting firm which audited financial statements of Westside Mortgage Company.[28] The plaintiff, International Mortgage Co., a major real estate developer, in reliance upon the inaccurate statements, entered into a complex master purchase agreement with Westside for the purpose of buying and selling various loans, including government (Federal Housing Authority) loans.

Although the accounting firm was unaware of the plaintiff's presence at the time of the audit, it was aware of FHA's net worth requirements for a mortgage company to qualify to do FHA business. The Westside Mortgage Company did not in reality meet the minimal ($100,000) net worth requirements, and when it defaulted on its obligations to the plaintiff, plaintiff successfully sought to recover monetary damages from the accountants. The opinion of the California court referred to the changing "role of an independent auditor in today's society" and specifically stated that "the rule of *Ultramares* is no longer consistent with fundamental principles of California negligence law."[29]

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25. The court stated:

> When the independent auditor furnishes an opinion with no limitation in the certificate as to whom the company may disseminate the financial statements, he has a 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.

Id. at 352, 461 A.2d at 153.

26. 335 N.W.2d 361 (Wis. 1983).

27. *Id.* at 366.

28. International Mfg. Co. v. John P. Butler Accountancy Corp., No. G001099, slip op. (Cal. Ct. App.) Feb. 20, 1986.

29. *Id.*

Although the reasoning of *Rosenbloom*, *Citizens' Bank* and *International Mortgage Co.* is not yet universally applied, these cases represent a legal trend toward expanding liability for accountants which is grounded upon a changing perception of the role of the accountant in today's complex economic affairs. The modern view of public accountants and their duties was recently expressed by the Supreme Court of the United States in *United States v. Arthur Young & Co.*:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.[30]

One effect of this trend is an increase in accountants' liability exposure to third persons. The resultant higher insurance costs will require accountants to raise their fees, ultimately spreading this cost through society as a whole.[31]

B. *Statutory Liability Of Accountants*

The main sources of accountants' federal statutory liability are sections 11 and 17(a) of the 1933 Securities Act and sections 10(b) and 18 of the 1934 Securities Exchange Act.[32] Section 11 of the 1933 Act imposes a duty of due care on accountants practicing in securities transactions,[33] and section 18 of the 1934 Act provides for a good faith defense to otherwise actionable conduct taken under the 1934 Act, which prohibits false and misleading statements filed pursuant to it.[34] Under Rule 10(b)-5 of the 1934 Act,

30. 465 U.S. 805, 817-18 (1984).

31. *See generally* G. CALABRESI, THE COST OF ACCIDENTS (1970) for the argument that such "risk-spreading" is what the tort system should be about.

32. *See generally* Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1970). Section 12 of the 1933 Act may also be relied upon by plaintiffs suing accountants, but §13 of the Act, 15 U.S.C. §77m, subjects them to a short one-year statute of limitations. Furthermore, §12(2) of the Act, which provides for broader proscriptions, contains a privity defense.

33. 15 U.S.C. § 77k (1976).

34. 15 U.S.C. § 78r provides, in pertinent part:

(a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, which statement was at the time and in the light of the circumstances under which it was made false, or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false however, mere negligence is not enough to incur liability; intentional misconduct is required.[35]

C. *Rule 2(e) Of The SEC's Rules Of Practice*

Perhaps the most striking development in the federal statutory area having a bearing on accountants is the increased oversight and regulation of the profession by the Securities and Exchange Commission under Rule 2(e) of the SEC Rules of Practice.[36]

The Securities and Exchange Commission is the administrative creature of the Securities Exchange Act of 1934. The Act delegates to the Securities and Exchange Commission the power to "make such rules and regulations as may be necessary or appropriate to implement the provisions of [the Act] for which it is responsible or for the execution of the functions vested [in it] by [the Act].[37] Pursuant to this general grant of rulemaking power, the SEC promulgated regulation § 201.2(e) as part of its body of rules governing the procedures, standards and practice of its proceedings.[38]

Fairly read, Rule 2(e) appears to empower the SEC to create its own bar of professionals who practice before it, all of whom are subject to the professional standards enunciated by the Commission.[39] One who practices before the Commission must "possess the requisite qualifications." He or she must not be "lacking in character or integrity." The negative proscriptions of the rule are somewhat less vague. The SEC professional must not have engaged in willful or "improper" conduct, or have "willfully violated" any federal securities law (or have assisted another in doing so).[40]

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or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

35. *United States v. Brown*, 578 F.2d 1280, 1284-85 (9th Cir. 1978).

36. 17 C.F.R. § 201.2(e) (1979).

37. 15 U.S.C. § 78w(a)(1) (1976).

38. The rule provides, in pertinent part:

(e) *Suspension and disbarment.* (1) The Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws (15 U.S.C. 77a to 80b-20), or the rules and regulations thereunder.

17 C.F.R. § 201.2(e) (1979).

39. *Id.*

40. *Id.*

The constitutional validity of this type of administrative regulation of the accounting profession is illustrated by the case of *Touche Ross & Co v. Securities and Exchange Commission.*[41] In *Touche Ross*, plaintiff accounting firm, along with three of its former partners, brought an action seeking to enjoin the SEC from conducting the first public 2(e) proceeding. Touche Ross framed its arguments in terms of authority, asserting that the SEC lacked the statutory power to regulate and discipline the accounting profession. The court, however, did not agree:

> [W]e reject appellant's assertion that the Commission acted without authority in promulgating Rule 2(e). Although there is no express statutory provision authorizing the Commission to discipline professionals . . . Rule 2(e) . . . represents an attempt by the Commission to protect the integrity of its own processes. It provides the Commission with the means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence.[42]

The SEC's implementation of the rule has met with much criticism.[43] Some commentators have argued that the SEC lacks the authority to regulate and discipline professionals, echoing the arguments made in *Touche Ross.*[44] Others have intimated that the rule violates due process.[45] This much, at least, can be certain: the rule represents a substantial inroad upon the professional independence of the accountant who practices before the SEC, and exposes him or her to a risk of substantial liability at the hands of an external regulatory entity. The ramifications for the integrity of the profession are obvious:

> Rule 2(e) . . . is one of the primary means by which the SEC exercises control over accountants . . . who practice before [it] . . .[but] . . . the SEC has converted the rule from one designed to serve the limited salutory purpose of exercising disciplinary authority over the incompetent, unethical or dishonest accounting practitioner to a rule which has effectively been utilized to pervasively regulate accounting firms and the profession as a

41. 609 F.2d 570 (2d Cir. 1979).

42. *Id.* at 582.

43. *See, e.g.*, Downing and Miller, *The Distortion and Misuse of Rule 2(e)*, 54 NOTRE DAME LAWYER 774 (1979); Note, *Disciplinary Proceedings Against Accountants: The Need For A More Ascertainable Improper Professional Conduct Standard In The SEC's Rule 2(e)*, 53 FORDHAM L. REV. 351 (1984).

44. Note, *Regulation of the Accounting Profession Through Rule 2(e) of the SEC's Rules of Practice: Valid or Invalid Exercise of Power?*, 46 BROOKLYN L. REV. 1159, 1172-87 (1980).

45. Downing and Miller, *supra* note 43, at 776-81.

whole.[46]

D. *The Foreign Corrupt Practices Act*

In 1977, Congress enacted the Foreign Corrupt Practices Act, which imposes bookkeeping responsibilities on publicly held companies.[47] It imposes both civil and criminal liability upon violators of its norms.[48] The part of the Act that poses the most significant problem for accountants is section 13(b)(2), which provides, in pertinent part: "[Publicly held companies shall] make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the[ir] assets."[49] The section also provides that every publicly held company must "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that "transactions are executed in accordance with certain standards."[50]

At this writing, little relevant case law concerning accountant's liability under the FCPA has developed.[51] The ensuing analysis endeavors to illuminate the road ahead.

While the FCPA on its face places the liability burden upon the public company, the nature of the requirements that the Act imposes upon the public company could result in a growing spectre of accountants' liability under the FCPA. As one commentator noted:

> [B]ecause the mandated "books and records" and "internal accounting control" provisions of the FCPA involve matters within the technical expertise

46. *Id.* at 774.

47. Title 1 of Pub. L. No. 95-213, 91 Stat. 1494 (Dec. 1977) (amending §13(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78m(b) (Supp. 1979)).

48. *Id.*

49. 15 U.S.C. §78m(b)(2)(Supp. 1977).

50. §78m(b)(2)(B) requires that every issuer of registered securities provide reasonable assurances that:

> (i) transactions are executed in accordance with management's general or specific authorization; (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

51. To date, virtually no cases have been reported involving significant issues of accountant's liability as a result of SEC enforcement of the Act. There have been cases involving the issue of whether a private right of action exists under the FCPA, *see infra* note 54. *See also* Minow, *supra* note l, at 80 (discussion of judicial application of the Racketeer Influenced and Corrupt Organizations Act to accounting firms and their resulting civil liability).

> of the accountants, companies subject to the Act are likely to engage and rely upon their accountants to develop and review adequate internal compliance systems. This no doubt foreshadows charges against accountants when the companies themselves are charged with violating [the Act's] requirements.[52]

The Act on its face provides for no private cause of action against violators. This does not mean that a cause of action may not be implied.[53] At present, the lower federal courts seem to be divided on the question.[54] Should such a private right of action clearly emerge, accountants would likely be subject to civil liability for violations of 13(b)(2).[55]

The SEC is clearly authorized to bring civil injunctive suits for violations of the Act.[56] Thus in suits brought against public companies under section 13(b)(2) of the Act,[57] liability could be extended to accountants on an aider and abettor theory.[58]

Since the legislative history of the FCPA makes plain that the enactment of the Act does not preclude the Commission from

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52. Gruenbaum and Steinberg, *Accountants' Liability and Responsibility: Securities, Criminal and Common Law*, 13 LOY. L.A. REV. 247, 288 (1980) (footnote omitted).

53. The standards for implying such rights were definitely stated in *Cort v. Ash*, 422 U.S. 66, 78 (1975):

> First, is the plaintiff "one of the class for whose *especial* benefit the statute was enacted,"—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on Federal law?

Id. (citations omitted).

54. *See* Sanders v. Thrall Car Mfg. Co., 582 F. Supp. 945 (S.D.N.Y. 1983), *aff'd*, 730 F.2d 910 (2d Cir. 1984) (no private right of action exists under section 13(d)); Lewis on Behalf of National Semi-Conductor Corp. v. Sporck, 612 F.Supp. 1316 (N.D. Cal. 1985) (no private right of action will be implied under section 13(b)(2)); *but see* Crane Co. v. Harsco Corp., 511 F.Supp. 294 (D. Del. 1981) (tender offeror has private right of action under section 13).

In light of this lower court confusion, the emergence of a private right of action under the FCPA is perhaps unlikely, given the Supreme Court's demonstrated reluctance to imply private rights of action in recent years. *See* Steinberg, *Implied Private Rights of Action Under Federal Law*, 55 NOTRE DAME LAWYER 33, 41 (1979). However, the SEC has expressed the view that such an implied right of action exists under FCPA. *See Notification of Enactment of Foreign Corrupt Practices Act of 1977*, ASR No. 242 (1978), 6 FED. SEC. L. REP. (CCH) 72.264 at 62.701.

55. *See supra* note 49 and accompanying text.

56. 15 U.S.C. § 78v(d) (Supp. III 1985).

57. *See supra* note 49.

58. Gruenbaum and Steinberg, *supra* note 52, at 289.

utilizing all of its existing remedies under the securities laws,[59] an accountant found liable under the FCPA could also be subjected to a Rule 2(e) disciplinary proceeding.[60] Such a proceeding would be a component of the Commission's general power to institute administrative proceedings under the Act.

An interesting aspect of the FCPA is its lack of an express materiality requirement. Such an absence of a materiality provision, construed to its extreme, would mean that deviation from the standards of the Act, whether material or de minimis, would constitute a violation. As to this issue, the SEC has taken a middle ground, holding that while the traditional materiality standard is not appropriate in the FCPA context, neither would exacting compliance in unreasonable and burdensome detail be required: "The statute does not require perfection but only that books, records and accounts '*in reasonable detail*, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.' "[61]

Whatever the ultimate impact of this "in reasonable detail" standard may be, clearly the lack of an express materiality requirement "will mandate close scrutiny by accountants of their clients' compliance with the provisions of the FCPA."[62]

Attorneys and accountants should also be aware that numerous state statutes exist that govern accountants. Since substantial variation may exist from state to state, the attorney must examine each state statute for its particular requirements.[63]

E. *Criminal Liability Of Accountants*

"No potential legal hazard has so surprised and alarmed the public accounting profession as the spectre of criminal liability."[64] So wrote accounting scholars Paul Hooper and John Page in 1984.[65] The exposure of accountants to the risk of criminal penal-

59. S. REP. No. 114, 95th Cong., 1st Sess. 12 (1977).

60. *See supra* notes 36-46 and accompanying text.

61. Securities Exchange Act Release No. 34-15570, FED. SEC. L. REP. (CCH) ¶ 81,959, pg. 81,398 (Feb. 15, 1979) (emphasis in original).

62. Gruenbaum and Steinberg, *supra* note 52, at 290.

63. Most state securities statutes substantially mirror the fraud laws of the federal securities provisions. Some also impose civil liability for negligently made false statements involving the sale of any security. For an overview, *see* PRACTISING LAW INSTITUTE, ACCOUNTANT'S LIABILITY: LAW AND LITIGATION (1975).

64. Hooper and Page, *The Legal Environment Of Public Accounting*, 54 C.P.A.J. 6, 36 (1984).

65. *Id.* at 38.

ties is expanding.[66]

In general, most criminal liability actions against accountants are brought under the federal securities laws, most notably under section 24 of the 1933 Act[67] and section 32(a) of the 1934 Act.[68] The Federal Mail Fraud Statute[69] is also a principal source of

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66. [T]he scope of accountant's liability is expanding. *Simon* [*see infra* note 76 and accompanying text] . . . define[s] compliance with [generally accepted accounting principles] as a relevant, but not determinative, criterion in assessing a defendant's liability. . . . [R]ecent state court decisions have ramifications of imposing criminal liability upon accountants for preparing workpapers, making adjusting entries and being associated with unaudited financial statements. In light of [such] decisions, accountants must engage in their professional practice in a most prudent and circumspect manner.

Gruenbaum and Steinberg, *supra* note 52, at 307-08 (footnote omitted).

67. Section 24 provides:

Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this subtitle, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $10,000 or imprisoned not more than five years or both.

15 U.S.C. § 77x (1982).

68. Section 32 provides:

(a) Any person who willfully violates any provision of this chapter (other than section 78dd-1 of this title), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $100,000 or imprisoned not more than five years, or both, except that when such person is an exchange, a fine not exceeding $500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

15 U.S.C. § 78ff(a) (Supp. III 1985).

69. 18 U.S.C. § 1341 (1982) provides:

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or criminal liability for auditors.

Both section 24 of the 1933 Act and section 32 of the 1934 Act make *willful* violations of any provision, rule or regulation of the respective Acts a crime.[70] However, unlike section 24, section 32 uses the word "knowingly" in conjunction with "willfully."[71] Whether the two words are to be construed as synonymous is the subject of debate.[72] Regardless of whether these two terms are interpreted independently or together, however, it appears well settled that in a prosecution under either section, a specific intent on the part of the defendant to violate the law need not be shown.[73] In a prosecution under the "willfully knowing" standard of section 32(a), an evil purpose on the part of the defendant must usually be established.[74]

Case law under the criminal provisions of the federal securities laws reveals a tendency toward increasing criminal liability for accountants. In *United States v. Benjamin*,[75] the United States Court of Appeals for the Second Circuit held that an accountant cannot "shut his eyes" in the presence of fraud.[76] *Benjamin* involved a prosecution against a certified public accountant who, after preparing pro forma statements relating to his client's financial status, falsely reported that certain assets existed, when no procedures for verification or examination had been used. Responding to the argument that the evidence adduced at trial was insufficient to establish defendant's criminal state of mind, Judge Friendly held

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thing, shall be fined not more than $1,000 or imprisoned not more than five years, or both.

70. *See supra* notes 67-68.

71. *Id.*

72. *See* Note, *The Securities and Exchange Commission: An Introduction to The Enforcement of the Criminal Provisions of the Federal Securities Laws*, 17 AM. CRIM. L. REV. 121, 128-32 (1979).

73. United States v. Dixon, 536 F.2d 1388, 1397 (2d Cir. 1976).

74. *Id.*

75. 328 F.2d 854 (2d Cir. 1963), *cert. denied*, 377 U.S. 953 (1964).

76. This notion had been implicit since *United States v. White*, 124 F.2d 181 (2d Cir. 1941), in which defendant public accountant was charged with preparing false financial statements mailed to investors. Despite the lack of proof that defendant knew that the statements were false, Judge Learned Hand upheld the conviction, noting:

> It is true that all these instances, taken singly, do not prove beyond question that [the defendant] knew that the statements which he prepared were padded with false entries; but logically the sum is often greater that [sic] the aggregate of the parts, and the cumulation of instances, each explicable only by extreme credulity or professional inexpertness, may have a probative force immensely greater than any one of them alone.

Id. at 185.

that:

> [t]he government can meet its burden by proving that a defendant deliberately closed his eyes to facts he had a duty to see . . . or recklessly stated as facts things of which he was ignorant. . . . Congress . . . could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.[77]

The issue of the extent to which accountants can rely on generally accepted practices of their profession as a defense to criminal charges was addressed in *United States v. Simon*.[78] In *Simon*, accountants were prosecuted for including in their clients' financial statements a footnote which concealed looting of the corporation by its president.[79] Eight accounting experts testified at trial that the footnote was not inconsistent with generally accepted accounting principles or standards.[80] The trial judge denied defendants' request for a jury instruction that would have made proof of compliance with generally accepted accounting principles a valid defense, and held that compliance with such standards is persuasive but not necessarily conclusive evidence of good faith.[81]

The United States Court of Appeals for the Second Circuit affirmed, with Judge Friendly once again writing for the court:

> Generally accepted accounting principles instruct an accountant what to do in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe that this basic assumption is false, an entirely different situation confronts him. Then . . . he must "extend his procedures to determine whether or not such suspicions are justified." If . . . his suspicions [are] confirmed, full disclosure must be the rule, unless he has made sure the wrong has been righted and procedures to avoid a repetition have been established.[82]

Thus, after *Simon*, compliance with generally accepted accounting standards is a defense only in those cases where the auditor has no reason to believe that the affairs of the corporation are not properly in order.

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77. 328 F.2d at 862-63.
78. 425 F.2d 796 (2d Cir. 1969), *cert denied*, 397 U.S. 1006 (1970).
79. *Id.* at 799-804.
80. *Id.* at 805.
81. *Id.*
82. *Id.* at 806-07.

F. *Conclusion*

As the accounting profession comes to grips with the storm clouds of legal liability gathering above its head, it will suffer from the financial burdens imposed by swelling monetary damage awards and from the rising cost of professional insurance. Because accountants may be held liable to third parties despite the absence of the traditional contractual privity requirements on the theory that the third party's reliance was reasonably foreseeable, they will have to raise their audit fees.[83]

If professional uncertainty has been engendered by the possibility of administrative censure or loss of license to practice before the SEC, the American Institute of Certified Public Accountants (AICPA) and state societies must guide their members through the current legal thicket and lobby for legislative changes to clarify and improve the accountant's and auditor's lot both at common law and pursuant to statute. These groups must ensure that accountants who comply with the Code of Ethics, generally accepted accounting principles and auditing procedures, and relevant state statutes and regulations are protected from unwarranted legal liability and professional discipline based upon the hindsight of the courts and administrative agencies. Just as doctors and lawyers have developed defensive modes of practicing their professions, so too must accountants. Advocates for the accounting profession should also consider spearheading a fresh challenge to the broad discipline of practitioners by the SEC pursuant to Rule 2(e), a rule which might be overthrown or favorably restricted in a carefully selected judicial contest.

83. *Ruling Gives Accountants Liability Worry*, Wall Street Journal, Feb. 26, 1986, at 14, col.2.