

# Accountant's Liability to Third Persons

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These views, therefore, could not be adopted unless ancient tradition were completely repudiated. It would lead to the conclusion that it would be wiser to proceed on the premise that every man who is indicted is guilty of the charges set forth in the indictment, and then to effectuate this theory, adopt the wisdom of the Queen in "Alice of Wonderland"—we will have the execution first and the judgment afterward.

WILLIAM EDELSON.

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#### ACCOUNTANT'S LIABILITY TO THIRD PERSONS.

With the growth of any profession or industry to economic importance, there is a concomitant evolution in the law in its application to that particular enterprise.<sup>1</sup> Basic principles of law remain the same, but unforeseen situations demand new interpretations of old rules. The profession of accountancy has provided us with a question which, though possessing analogies in the law, has a flavor peculiar to the auditing field. The increasing use of auditor's financial statements and certificates as a basis for the extension of credit has led to the query: What is the liability of an auditor who, in a statement, has certified to the accuracy of the accounts of his client? Does the accountant owe any duty of care to strangers who extend credit on the faith of his certificate, or is his sole obligation a matter of contract with his client?

A noted English accountant has said <sup>2</sup> of the auditor's responsibility:

"Although the auditor is responsible primarily to the shareholders, yet in the light of modern company development a somewhat wider view should be taken, I think, by the auditor himself. He should remember that balance sheets of public companies are, for practical purposes, public documents; they are studied by the stock exchange and the prospective investor when forming an opinion as to the value of the share and the debenture capital; are made available to traders as an indication of the financial stability, and they are used by the companies themselves when raising bank loans and making other financial arrangements."

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<sup>1</sup> Cardozo, *Nature of the Judicial Process*, p. 62.

<sup>2</sup> Plender, *Accountant's Certificate in Connection with the Accountant's Responsibility*, *J. of Accty.*, vol. 43, p. 253 (1926).

More specifically it has been held that an accountant is not an insurer of the correctness of his statement,<sup>3</sup> therefore, in the absence of negligence, there can be no liability. If, however, the auditor has been negligent in his work, he is liable to the person with whom he contracted,<sup>4</sup> either for the fee if the suit is brought in contract, or for all the damage that flowed from his fault if the suit is brought in tort.<sup>5</sup>

With these general rules in mind, let us examine a recent case which has put the question squarely before the court: Is an accountant liable to third persons who have relied upon a statement which he prepared negligently, and by virtue of which reliance they have been damaged? In *Ultramares Corporation v. Touche, Niven & Company*,<sup>6</sup> defendants, a firm of public accountants, were employed by Fred Stern & Co. to make an audit of their books for the annual period ending December 31, 1923. The audit was made, and a balance sheet prepared, the latter being submitted to Stern & Co. along with the certificate of audit. According to the balance sheet Stern & Co. had a net worth of over \$1,000,000, whereas in point of fact they were insolvent. Defendants also prepared and gave to Stern & Co. thirty-two signed counterpart originals of this erroneous balance sheet. In order to obtain advances on their shipments, Stern & Co. presented one of these balance sheets to the plaintiff, who, in reliance thereon, loaned them large sums of money which were lost when Stern & Co. went into bankruptcy. Plaintiffs instituted an action sounding in negligence on the theory that the defendants owed them the duty to exercise reasonable care in the conduct of its audit and the preparation of its statements, and that this duty had been violated. The jury found the defendants were negligent, and the Appellate Division, by a divided court, rendered a decision in favor of the plaintiff.

Ordinarily there can be no recovery by a third person who has suffered damage when one of the parties to a contract has performed his part in a negligent manner.<sup>7</sup> There is a limitation or exception to this general rule, however, which holds that a person who undertakes to do an act which will tend to govern the conduct of others is bound to perform with diligence and care that the other may not be injured.<sup>8</sup> The two leading cases in New York are *Glanzer v. Shepard*<sup>9</sup> and *International Products Co. v. Erie R. R. Co.*<sup>10</sup> In the *Glanzer* case

<sup>3</sup> *Craig v. Anyon*, 212 App. Div. 55, 208 N. Y. Supp. 259 (1st Dept., 1925); *aff'd* 242 N. Y. 569 (1926); *Re Kingston Cotton Mills Co., Ltd.*, No. 2, 2, ch. 279 (1896); *Re London and General Bank, Ltd.*, 2, ch. 673 (1895).

<sup>4</sup> *Craig v. Anyon*, *supra* Note 2; *Smith v. London Assurance Corp.*, 109 App. Div. 882, 96 N. Y. Supp. 820 (2nd Dept., 1905).

<sup>5</sup> *Sutherland, Damages* (3rd ed.), p. 45; *Smith v. London Assurance Corp.*, *ibid.*

<sup>6</sup> 243 N. Y. Supp. 179 (App. Div., 1st Dept., 1930).

<sup>7</sup> 13 *Corpus Juris* 702, sec. 805, and cases cited in Footnotes 67, 68.

<sup>8</sup> Wharton, *Negligence* (2nd ed.), sec. 437, p. 365.

<sup>9</sup> 233 N. Y. 236, 135 N. E. 275 (1922).

<sup>10</sup> 244 N. Y. 331, 155 N. E. 662 (1927).

a seller of merchandise asked the defendants, public weighers, to weigh goods and to forward a copy of the certificate to the plaintiff buyer, who paid according to the certificate. When it was later found out that, as a result of the defendant's negligence, the weight was incorrectly certified, the buyer was allowed to recover his loss. In the second case the plaintiff, an importer, anticipated goods from abroad and wished to insure them upon arrival. He inquired of the defendants, who were to warehouse them, where they were to be stored, and, upon being told, he insured them as being stored there. Instead the goods were placed on another dock which was destroyed by fire, and the importer was unable to collect his insurance. Here, too, the plaintiff recovered, since the defendant, having taken it upon himself to speak, was under an obligation to do so with caution.

Andrews, J., speaking for the court, states the rule governing cases of this type:

"Liability in such case arises only where there is a duty, if one speaks at all, to give the correct information. And that involves many considerations. There must be knowledge or its equivalent that the information is desired for a serious purpose; that he to whom it is given intends to rely and act upon it; that if false or erroneous he will, because of it, be injured in person or property. Finally, the relationship of the parties, arising out of contract or otherwise, must be such that in morals and good conscience the one has the right to rely upon the other for information, and the other giving the information owes a duty to give it with care."<sup>11</sup>

These same elements will be found in the decisions of the courts which have held liable an abstractor who made a search of title at the request of his client and delivered it to another with knowledge that it was to be relied upon;<sup>12</sup> though no such liability existed if the searcher was unaware of the purpose for which it was to be used or the person to whom it was to be communicated.<sup>13</sup>

The majority opinion in the instant case proceeded on the theory of the International Products case, *viz.*, that a duty existed towards those whom the accountant knew would act upon the statement; that the auditor knew his statement would be relied upon, and that if it were false, those who relied would be damaged. The dissent insists that "not only the purpose for which the statement is to be used, but the person or class of persons who is to rely thereon, must be definite

<sup>11</sup> *Ibid.* at 338, 155 N. E. at 664. See also *Courteen Seed Co. v. Hong Kong & Shanghai Banking Corp.*, 245 N. Y. 377, 381, 157 N. E. 272 (1927).

<sup>12</sup> *Economy Bldg. & Loan Assn. v. West Jersey Title Co.*, 64 N. J. L. 27, 44 Atl. 854 (1899); *Anderson v. Spriesterbach*, 69 Wash. 393, 125 Pac. 166 (1912); *Brown v. Sims*, 22 Ind. App. 317, 53 N. E. 779, 72 Am. St. Rep. 308 (1899); *Dickle v. Abstract Co.*, 89 Tenn. 431 (1890).

<sup>13</sup> *Savings Bank v. Ward*, 100 U. S. 195 (1879); *Glawatz v. People's Guaranty Search Co.*, 49 App. Div. 465, 63 N. Y. Supp. 691 (4th Dept., 1900); *Day v. Reynolds*, 23 Hun 131 (1880).

to the knowledge of the defendants.”<sup>14</sup> Certainly this case can be distinguished from the Glanzer and International Products cases, for in each of them the defendant communicated his information directly to the plaintiff, and had exact knowledge of the purpose for which the information was to be given to the plaintiff. The same was true of the cases in which a title search was made; when the searcher knew the person who would rely on his abstract, and sent it to him, he was liable.<sup>15</sup> None of these cases has held that one who has prepared a certificate for, and presented it to another, will be liable to a third person to whom it is shown unless that person or class of persons is definite to the knowledge of the certifier. Can we say that the plaintiffs here were known to the defendants as a class, that their knowledge that prospective creditors would rely on the certificate would include the plaintiffs who were specifically unknown?

A more recent case might assist us on the point. In *Doyle v. Chatham & Phenix National Bank*<sup>16</sup> the defendant agreed to act as the trustee of a trust indenture with the Motor Guaranty Corporation whereby it was to certify that a stipulated amount in notes of purchasers of motor cars had been deposited with it as collateral for the issuance of bonds. Defendant negligently certified that such notes had been deposited whereas worthless notes of a different nature had been received. Plaintiff bought some of the bonds which bore the certification of the defendant, and lost his investment when the bonds proved to be worthless. Plaintiff was permitted to recover, not on the theory of a trust relationship, for none existed at the time the defendant certified to the security, but because, having made a statement by which they intended to induce action by others, they were bound to those who relied on it should it prove false.

Here the Court seems to have extended the doctrine of liability for negligent language beyond previously established limits. Before this the plaintiff was a definitely known person, now he becomes one of a class. Though his personal identity is obscure, he is, nevertheless, a dominant figure on the defendant's horizon. He is the target of the defendant's fire; and though the broadside be aimed at the mass, it is the individual who is the object of the attack. He is the one to be convinced and *induced to reply*.

Our own case is not unlike the *Doyle* case. The defendant here prepared and submitted thirty-two copies of the balance sheet, which, it is conceded, they knew generally would be used for obtaining loans from banks and others. In the *Doyle* case the certification of the bank was sent to the Motor Corporation so that it might be used to induce investors to purchase their bonds. It can hardly be maintained that there is a distinguishable difference between prospective investors who are unknown and prospective creditors who are likewise unknown. Thus it would appear that the intention of the Court of

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<sup>14</sup> *Supra* Note 6 at 185.

<sup>15</sup> *Supra* Note 12.

<sup>16</sup> 253 N. Y. 369, 171 N. E. 574 (1930).

Appeals is not to restrict the doctrine of recovery for negligent language to those persons only who are definitely known to the speaker, but to include those who, as a class, would rely on the statement. And since prospective purchasers of bonds can be characterized as a specific class, it would appear logical to so denominate prospective creditors.

As has been well stated elsewhere,<sup>17</sup> our problem is one of extension. How far are we going to extend this liability for negligent language? Not every careless remark will give rise to a suit. Whatever the answer to that question may be, we do not believe that to hold the accountants in this instance liable would be an undue extension of the principle. Socially, there are good reasons why the auditor should be held to a higher degree of care than is required by the terms of his own contract. He is fully aware of the extent of the faith and credence put upon his work by business men in general, and to relieve him of all obligation in a case like this is tantamount to saying that he can be as careless as he chooses and, though knowing of the reliance to be placed on him, he is, nevertheless, immune from liability. Nor are we impressed by the argument that if the accountant is held to so broad a liability he will be driven out of business, since he must charge exorbitant fees to protect himself. One might as well say that because a taxi-driver might negligently strike and injure a pedestrian, his fare must be excessive in order to insure himself. The accountant does not guarantee absolute accuracy; all he warrants is reasonable care and skill.<sup>18</sup>

The contention that the audit was only a balance sheet audit and, therefore, not comprehensive enough for use in credit extension and should not have been relied on by the plaintiff, is not in accord with what accountants themselves say on the subject. The sufficiency of a balance sheet audit already has been attested to by the American Institute of Accountants in a pamphlet<sup>19</sup> prepared by that body. This pamphlet was prepared at the request of the Federal Reserve Board and the Federal Trade Board, and its purpose was to standardize forms of statements and to provide a program of verification of items and uniform statements to be used in the extension of credit. Thus the parent body of accountants in America has put its approval on the use of a balance sheet audit in credit dealings.

Much has been said of the fact that the certificate purported to render merely an opinion, and that the accountants should not be held liable for a mistaken expression of judgment. Had the statement been issued casually with no knowledge of its intended use, there might be more force in this argument. But when, as the defendants here did, there was published a report for others to use and rely on, this contention loses much of its merit. One had the right to presume

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<sup>17</sup> Smith, *Liability for Negligent Language* (1900), 14 Harv. L. Rev. 184.

<sup>18</sup> (1925) 35 Yale L. J. 81.

<sup>19</sup> "Verification of Financial Statements," revised May, 1929, U. S. Govt. Ptg. Office, p. v.

that the opinion was arrived at by the use of reasonable care. Immunity cannot be purchased by the use of a word or phrase.<sup>20</sup>

Suppose, however, that the auditor had no knowledge of the intended use of his balance sheet,<sup>21</sup> other than the cognizance that such statements are often used to obtain loans. Would he, in such case, be bound to another who has relied on it? Definite knowledge is wanting. In fact, his balance sheet might never be shown to another. All he is aware of is a custom of practice that such statements are, and have been, so used in business. In this case it seems that there can be no recovery because it cannot be said that he knows the purpose for which it is desired.<sup>22</sup> One could as easily infer that the client desired it to analyze his business, and since one view can be taken as readily as the other, proof of actual knowledge would be required.

THOMAS M. McDADE.

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#### THE VALIDITY OF A COVENANT OF INDEMNITY IN AN ILLEGAL LEASE.

It is an ancient principle of the common law that no cause of action may be predicated upon an illegal or immoral contract.<sup>1</sup> While this may, and often does, result in allowing a culpable person to escape liability, the theory behind it is not designed to accomplish this result, but rather to discourage the making of such contracts, by rendering them futile.<sup>2</sup>

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<sup>20</sup> Montgomery, *Auditing—Theory and Practice* (4th ed.), p. 466: "As a general principle of law, an accountant's responsibility for his certificate is not affected by the inclusion or omission of the phrase 'in our opinion.' The language of an auditor's certificate cannot excuse breach of contract or negligence." Plender, *supra* Note 2 at 259; Smith, *supra* Note 17 at 197.

<sup>21</sup> In the instant case the jury found that the defendant had actual notice of the use to which the balance sheet was to be put. This they may have concluded from the submission of the thirty-two copies of the statement, or from the auditor's knowledge gleaned from former audits.

<sup>22</sup> *Landell v. Lybrand*, 264 Pa. 406, 107 Atl. 783 (1919).

<sup>1</sup> *Peck v. Burr*, 10 N. Y. 294 (1851); *Tracy v. Talmage*, 14 N. Y. 162 (1856); *Saratoga County Savings Bank v. King*, 44 N. Y. 87 (1870); *Knowlton v. Spring Co.*, 57 N. Y. 534 (1874); *Smith v. City of Albany*, 61 N. Y. 444 (1875); *Arnot v. Pittston & Elmira Coal Co.*, 68 N. Y. 558 (1877); *Materne v. Horwitz*, 101 N. Y. 469, 5 N. E. 331 (1886); *Hart v. City Theatres*, 215 N. Y. 322, 109 N. E. 497 (1915); *Burger v. Koelsch*, 77 Hun 44 (N. Y., 5th Dept., 1894); *Doherty v. Eckstein Brewing Co.*, 198 App. Div. 708, 191 N. Y. Supp. 59 (1st Dept., 1921); *Security Mortgage Co. v. Thompson*, 66 Misc. 151, 121 N. Y. Supp. 326 (1910).

<sup>2</sup> 3 Williston, *Contracts* (1920), sec. 1630.