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Contract--Deceit--Accountant's Liability to Third Parties (State Street Trust Co. v. Ernst, 278 N.Y. 104 (1938))

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CONTRACT — DECEIT — ACCOUNTANT'S LIABILITY TO THIRD PARTIES.—Plaintiff granted a loan to a factor in reliance upon a certified balance sheet prepared by defendant, a firm of accountants. It was contended that defendant, though aware that the balance sheet would be used to obtain credit, failed (1) to verify fictitious accounts fraudulently inserted by the factor and (2) to point out the stagnant condition of, and the inadequate reserves for other accounts. It was further claimed that thirty days later—after the loan had been made —defendant sent an accurate description of the latter condition to the factor but no attempt was made to notify creditors. Plaintiff brought an action for deceit against defendant for misrepresentation as to the solvency of the factor. The Appellate Division affirmed a decision of the trial court which set aside a verdict for plaintiff. Upon appeal, *held,* reversed and new trial granted. A *prima facie* case in deceit was established by evidence of gross negligence from which the jury in the instant case would be authorized to infer fraud. *State Street Trust Co.* v. *Ernst,* 278 N. Y. 104, 15 N. E. (2d) 416 (1938).

Most of the early actions for deceit, like their modern counterparts, were brought when plaintiff was misled into some business venture by defendant's misrepresentation.[1] Since early common law the elements of the action have remained substantially the same: [2] a false statement of a material fact,[3] knowingly [4] made, which is intended to [5] and does induce the deceived to act to his detriment.[6] Accountants

herself to the direction and control of the defendant for the treatment and cure of certain disease, stated a cause of action, not only for the installment due at the time of the testator's death, but also for entire damages for breach of the contract. The decision can be justified on the ground that since the contract was bilateral, the defendant's anticipatory breach gave the plaintiff an immediate action for entire damages; *cf.* Werner v. Werner, 169 App. Div. 9, 154 N. Y. Supp. 570 (1st Dept. 1915), where the court held that the non-payment of an installment and repudiation by defendant under a unilateral contract, did not entitle plaintiff to sue for damages for breach of the contract, but only to sue for each installment as it fell due. Compare Federal Life Ins. Co. v. Rascoe, 12 F. (2d) 693 (C. C. A. 6th, 1926), noted with approval in 36 YALE L. J. 263 (where a recovery on an insurance policy which provided for specified weekly payments, was allowed to include all installments, including those not due, on the theory that the contract was not unilateral, but bilateral, since the insured was required to furnish physician's report of her condition every thirty days) with Kevan v. John Mut. Life Ins. Co., 1 F. Supp. 719 (W. D. Mo. 1932).

[1] Bohlen, *Misrepresentation as Deceit, Negligence, or Warranty* (1929) 42 HARV. L. REV. 733.

[2] EDGAR AND EDGAR, TORTS (3d ed. 1936) 178–187.

[3] Seneca Wire & Mfg. Co. v. Leach, 247 N. Y. 1, 159 N. E. 700 (1928); Moore v. Abbey, 213 App. Div. 787, 210 N. Y. Supp. 766 (4th Dept. 1925).

[4] Reno v. Bull, 226 N. Y. 546, 124 N. E. 144 (1919); Rose v. Goodale, 169 N. Y. Supp. 446 (1918).

[5] Habeeb v. Dass, 111 Misc. 437, 181 N. Y. Supp. 392 (1920), *aff'd,* 196 App. Div. 974, 188 N. Y. Supp. 925 (2d Dept. 1921).

[6] Laska v. Harris, 215 N. Y. 554, 109 N. E. 599 (1915) (defendant's deceit need not be the sole inducing cause); Mahon v. Equitable Trust Co., 181 App. Div. 335, 168 N. Y. Supp. 757 (1st Dept. 1918); EDGAR AND EDGAR, *loc. cit. supra* note 2.

are no exception to liability for deceit when all the elements are proved.[7] Where, however, as in the case at bar, an accountant makes negligent misrepresentations two questions arise: (1) To whom is he liable on the theory of negligence? and (2) Can negligence be equivalent to deceit?

In general, liability for negligent misrepresentation tends to be restricted to cases where there is a contractual relationship.[8] But assaults have been made on this "citadel of privity".[9] In *Glanzer* v. *Shepard,*[10] defendant was liable to the third party when he knew that reaching the plaintiff was the sole purpose of the transaction. And in *Doyle* v. *Chatham & Phenix National Bank,*[11] a recovery was allowed where the third party, though not known to defendant, as above, was a member of a definitely ascertainable class of people who would

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[7] O'Connor v. Ludlam, 92 F. (2d) 50 (C. C. A. 2d, 1937); Ultramares v. Touche, 255 N. Y. 170, 174 N. E. 441 (1931); Tindle v. Birkett, 171 N. Y. 520, 64 N. E. 210 (1902) (defendant owed a duty to creditors and investors to make the balance sheet they prepared for their employer without fraud when from the circumstances they could tell the employer didn't intend to keep it to himself).

[8] Ultramares v. Touche, 255 N. Y. 170, 174 N. E. 441 (1931); Craig v. Angon, 212 App. Div. 55, 208 N. Y. Supp. 259 (1st Dept. 1925), *aff'd,* 242 N. Y. 569, 152 N. E. 431 (1926); Landell v. Lybrand, 264 Pa. 406, 107 Atl. 783 (1919); Note (1931) 31 Col. L. Rev. 858. In the absence of statute, in cases involving: attorneys in instances other than where they have prepared abstracts, good inspectors, tax collectors, notaries, public accountants, and banks, responsibility for statements negligently made has been restricted to instances of contractual relationship.

[9] MacPherson v. Buick Co., 217 N. Y. 382, 111 N. E. 1050 (1916) (a manufacturer owes a duty of care to *anyone likely to be harmed* by a defective article which is dangerous to life or limb if not properly made. Originally this case was limited to dangerous instrumentalities. By analogy to this case, it is submitted that an accountant's statement might be considered a dangerous instrumentality); Seaver v. Ransom, 224 N. Y. 233, 120 N. E. 639 (1918) (in which the Court of Appeals explains the four situations in which a third party beneficiary may maintain an action); Whitney, Contracts (3d ed. 1937) 200–208; Cardozo, C. J., in Ultramares v. Touche, 255 N. Y. 170, 180, 174 N. E. 441 (1931): "The assault upon the citadel of privity is proceeding in these days apace". Nichols v. Clark, MacMullen & Riley, Inc., 261 N. Y. 118, 184 N. E. 729 (1938); Notes (1938) 12 St. John's L. Rev. 281; (1937) 37 Col. L. Rev. 126.

[10] 233 N. Y. 236, 135 N. E. 275 (1922) (a seller of beans hired defendant public weigher, to weigh the beans. In reliance upon the certificate of weight the buyer paid the seller. The certificate was erroneous and defendant was liable to the buyer for negligence though privity was lacking. Defendant knew his certificate was solely for the purpose of the buyer; and then again, defendant was engaged in a public calling, *i.e.,* public weigher. Where an accountant knew that reaching a certain third person was the end and aim of the transaction the court would probably extend liability under the reasoning of this case; but the court would not consider the accountant as engaged in a public calling, it is public only in that the accountant offers his services to the public.

[11] 253 N. Y. 369, 171 N. E. 574 (1930) (a trustee under a deed of trust to secure an issue of bonds, certified them falsely and was liable to a subscriber of the bond because the certification was made for the very purpose of influencing the conduct of such subscribers); Note (1930) 5 St. John's L. Rev. 76.

ordinarily rely upon the statements. But in *Ultramares* v. *Touche*,[12] although defendant accountants knew "prospective creditors" were likely to rely upon the balance sheet, the Court of Appeals refused to hold defendant liable on the theory of negligence because of the absence of privity.[13] However, though defendant was not held liable on the theory of negligence, the court held that the facts might lead to an inference of fraud by the jury, and ordered a new trial for a determination of these facts.[14]

But intent is an essential element of deceit, while in negligence intent plays no part. Therefore, negligence can not be equivalent to deceit.[15] But, in *Ultramares* v. *Touche*[16] and in the instant case, by holding that acts or omissions which are heedless and reckless may be evidence from which fraud may be inferred, the court attempts to bridge this gap between intentional wrongdoing and negligent misconduct; gross negligence is thus taking the place of intent.[17] As to mere negligence, *i.e.*, honest blunder as distinguished from heedlessness and recklessness, no fraud can be inferred, and recovery can be had only on the theory of negligence if there is privity.

It is only fitting that accountants should be held to a high degree of care.[18] They know the faith and credit placed upon their work

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[12] 255 N. Y. 170, 174 N. E. 441 (1931) (defendant accountants prepared a balance sheet they knew would be used for credit purposes, but failed to verify $700,000 of accounts fraudulently inserted in the books by their employer). This is the leading New York case on accountants' liability to third parties.

[13] Id. at 179, "* * * otherwise accountants may be liable in an indeterminate amount, for an indeterminate time to an indeterminate class." *Cf.* Doyle v. Chatham & Phenix Nat. Bank, 253 N. Y. 369, 171 N. E. 574 (1930). It is difficult to see why "prospective creditors" are not members of the "reasonably ascertainable class" that the subscribers were in the *Doyle* case, *supra* note 11.

[14] See *infra* note 17.

[15] Reno v. Bull, 226 N. Y. 546, 124 N. E. 144 (1919); Habeeb v. Dass, 111 Misc. 437, 181 N. Y. Supp. 392 (1920), *aff'd*, 196 App. Div. 974, 188 N. Y. Supp. 925 (2d Dept. 1921); EDGAR AND EDGAR, TORTS (3d ed. 1936) 202.

[16] 255 N. Y. 170, 174 N. E. 441 (1931).

[17] Ultramares v. Touche, 255 N. Y. 170, 174 N. E. 441 (1931); Derry v. Peek, 14 App. Cas. 337, H. L. (1889).

In the instant case the court described the negligent conduct which would take the place of deliberate intent as follows:

(1) A representation certified as true to the knowledge of the accountant when knowledge there is none.

(2) A reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth.

(3) A refusal to see the obvious, a failure to investigate the doubtful if sufficiently gross.

(4) Heedless and reckless disregard of consequence.

In the light of this description the question of whether fraud could be inferred in the instant case was properly left to the jury.

[18] THE SECURITIES ACT OF 1933, as amended (48 STAT. 74 [1933], 15 U. S. C. § 77a [1934]) has considerably extended liability of accountants to third party investors, for innocent but negligent misrepresentation, and fraud, in connection with auditing books and furnishing statements used in furthering the sale of securities. "77k(a): In case any part of the registration statement * * * contained an untrue statement of a material fact required to be stated therein, * * * *any person acquiring such security* * * * may either at law or

and the group of people who would ordinarily rely upon it.[19] The law in New York as developed from the *Ultramares* case and the instant case may be summarized as follows:

1. In the absence of privity an accountant is not liable to third persons for honest blunder, on the theory of negligence, because he owes no duty of care.[20]

2. In the absence of privity an accountant is not liable to third persons for gross negligence on the theory of negligence, because he owes no duty of care.[21] But he is liable to third persons on the theory of *deceit* for gross negligence, because from this a jury may infer fraud.[22]

3. Negligence, no matter how gross, is never equivalent to fraud *as a matter of law;* it always remains a question of fact.[23]

R. A. K.

COURTS—PROVINCE OF FEDERAL AND STATE COURTS—QUESTIONS OF GENERAL LAW—VALIDITY OF DOCTRINE OF SWIFT V. TYSON.—Plaintiff sues to recover for personal injuries allegedly sus-

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equity * * * sue * * * (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him who has with his consent been named as having prepared or certified any part of the registration statement. * * *" (Italics ours.) This is, of course, subject to certain enumerated defenses for which see the Securities Act. However, under the present law, the Securities Act of 1934, 48 STAT. 881 (1934), 15 U. S. C. § 78a (1934) 78r, the defendant may escape liability for a false or misleading statement if he proves that he acted in good faith and had no *knowledge* that such statement was false or misleading.

[19] In REID, LEGAL RESPONSIBILITIES AND RIGHTS OF PUBLIC ACCOUNTANTS (1935), an excellent book on the whole subject of liability of public accountants, the author suggests: (1) If liability for mere negligence is to be extended it should be limited to those persons the accountant knows will use his statements for business transactions with his client. (2) That it would seem more just for the courts to require a different degree of care to third parties where the accountant's services are gratuitous. And (3) in the event of an extension of liability, the defense of contributory negligence should still be available against the third party. It is submitted that where an accountant knows that the balance sheet he prepared will be used for credit purposes, and after he has sent it to his employer he discovers that the condition of the items is not as represented, he owes a duty not only to notify promptly his employer, but to take reasonable steps to find out and notify every person who received a copy.

[20] See cases cited *supra* notes 7, 8 and 9.

[21] *Ibid.*

[22] *Ibid.*

[23] *Ibid.*