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Common Law Deceit: Accountants' Liability Under Section II of the Securities Act of 1933; Implied Civil Liability Under Rule 10b-5

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COMMON LAW DECEIT: ACCOUNTANTS' LIABILITY UNDER SECTION 11 OF THE SECURITIES ACT OF 1933; IMPLIED CIVIL LIABILITY UNDER RULE 10b-5

An independent public accountant audited and certified the annual financial statements of a corporation. These statements were then issued to the stockholders and the Securities and Exchange Commission as required by that agency's rules and regulations.[1] The accountants, subsequently hired to conduct special studies of the corporation's past and current income and expenses,[2] discovered that the figures in the annual report were substantially false and misleading.[3] Not until several months later did they disclose this finding to the exchange on which the corporation's securities were traded, to the SEC, or to the public at large. In a class action against the accounting firm for damages in connection with the corporation's financial statements and interim statements, defendants cross moved to dismiss under Federal Rules of Civil Procedure 12 (b) (1) and 12(b)(6). The District Court for the Southern District of New York *held*, motion denied: The complaint was sufficient; no reason was found to bar plaintiffs from the opportunity to prove a common law action of deceit. *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967).[4]

The principal issue raised by the motion was whether there is a continuing duty on the part of a certifying accountant to promptly and publicly disclose any material information he acquires indicating that financial statements which he has certified and filed with the SEC are false.

Plaintiff's claim was grounded on the common law action of deceit, attacking defendant's non-disclosure or silence.

Since most cases of deceit involve affirmative misrepresentations, difficult problems arise as to whether the passive failure to disclose after-acquired information can serve as the foundation of a deceit action.[5] Historically, the general rule was that an action would not lie for non-

1. The filing of the annual report is required by Form 10-K, 17 C.F.R. § 249.310 (1967), pursuant to § 13(a)(2), Securities Exchange Act of 1934, 15 U.S.C. § 78m(a) (1964) and SEC Rule 13a-1 thereunder, 17 C.F.R. § 240.13a-1 (1967).

2. The accountants served two functions during the period in question: first, as statutory independent public accountants and then, following certification, as dependent public accountants.

3. There is factual dispute here. The accountants maintain that the falsity of the figures was discovered after the filing of the required 10-K report with the SEC; plaintiffs contend that the discovery was made before this filing.

4. For other published opinions dealing with this controversy, see 249 F. Supp. 539 (S.D.N.Y. 1966) (denial of motion to dismiss or, in the alternative, for a stay pending the resolution of certain factual determinations by the Interstate Commerce Commission) and 41 F.R.D. 377 (S.D.N.Y. 1966) (determination that a class action could be maintained).

5. W. PROSSER, TORTS 710 (3rd ed. 1964).

disclosure.[6] Lord Cairns stated in *Peek v. Gurney*[7] that there was no duty to disclose facts, however morally censurable their non-disclosure may be. This was his statement of the law as shaped by an individualistic philosophy based upon freedom of contract.

The importance of the *Fischer* decision is two-fold: (1) a drawing away from the idea expressed by Lord Cairns and (2) an imposition of an objective duty to speak whenever justice, equity and fair dealing demand it.

There is a considerable amount of confusion as well as actual conflict concerning the liability of a defendant for financial loss resulting from plaintiff's reliance on defendant's innocent misrepresentation.[8] The question arises in connection with the two actions of negligence and deceit. Historically, deceit developed as a remedy for financial loss while negligence, so far as liability for misrepresentation[9] was concerned, developed in the field of physical injury to person or property.[10] *Scienter* has been considered to be a necessary element in the action of deceit,[11] but an innocent misrepresentation by hypothesis involves no deliberate fraud. Therefore, in the action of deceit there would seem to be no liability for innocent misrepresentation. However, there have developed groups of cases, each handling the problem differently. One group adheres strictly to the elements of deceit and has held that an honest belief in the truth of one's statements is a defense.[12] Professor Williston vigorously criticizes this view, contending that the results obtained are inconsistent with the law of misrepresentation in warranty or estoppel, and that liability should be broader.[13] The other group of cases have modified the requirements to different degrees and have allowed recovery for honest misrepresentation in deceit.[14] Professor Bohlen contends, however, that

6. Cases cited note 12 *infra*.

7. L.R. 6 H.L. 377 (1873).

8. RESTATEMENT OF TORTS §§ 525, 552 (1938); Bohlen, *Misrepresentation As Deceit, Negligence, or Warranty*, 42 HARV. L. REV. 733 (1929); Carpenter, *Responsibility for Intentional, Negligent and Innocent Misrepresentation*, 24 ILL. L. REV. 749 (1930); Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 U.C.L.A.L. Rev. 583 (1958); Smith, *Liability for Negligent Language*, 14 HARV. L. REV. 184 (1900); Williston, *Liability for Honest Misrepresentation*, 24 HARV. L. REV. 415 (1911).

9. The American Law Institute regards a misrepresentation as an assertion not in accordance with the truth. RESTATEMENT OF TORTS § 525, comment *b* at 60 (1938).

10. Bohlen, *Misrepresentation As Deceit, Negligence, or Warranty*, 42 HARV. L. REV. 733 (1929).

11. The elements of deceit are: (1) a false misrepresentation of (2) a material fact; (3) the defendant must know of the falsity (*scienter*) but make the statement nevertheless for the purpose of inducing the plaintiff to rely on it; (4) the plaintiff must justifiably rely on it and (5) suffer damages as a consequence. W. PROSSER, TORTS 700 (3d ed. 1964).

12. Union Pac. Ry. v. Barnes, 64 F. 80 (8th Cir. 1894); Dwyer v. Redmond, 103 Conn. 237, 130 A. 108 (1925); Lamberton v. Dunham, 165 Pa. 129, 30 A. 716 (1895); Duff v. Williams, 85 Pa. 490 (1877); Derry v. Peek, 14 App. Cas. 337 (1889).

13. Williston, *Liability for Honest Misrepresentation*, 24 HARV. L. REV. 415, 434-40 (1911).

14. National Bank v. Hamilton, 202 Ill. App. 516 (1916); Litchfield v. Hutchinson, 117

this formula imposes a liability without fault and urges that to hold persons liable is in effect to require a warranty of them.[15] Dean Green adheres to still another approach, *i.e.*, that the transactions involved vary so greatly in their requirements of certainty and accuracy that no general rule adaptable to all cases can be formulated.[16]

Thus, for the most part the concern has been with the question of the proper action for the enforcement of the liability rather than whether such a liability should exist in a particular case.

With the declining importance of the form and theory of the action under modern code pleading, it is the nature of the defendant's conduct rather than the form of his recovery with which we must be chiefly concerned.

Hopefully the courts will apply some standard which will give a measure of certainty and at the same time a measure of justice. With respect to negligence certain situations, or combinations of situations, recur with such frequency that it is possible to find a fairly definite expression of judicial opinion as to the manner in which persons who find themselves therein should conduct themselves, *e.g.*, the standard of reasonableness in the law as to restraint of trade.[17] Justice Holmes expressed a similar idea in the following passage:

> If, now, the ordinary liabilities in tort arise from a failure to comply with fixed and uniform standards of external conduct, which every man is presumed and required to know, it is obvious that it ought to be possible, sooner or later, to formulate these standards at least to some extent and that to do so must at last be the business of the court. It is equally clear that the featureless generality that the defendant was bound to use such care as a prudent man would do under the circumstances ought to be continually giving place to the specific one that he was bound to use this or that precaution under these or those circumstances.[18]

Mass. 195 (1875); Harris v. Delco Prods., 305 Mass. 362, 25 N.E.2d 740 (1940); Braley v. Powers, 92 Me. 203, 42 A. 362 (1898); Peterson v. Schaberg, 116 Neb. 346, 217 N.W. 586 (1928); Lawson v. Vernon, 38 Wash. 422, 80 P. 559 (1905); Osborne v. Holt, 92 W. Va. 410, 114 S.E. 801 (1922).

15. Bohlen, *Misrepresentations As Deceit, Negligence, or Warranty*, 42 HARV. L. REV. 733, 743-45 (1929). *See* Pumphrey v. Quillen, 165 Ohio St. 343, 135 N.E.2d 328 (1956), *noted in* 55 MICH. L. REV. 461 (1957). The law review note concludes that the court is imposing strict liability.

16. Green, *Deceit*, 16 VA. L. REV. 749, 761 (1930).

17. RESTATEMENT OF TORTS (1934) § 285, comment *c* at 747:

> If the standard of obligatory conduct is not fixed by a legislative enactment, it is that of a reasonable man under the circumstances which, at the time of his action, the actor knows or has reason to know. This standard is, without more, incapable of application to the facts of a particular case. It requires further definition, so as to express the opinion of society as to what should be done or left undone by a reasonable man under the circumstances of the particular case.

18. O. W. HOLMES, THE COMMON LAW 111 (1881).

Could not courts arrive at a standard of fair conduct equally applicable to the situation at hand?

In the instant case Judge Tyler is in effect adopting such an approach by imposing an objective standard against which to measure a defendant's action. This objective standard "leaves no room for an analysis of the subjective consideration inherent in the area of intent."[19] Thus the standard adopted for the purpose of determining when a duty of disclosure exists is analogous to the standard of due care under the same circumstances in the field of negligence.[20]

Plaintiffs additionally contend that the disputed allegations against the accountants could be maintained under section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 promulgated thereunder.

Several federal civil liability provisions protect investors from losses due to improper conduct in connection with the sale or purchase of securities in interstate commerce.[21]

Section 10b of the Securities Exchange Act of 1934[22] authorizes the Securities and Exchange Commission to promulgate rules and regulations to prevent "manipulative and deceptive devices." Rule 10b-5,[23] the general "anti-fraud" rule, was created thereunder and with its expanded use, serious questions as to the scope of this provision remain unanswered.[24]

These provisions do not specifically provide a private cause of action; however, the federal courts have taken them to establish a civil remedy under which an injured investor may sue.[25]

19. Fischer v. Kletz, 266 F. Supp. 180, 188 (S.D.N.Y. 1967).

20. Hedley Byrne & Co. v. Heller & Partners, (1964) A.C. 465, [1963] 2 All E.R. 575.

21. Federal Securities Act of 1933, §§ 11-12, 15 U.S.C. §§ 77k, 77l (1964); Securities Exchange Act of 1934 §§ 9, 10b, 18, 15 U.S.C. §§ 78i, 78j, 78r (1964); 17 C.F.R. § 240.10b-5 (1967). *See* Shulman, *Civil Liabilities and the Securities Act*, 43 YALE L.J. 227 (1933).

22. 15 U.S.C. § 78j(b) (1964):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national exchange—
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> . . . .
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> (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

23. 17 C.F.R. § 240.10b-5 (1967).

24. Courts initially imposed the requirement of privity on 10b-5 liability. *See, e.g.*, Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952).

Recently, courts have been willing to allow suits where privity of contract does not exist. *See* Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964); Freed v. Szabo Food Service, Inc., CCH Fed. Sec. L. Rep. ¶ 91,317 at 34,364 (N.D. Ill. 1964); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962); Comment, *Civil Liability Under Section 10b and Rule 10b-5; A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L. J. 658 (1965).

25. Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); Boone v.

Section 12(2) of the Securities Act of 1933[26] (available only to a securities purchaser) specifically allows civil relief for misconduct identical with that treated by clause (2) of Rule 10b-5.[27] In addition, section 11 of the 1933 Act[28] and section 18 of the 1934 Act[29] provide a right of recovery for misrepresentations of a special kind—those appearing in a registration statement (also the prospectus) or in any document filed with the SEC. Under section 11 the defendant may avoid liability by proving he actually did investigate and still had reasonable grounds to believe the statement was true. With respect to these four general provisions, what about our old nemesis *scienter*?

Several cases, in an action involving Rule 10b-5, have shown a willingness to let a buyer sue under this provision without pleading and proving *scienter*. In *Texas Continental Life Ins. Co. v. Bankers Bond Co.*[30] the opinion indicates that a plaintiff need only prove that a statement upon which he relied was in fact false, or that an omission was misleading.

In *Dack v. Shanman*,[31] arising under clause (2) of section 17 (a) of the Securities Act of 1933 (containing language virtually identical to Rule 10b-5, except that it only applies to misdeeds in connection with the sale of securities), the court stated that it was sufficient that defendant made an untrue statement or omitted to state a material fact.

The *scienter* question was not squarely in issue before the court in *Kohler v. Kohler*, but in the dicta the court said: "The only traditional elements of common law fraud that definitely appear to be unnecessary under the statute are *scienter*—knowledge of the falsity or misleading nature of the statement—and fraudulent intent to mislead or misrepresent."[32]

In *Freed v. Szabo Food Service, Inc.*[33] the court sustained the plaintiff's cause of action, holding that all that is necessary for a 10b-5 suit is that plaintiff allege reliance upon the misstatements by the defendant, purchase of securities, and resulting injury.

Baugh, 308 F.2d 711 (8th Cir. 1962); Estate Counseling Serv. Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); Speed v. Transamerica Corp., 235 F.2d 369 (3d Cir. 1956); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951). *See* Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947), which is a leading case.

26. Federal Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1964).

27. Section 12(2) is restricted in several senses, the most notable being a short, one year statute of limitations. *See* Federal Securities Act of 1933, § 13, 15 U.S.C. § 77m (1964).

28. 15 U.S.C. § 77k (1964).

29. 15 U.S.C. § 78r (1964).

30. 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd on other grounds sub nom.* Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962).

31. 227 F. Supp. 26 (S.D.N.Y. 1964).

32. 208 F. Supp. 808, 823 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963) (emphasis added).

33. CCH Fed. Sec. L. Rep. ¶ 91,317 at 34,364 (N.D. Ill. 1964).

The direction of movement is in not requiring the proof of *scienter* in a 10b-5 suit, thus envisaging suits for negligence under a provision referred to as the "anti-fraud rule." Since privity is no longer a prerequisite in this area,[34] and the *scienter* requirement is questionable, workable limits to liability under Rule 10b-5 remain undefined. It is not inconceivable then that courts may be asked to apply, under the guise of 10b-5, modern tort concepts such as liability without fault and spreading of losses. This would result in sections 11, 12(2) and 18 becoming mere surplusage, which is, in the writer's opinion, undesirable.[35] While the appropriateness of a reallocation of cost may be desirable in the area of a manufacturer's warranty, such a reallocation in the securities market raises significantly different problems.

Even though plaintiffs in the instant case would be denied recovery under 10b-5, the provision which would be appropriate in section 11 of the 1933 Act.[36] Under section 11, an accountant certifying financial statements for purposes of registration must affirmatively show that a reasonable investigation[37] had been made and that he has reasonable ground to believe, and did believe, that the statements were true, and that there was no omission of a material fact. The purpose of this section is to insure full and honest disclosure of all relevant material covering a new security.[38]

If a registration statement becomes effective and such statement contains an untrue statement of a material fact or omitted a material fact, subsection (b) of section 11 enumerates the steps an accountant should take to exculpate himself from liability. In addition the accountants could have advised the SEC of the overstated earnings.[39] They could

34. *See* cases cited note 24 *supra*.

35. It is felt that this is not in accord with the legislative history of the Securities Exchange Act of 1934. *See*, S, Rep. No. 792, 73d Cong., 2d Sess. (1934); S. Doc. No. 185, 73d Cong., 2d Sess. (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934); H.R. Rep. No. 1838, 73d Cong., 2d Sess. (1934).

36. 15 U.S.C. § 77k (1964):

> In case any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein . . . any person acquiring such security . . . may . . . sue——
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> . . . .
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> (2) Every person who was a director of . . . or partner in the issuer at the time of the filing of the . . . registration statement . . . .
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> . . . .
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> (4) Every accountant . . . who has . . . certified any part of the registration statement . . . .

37. In considering a "reasonable investigation" Shonts v. Hirliman, 28 F. Supp. 478 (S.D. Cal. 1939) established a standard which has been severely criticized. *See* Note, *Civil Liability Under the Federal Securities Act*, 50 YALE L.J. 90, 98 (1940); Rappaport, *Accountants' Responsibility for Events Ocurring After Statement Date: The Shonts Case*, 95 J. ACCOUNTANCY 332, 334 (1953). For cases dealing with accountants' duty, *see In re* Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 670-71 (1957); *In re* Mckesson & Robbons SEC Acct. Ser. Rel. No. 19 at 30 (1940), 3 CCH Fed. Sec. L. Rep. ¶ 72,023 at 62,070; *In re* Cornucopia Gold Mines, 1 S.E.C. 364 (1936).

38. *See* 3 L. Loss, SECURITIES REGULATION 1712, 1805 (2d ed. 1961); H.R. Rep. No. 85, 73d Cong., 1st Sess. 2-3 (1933); Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 173 (1933).

39. *See* Adolf Gobel, Inc., SEC Release No. 5003, at 3-4 (Feb. 18, 1954).

have withdrawn their certificate.[40] Or they could have sent a notice to management and to the regulatory agencies.[41]

The settled rule of statutory construction is that, where there is a special statutory provision affording a remedy for particular specific cases and where there is also a general provision which is comprehensive enough to include what is embraced in the former, the special provision will prevail over the general provision, and the latter will be held to apply only to such cases as are not within the former.[42]

The writer favors the result but not the approach taken in *Fisher*. Even though the existence of explicit liability under the Securities Act has been held not to negate implied liabilities arising from violations of section 10(b) of the Exchange Act and Rule 10b-5 thereunder,[43] it is felt that the accountant's liability should be based on section 11.

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THE APPEALABILITY OF A CONVICTION BASED ON A PLEA OF GUILTY

The defendant, represented by his court-appointed counsel, withdrew a plea of not guilty and entered a plea of guilty to a charge of burglary. He was found guilty and sentenced. The defendant then filed a notice of appeal. The trial court treated the notice as a petition for relief under Criminal Procedure Rule No. 1 and denied it as frivolous.[1] On appeal, the State moved to dismiss on the ground that the conviction was based on a plea of guilty. The Second District Court of Appeal *held*, motion denied: An accused in a criminal case has a right to appeal a judgment of conviction even though he has waived trial by jury and pleaded guilty. The supposed "rule" that a conviction based on a plea of guilty cannot be appealed finds no support in Florida other than in the dicta of cases which on appeal were decided on the full merits. *Ramey v. State*, 199 So.2d 104 (Fla. 2d Dist. 1967).[2]

By denying the State's motion to dismiss, Florida became part of the growing majority of jurisdictions that reject the rule that a conviction based upon a plea of guilty cannot ordinarily be reviewed on appeal. Only

40. *See* Wall Street Journal, Oct. 18, 1966, at 32, col. 2, *re* Continental Vending Machines, Corp.

41. *See* Wall Street Journal, Oct. 17, 1966, at 4, col. 2, *re* Public Bank of Detroit.

42. Montague v. Electronic Corp. of America, 76 F. Supp. 933, 936 (S.D.N.Y. 1948).

43. Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); *see also* J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

1. Brief for Appellant at 1, Ramey v. State, 199 So.2d 104 (Fla. 2d Dist. 1967).

2. Subsequently, the case was disposed of in a per curiam decision which affirmed the trial court's holding. Ramey v. State, 201 So.2d 270 (Fla. 2d Dist. 1967).