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To Our Clients:

Accountants' Liability

Hochfelder v. Ernst & Ernst, [Current] CCH Fed. Sec. L. Reg. ¶94,781 (7th Cir. Aug. 30, 1974) is a case of revolutionary importance on the question of an accountant's liability for a negligent audit. The Court held that an accountant has two duties of inquiry in conducting an audit -- a common law duty and a statutory duty. The common law duty, as in the Ultramares case, extends only to those in privity of contract with the accountant or those whom the accountant could specifically foresee might suffer from a negligent audit and who in fact relied on the audit and were thereby damaged. However, for all practical purposes, the Court completely discarded the limitations of the common law duty as expressed in Ultramares by holding that for companies required by the securities laws to file audited financial statements with the SEC there is a statutory duty that is not limited by privity or foreseeability. The accountant's statutory duty extends to all those members of the investing public for whose protection the securities laws were enacted. An audit which because of the negligence of the accountant fails to disclose a material defect in a company's financial statements or internal accounting procedures constitutes the accountant an aider and abettor of the company's Rule 10b-5 violation and thereby makes the accountant equally liable with the company to all those who were damaged by the nondisclosure. The Court said that an accountant aids and abets a Rule 10b-5 violation through mere nondisclosure where "adequate inquiry and subsequent disclosure would have led to discovery of the underlying fraud or its prevention".

The Court held that in determining whether or not an accountant was negligent in performing an audit the standard is -- "the standard of care reasonably expected of persons holding themselves out as skilled accountants. ... [T]he standard of care which generally prevailed in the accounting profession during the years of [the] audits ... is the standard to which [the accountant] must be held". The Court also held that the "Auditing Standards and Procedures" of the AICPA and the auditing requirements of the SEC are appropriate standards by which to measure an accountant's audit and that a negligent failure to discover a material inadequacy in internal accounting controls does not satisfy generally accepted auditing standards. Further, the Court notes that where generally accepted auditing standards are not adequate a court will not be bound by them in judging the accountant's performance.

The Hochfelder case involved a brokerage firm audit and there was a contention that the accountant was also negligent for failure to detect a violation of the NASD rules. The Court rejected this contention on the basis of impracticality. The Court said: "To direct full examination for compliance with the various rules of all the self regulatory organizations to which a broker or dealer might belong would be to impose a burden of inquiry -- otherwise not demanded by contract, statutory law, or professional practices -- of indefinable proportions which arguably could never effectively and completely be implemented. We cannot subscribe to a situation whereby the accountant has the burden of an investigation which is unascertainable and everchanging."

There can be little doubt that the Hochfelder case bids fair to become as well known and oft cited as Ultramares which, at least as to SEC reporting companies in this age of consumerism, has now gone the way of the other old common law restraints on liability for negligence. The long-held fears of the accountants have been realized and the floodgates of litigation have been opened fully.

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