NOTE

SECTION 11 OF THE SECURITIES ACT OF 1933: 
THE DISPROPORTIONATE LIABILITY 
IMPUTED TO ACCOUNTANTS

ABSTRACT

Congress enacted the Securities Act of 1933 to regain investor confidence in the stock market by requiring that issuers provide certain disclosures to the investing public. Specifically, under section 11 of the Act, an investor may sue every person who signed the registration statement. Issuers and underwriters are properly within the scope of section 11 liability because of their close connection with the offering and distribution of securities.

Accountants are also liable under the Securities Act. This note posits that accountants' roles are too attenuated with respect to their limited involvement to be subject to section 11 liability. The resulting increase in litigation against accounting firms has caused a backlash by the firms and exploitation of the accountants. Because of the limited and attenuated role of the accountant in the offering of securities, attaching liability to the accountant seems disproportionate. Perhaps section 11 should be more narrowly tailored to exclude causes of action against those who merely assist in the registration process.

I. INTRODUCTION

Following the stock market crash of 1929 and the resulting distrust of the market, President Roosevelt appealed to Congress "to enact legislation that 'puts the burden of telling the whole truth on the seller' of securities in order to 'bring back investor confidence.'"\(^1\) In an attempt to regain investors' trust in the market, Congress enacted the Securities Act of 1933\(^2\) (Securities Act). The Securities Act aims to protect investors by imposing disclosure requirements on issuers of securities. "The Act seeks not only to secure accuracy in the information that is volunteered to

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investors, but also ... to compel the disclosure of significant matters which were heretofore rarely, if ever, disclosed.\textsuperscript{3}

The Securities Act requires issuers to register securities with the Securities and Exchange Commission (Commission) prior to offering such securities to the public by filing a Registration Statement with the Commission.\textsuperscript{4} In light of the fluctuating market and its uncertainty, the purpose behind the registration requirement, namely, the protection of potential investors, becomes evident.\textsuperscript{5} "A key policy underlying this requirement is to enable prospective purchasers to make informed investment decisions based upon the disclosure of adequate and truthful information regarding the issuer, its associated persons, and the offering."\textsuperscript{6}

In deciding whether to purchase securities, investors will often rely on the information presented in the Registration Statement concerning a company's financial stability. When investors are economically harmed as a result of material misstatements or omissions in Registration Statements, issuers of such securities may be subject to strict liability.\textsuperscript{7} Similarly, other professionals involved in compiling the Registration Statement, or even remotely involved in the registration process, may also be held liable for material misstatements or omissions.\textsuperscript{8} For example, section 11 of the Securities Act provides that any person who prepares or certifies a report for inclusion in the Registration Statement may fall prey to liability.\textsuperscript{9} One such person is the professional accountant.\textsuperscript{10}

\textsuperscript{3}Harry Shulman, \textit{Civil Liability and the Securities Act}, 43 \textit{Yale L.J.} 227, 227 (1933).
\textsuperscript{5}See Scott A. Crist, \textit{Walking on Thin Ice: The Changing Liability of Attorneys in the Securities Arena}, 27 J. MARSHALL L. REV. 909, 909-10 (1994) (explaining that Congress, by enacting the Securities Act, "attempted to provide protection for the investing public that had previously been lacking by imposing broad disclosure requirements upon those offering securities to the public") (citations omitted).
\textsuperscript{8}See id.
\textsuperscript{9}See id. See also William H. Hardie, \textit{Liability of Professionals for Negligent Certification}, 55 ALA. LAW. 226, 231 (1994) (noting that "[a]ll professionals who issue opinions and certifications must be aware that their work product can be the source of liability").
\textsuperscript{10}See Monroe v. Hughes, 31 F.3d 772, 774 (9th Cir. 1994) (recognizing a cause of action by investors against accountants as to those portions of the Registration Statement that such accountants prepared or certified). See also David Gilbertson & Steven D. Avila, \textit{The Plaintiffs' Decision to Sue Auditors in Securities Litigation: Private Enforcement or Opportunism?}, 24 J. CORP. L. 681, 699 (1999) ("[P]ublic offerings pose a significant ... risk to the auditor of being named as a codefendant in a securities lawsuit.").
The early 1990s saw an increase of litigation against accounting firms with regard to financial reporting in the corporate sector.\(^\text{11}\) As one author has noted, "Accountants have been named as defendants in securities lawsuits more often than lawyers and have settled these suits for much more money than lawyers have."\(^\text{12}\) This increase in litigation against accountants has caused a backlash by the accounting firms and, as a result, firms are becoming more selective in choosing clients.\(^\text{13}\) Additionally, accountants have also begun to launch their own actions against those deemed "more culpable" with respect to financial reporting.\(^\text{14}\)

Part II of this note will introduce section 11 of the Securities Act and the possible defendants within its reach. Next, this note will address the manner in which members of the accounting profession are governed. With this foundation, an accountant as a defendant under section 11 of the Securities Act will be discussed. Part II will conclude with an overview of judicial resolution of professional accountant liability and the response from the accounting profession.

Part III of this note will survey section 11 liability of securities lawyers and underwriters, and compare the treatment of accountants with these potential defendants. Finally, Part IV will discuss the limited role of the accountant in the registration process and posit reasons why accountants should not be among those subject to liability. Part IV will also consider the possibility that accountants are being exploited by increased liability as compared to other professionals involved in the registration of securities.

II. BACKGROUND

A. Section 11 of the Securities Act

Under the Securities Act,\(^\text{15}\) a Registration Statement must be filed with the Commission when an issuer offers securities to investors by way

\(^{11}\)See Michael R. Young, The Liability of Corporate Officials to Their Outside Auditor for Financial Statement Fraud, 64 FORDHAM L. REV. 2155, 2159-60 (1996) (discussing the "litigation crisis" over who bore the responsibility for financial reporting—the corporation or the accountant).


of an initial public offering (IPO).\textsuperscript{16} A Registration Statement contains a wealth of information pertaining to the issuer\textsuperscript{17} and provides for the protection of investors by insuring that certain disclosures are made with respect to the offered securities as well as the financial stability of the issuer.\textsuperscript{18}

A registration statement . . . requires such information as: (1) a description of the risk factors of the offering; (2) a description of the use of the proceeds raised in the offering; (3) a description of the securities to be offered; (4) a description of the issuer's business; (5) a description of the issuer's property; (6) the financial statements of the issuer; (7) management's discussion and analysis of the issuer's financial condition and results of operations; (8) information on the issuer's officers and directors; (9) information concerning executive compensation; and (10) copies of certain documents, including the issuer's organizational documents and material contracts.\textsuperscript{19}

Because of the technical aspects of financial statements and other reports required to be disclosed, professionals not otherwise affiliated with the issuer may be called upon to issue expertised portions\textsuperscript{20} of the Registration Statement. Consequently, investors must rely on disclosures not only from the issuer of the securities, but also from each individual involved in compiling the Registration Statement.

The Securities Act, with a view toward investor protection, provides that a person who acquires a security issued pursuant to a Registration Statement

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\textsuperscript{16}Id. \textsection 77f.
\textsuperscript{17}See id. \textsection 77g. See also Stack v. Lobo, No. 95-20049 SW, 1995 U.S. Dist. LEXIS 19966, at *30 (N.D. Cal. Apr. 20, 1995) ("An SEC registration statement contains a cover letter, a preliminary prospectus, and a technical disclosures section.").
\textsuperscript{18}See 15 U.S.C. \textsection 77g (2000). Additionally, the Commission may require issuers to provide additional information "necessary or appropriate in the public interest or for the protection of investors." Id.
\textsuperscript{19}See LARRY D. SODERQUIST & THERESE A. GABALDON, SECURITIES LAW 98 (1998) (explaining that "[u]nder section 11(a)(4) of the Securities Act, an expert is a person whose profession gives authority to his or her statements, such as accountants"). Reports or audits certified by accountants regarding financial statements of an issuer have been considered to be "expertised." See Dennis J. Block & Jonathan M. Hoff, Underwriter Due Diligence in Securities Offerings, N.Y. L.J., May 27, 1999, at 5.
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Statement containing a material misstatement or omission of fact has a cause of action against several defendants.\textsuperscript{21} Section 11 of the Securities Act determines that an investor may sue:

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every person who signed the registration statement . . . [and]
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, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him . . . .\textsuperscript{22}
\end{quote}

In light of this statutory provision, various professionals involved in the registration of securities may be held liable for material misstatements or


\textsuperscript{22}15 U.S.C. § 77k(a)(1)-(a)(5) (2000). \textit{See also} Danis v. USN Communications, Inc., 121 F. Supp. 2d 1183, 1188 (N.D. Ill. 2000) (citing 15 U.S.C. § 77k(a), the court explained that "[s]ection 11 liability is triggered when (1) a prospectus contains false facts or misleading omissions; (2) the misrepresentations are material; and (3) the facts suggest preparation or certification by the defendant"); \textit{In re Transcrypt Int'l Sec. Litig.}, No. 4:98CV3099, 1999 U.S. Dist. LEXIS 17540, at *9 (D. Neb. Nov. 4, 1999) (providing that a claim under section 11 is comprised of "(1) a material misstatement or omission in a registration statement, and (2) damages") (citations omitted); \textit{STEINBERG}, supra note 6, at 155-57 (outlining various requirements which a plaintiff must meet in order to establish a section 11 claim). To establish a cause of action under section 11, a claimant:

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\item must have purchased the security where a means or instrumentality of interstate commerce was used in connection with the offer or sale;
\item at the time of purchase, must not have known of the misrepresentation or nondisclosure;
\item must show that the misrepresentation or nondisclosure was "material," meaning that reasonable investigators would have considered the pertinent information important in making their investment decisions;
\item need not establish privity;
\item as held by most courts, can recover for aftermarket purchases but subject to the often difficult "tracing" requirement;
\item normally need not show reliance upon the misrepresentation or nondisclosure;
\item need not prove that the misrepresentation or nondisclosure "caused" the loss (in other words, causation is presumed once a material misstatement or nondisclosure has been show to exist);
\item must bring the action within the time period set forth by Section 13's statute of limitations.
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\textit{STEINBERG}, supra note 6, at 156-57.
omissions which they certify. In particular, professionals who, as experts, submit reports for inclusion in the Registration Statement or who actually sign the Registration Statement are potentially at risk.

The accountant is one such professional upon whose expert opinion an issuer relies when complying with section 11 of the Securities Act. In discussing the subject of financial disclosure in the area of securities, one commentator noted:

One of the primary mechanisms for implementing the disclosure philosophy of the federal securities laws was the requirement that the opinions of independent auditors accompany corporate financial disclosures . . . [T]he accounting profession works hand-in-hand with the SEC to ensure full and accurate reporting under the securities laws, and in so doing, fulfills a public responsibility assigned by law.

Given the responsibility to provide financial disclosure, accountants provide issuers with substantive analyses by way of reports to be included in the Registration Statement. As evinced in the statute, accountants who sign the Registration Statement, thereby certifying its accuracy, may be liable to an investor for material misstatements or omissions in the

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23The legislative history behind section 11 provides in part that: The House bill imposed liability upon the underwriters and also upon the experts, such as accountants, appraisers, and engineers, who gave the authority of their names to statements made in the registration statement. The Senate accepted the provisions of the House bill . . . with modification . . . [T]o protect an unauthorized use of the expert's name, written consent to the use of his name, as having prepared or certified part of the registration statement or as having prepared a report to which statements in the registration statement were attributed, should be filed at the time of the filing of the registration statement. H.R. CONF. REP. NO. 3891-3903, at 3902 (1933), reprinted in J.S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 (Fred B. Rothman & Co. 1973). See also Thomas Lee Hazen, THE LAW OF SECURITIES REGULATION 335 (West Publishing Co., 3d ed. 1996) (explaining that liability extends to "professionals who lend their services to deficient registration statements").

24Not all professionals who contribute to the registration of securities are considered "experts" under section 11. "To say that the entire registration statement is expertised because some lawyer prepared it would be an unreasonable construction of the statute." Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 683 (S.D.N.Y. 1968). In Escott, the court found that "[n]either the lawyer for the company nor the lawyer for the underwriters [was] an expert within the meaning of Section 11." Id.

Registration Statement upon which the investor relied. Accountants have also been held liable for failing to investigate and verify information with respect to expertised portions presented in Registration Statements.

Although liability may attach, accountants and other professionals may escape liability by invoking the due diligence defense. Courts have construed this defense as requiring reasonable inquiry and investigation by the accountant into representations made by issuers. The Commission has set forth various factors to consider in determining whether an inquiry or investigation is reasonable in terms of due diligence. At a minimum, the Registration Statement must be verified and the affairs of the issuer must be analyzed to determine what, if anything, should be added to the

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26See Recupito v. Prudential Sec., Inc., 112 F. Supp. 2d 449, 453 n. 2 (D. Md. 2000) (citing 11 U.S.C. § 77k(a)(4), emphasizing that "[t]he liability of auditors under § 11 is limited to those portions of the registration statement that purport to have been prepared or certified by them").

27See generally Escott, 283 F. Supp. at 703 (holding auditors liable because "[g]enerally accepted accounting standards required further investigation under the circumstances").

28See 15 U.S.C. § 77k(b)(3)(B) (2000). To establish a due diligence defense, an accountant must prove, among other things, that "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time . . . the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact." Id. See also Monroe v. Hughes, 31 F.3d 772, 774 (9th Cir. 1994) (recognizing a due diligence defense for accountants where damages have resulted from misrepresentations found within Registration Statements).

29See Danis v. USN Communications, Inc., 121 F. Supp. 2d 1183, 1188 (N.D. Ill. 2000) (explaining that in order to establish a due diligence defense, an auditor must show that the auditor's investigation was comparable to that of a reasonably prudent auditor in the same position).


In determining whether . . . the conduct of a person constitutes a reasonable investigation . . ., relevant circumstances include, with respect to a person other than the issuer:

The type of issuer;
The type of security;
The type of person;
The office held when the person is an officer;
The presence or absence of another relationship to the issuer when the person is a director or proposed director;
Reasonable reliance on officers, employees, and others whose duties should have been knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing); When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registrant; and
Whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

Id.
Registration Statement. Moreover, accountants have evaded liability by proving that statements, although misleading, were not material.

B. The Role of the Accountant and the Resulting Liability

In United States v. Arthur Young & Co., the United States Supreme Court depicted the accountant as a "public watchdog." The Supreme Court distinguished the role of the attorney with that of the public accountant by explaining that the difference lies in the idea that the accountant's responsibility to the public, in terms of depicting a corporation's financial status, "demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust." When the accountant issues an opinion regarding an issuer's financial well-being, the accountant owes a duty not only to the corporation for whom it issues a financial report, but also to the corporation's stockholders and other members of the investing public who may rely on the accountant's opinion.

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31 See Soderquist & Gabaldon, supra note 20, at 99.
32 See Recupito, 112 F. Supp. 2d at 459-60 (citing Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097 (1991)). "[T]here is a distinction between misleading financial statements and audit opinions and ones that are materially so." Id. In its analysis, the court explained that "the precise information Plaintiff claims was required to be included in the financial statements . . . was fully disclosed in the 'Risk Factor' section of the Prospectus. Repeating this information in the financial statements would not have altered . . . the 'mix' of information available to investors." Id. See also Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 681 (S.D.N.Y. 1968) (quoting Matter of Charles A. Howard, 1 S.E.C. 6, 8 (1934) (explaining that "[a] material fact . . . [is] a fact which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question")).
34 Id. at 818.
35 See id. at 817-18.
36 Id. See also Richard W. Painter, Lawyers' Rules, Auditors' Rules and the Psychology of Concealment, 84 Minn. L. Rev. 1399, 1400 n.5 (2000) (explaining the public's perception of the auditor as a professional).

"The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the nation's industries. It is . . . not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional . . . . If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost."

Id. (quoting Arthur Young, 465 U.S. at 819 n.15).
The accountant, much like the lawyer, is governed by certain codes of professional conduct.\textsuperscript{37} The American Institute of Certified Public Accountants (AICPA) is an organization that sets forth statements regarding auditing standards by issuing Generally Accepted Auditing Standards (GAAS) and Generally Accepted Auditing Principles (GAAP), which govern professional accountants.\textsuperscript{38} In determining liability for violations under the securities laws, courts have considered adherence to these guidelines as a pertinent factor.\textsuperscript{39} Notably, however, the Sixth Circuit has recognized that failure to abide by GAAP does not necessarily establish a claim of securities fraud.\textsuperscript{40}

\section*{C. Judicial Resolution of Accountant Liability}


In \textit{Escott v. BarChris Construction Corp.},\textsuperscript{41} the landmark case interpreting the scope of section 11, the United States District Court for the Southern District of New York imposed liability on auditors who certified financial information in a prospectus accompanying a Registration Statement.\textsuperscript{42} Plaintiff purchasers alleged section 11 violations and sued, among others, the corporation's auditors.\textsuperscript{43} The plaintiffs questioned the accuracy of the financial figures, alleged that the text of the prospectus was false, and claimed that the prospectus omitted material information.\textsuperscript{44} Peat, Marwick, Mitchell & Co. (Peat, Marwick), the corporation's auditing team,

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  \item[\textsuperscript{37}]See Painter & Duggan, supra note 12, at 234 ("[T]he American Institute of Certified Public Accountants Code of Professional Conduct ('AICPA Code') requires an AICPA member to comply with auditing and other standards 'promulgated by bodies designated by [the AICPA council]." (footnote omitted) (brackets in original)).
  \item[\textsuperscript{39}]See Monroe v. Hughes, 31 F.3d 772, 774 (9th Cir. 1994) (noting that compliance with such standards will not insulate an accountant for purposeful omissions in a Registration Statement).
  \item[\textsuperscript{40}]See Pirraglia v. Novell, Inc., 2000 Fed. Sec. L. Rep. (CCH) ¶ 91,259, at 95,421-22 (D. Utah Nov. 2, 2000) (citing \textit{In re Comshare, Inc. Sec. Litig.}, 183 F.3d 542, 553 (6th Cir. 1999) ("When a company's filings with the SEC fail to comport entirely with GAAP, the company is not automatically liable under the securities laws.")).
  \item[\textsuperscript{41}]283 F. Supp. 643 (S.D.N.Y. 1968).
  \item[\textsuperscript{42}]See id.
  \item[\textsuperscript{43}]See id. at 652.
  \item[\textsuperscript{44}]Id. at 655.
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invoked the due diligence defense. The Escott court, by applying the standard imposed upon auditors within the accounting profession, found that Peat, Marwick was required to undertake further investigation prior to its certification of the figures included in the Registration Statement. In other words, although Peat, Marwick questioned management regarding the issuer's financial representations, GAAS required further investigation. Particularly, the court found that "there were enough danger signals in the materials which [the auditor] did examine to require . . . further investigation."

2. Monroe: Materiality Under Section 11

In Monroe v. Hughes, investors sued the accounting firm responsible for compiling an audit report accompanying a prospectus. The Ninth Circuit found in favor of the accountants because the record did not provide any issues of fact as to whether the audit report contained material misstatements or omissions. The Ninth Circuit was also confronted with the larger issue of whether the accounting firm achieved its threshold of due diligence. Investors claimed that certain internal control deficiencies were material and should have been disclosed in the audit report. The Ninth Circuit could find no authority, legal or within the accounting field, for treating control deficiencies as material to an audit report. The court further noted that although such control deficiencies should be disclosed to the issuer's management, they are not "material" in terms of section 11 of the Securities Act. Materiality pursuant to section

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45See Escott, 283 F. Supp. at 697-98. See also supra notes 28-30 and accompanying text for a discussion of the due diligence defense.

46See Escott, 283 F. Supp. at 703 ("Accountants should not be held to a standard higher than that recognized in their profession.").

47Id.

48Id.

4931 F.3d 772 (9th Cir. 1994).

50See id. at 773.

51See id. at 775.

52Id. at 774. See supra notes 28-30 and accompanying text explaining the requirements to establish a due diligence defense.

53Monroe, 31 F.3d at 774. The system of internal controls refers to "the procedures used by the company to assure the reliability of its financial records." Id. at 773.

54Id. at 775.

55Id.
11, as the court explained, "concerns matters that would have significance to the purchaser of securities in understanding what is being purchased." \(^{56}\)

3. **Danis**: Compliance with GAAS and GAAP

The United States District Court for the Northern District of Illinois recently dismissed a claim against an accounting firm alleging violations of section 11 of the Securities Act. \(^{57}\) Plaintiffs in *Danis v. USN Communications, Inc.* \(^{58}\) argued that Deloitte & Touche, L.L.P. (Deloitte) should not have approved the inclusion of an audit report in the issuer's prospectus. \(^{59}\) Namely, plaintiffs claimed that the accounting firm "misrepresented the facts when it certified [that] (1) Deloitte conducted its audits in accordance with [GAAS]; (2) the consolidated financial statements 'present fairly in all material respects,' the 'financial position of the Company . . .' and (3) the financial statements are in accordance with [GAAP]." \(^{60}\) In its analysis, the court explained that expert testimony must be presented in order to establish a violation of GAAS or GAAP. \(^{61}\) Because plaintiffs' expert failed to establish any violations in this regard, the court held that the assurances that Deloitte complied with accepted accounting standards were not materially misleading. \(^{62}\)

4. **In re Transcript International**: Certifying the Audit

In another case involving section 11 liability with respect to accountants, the United States District Court for the District of Nebraska found the accounting firm liable. \(^{63}\) *In re Transcrypt International* ...

\(^{56}\) *Id.* See also *Recupito v. Prudential Sec., Inc.*, 112 F. Supp. 2d 449, 454 (D. Md. 2000) (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (explaining the standard for materiality in the context of securities law)). The standard requires a showing that the omitted or misrepresented fact would have assumed "actual significance" in the deliberations of a reasonable investor . . . [T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

\(^{57}\) *See Danis v. USN Communications, Inc.*, 121 F. Supp. 2d 1183 (N.D. Ill. 2000).

\(^{58}\) *Id.*

\(^{59}\) *See id.* at 1192.

\(^{60}\) *Id.* at 1189.

\(^{61}\) *See Danis*, 121 F. Supp. 2d at 1192.

\(^{62}\) *Id.*

Securities Litigation\textsuperscript{64} presented a case where plaintiffs who purchased stock in an IPO sued the issuer's auditor claiming that the auditor "knew or recklessly disregarded that the company was booking phony sales, improperly recognizing revenues and maintaining inadequate reserves for product returns and warranty expenses."\textsuperscript{65} More precisely, the claim alleged that the auditor's certification of materially false financial statements in the IPO constituted a section 11 violation.\textsuperscript{66} The court set forth the general rule that in order for an auditor to be held liable for a section 11 violation, such auditor must be identified as having certified or prepared the misleading statement.\textsuperscript{67} The company's prospectus, part of its IPO Registration Statement, provided: "The financial statements . . . included in this Prospectus have been audited by Coopers & Lybrand LLP, independent auditors, as stated in their report, which is included herein, and have been so included in reliance upon the report of such firm given upon their authority as experts in accounting and auditing."\textsuperscript{68} Additionally, the accounting firm resigned from the company, withdrew its reports and advised that the financial statements previously issued should not be relied upon.\textsuperscript{69} Based on these facts, the court inferred that the auditors likely made a material misstatement or omission in the company's Registration Statement, and thus held the accounting firm liable.\textsuperscript{70}

D. The Response of the Accounting Profession

In the realm of securities litigation, accounting firms may be targeted by investors due to their "deep pockets."\textsuperscript{71} As one author notes,
professional co-defendants are often the only plausible source of recovery where a corporate defendant filed for bankruptcy: \[72\] "When a codefendant in a securities fraud class action is bankrupt, the suit proceeds only against the other defendants." \[73\] In response to the increasing litigation impounded against accountants, \[74\] some firms have become more selective in choosing clients. \[75\] Accountants are also leveling the playing field by implicating either third parties who are "more guilty" or by implicating the investors' management. \[76\]

III. ANALYSIS

A. Comparison of Other Professionals Subject to Section 11 Liability

1. The Securities Lawyer

Like accountants, lawyers are governed within their profession by certain standards of care. Namely, lawyers must abide by the ABA's Model Rules of Professional Conduct as well as the Model Code of Professional Responsibility. \[77\] On the other hand, attorneys, as advocates for their clients, do not appear to be as vulnerable to third-party liability as accountants. The accountant owes a primary duty to the public, while the attorney owes a primary duty to his client. \[78\]

or because they are the only potential defendant that is still solvent." \( Id. \)

\[72\] See id.

\[73\] Id. at 701.

\[74\] See Young, supra note 11, at 2160 n.19 (noting that the fear of litigation and costs in defending against such actions are threatening to drive the accounting profession out of existence) (citations omitted).

\[75\] See Harrison, supra note 13, at 478 (noting that some accounting firms have "turn[ed] away clients ... consider[ed] to be high risk").

\[76\] See Swanson, supra note 14, at 28. Where an investor sues an accountant, the accountant may implead "guilty management, which perpetrated the fraud" or "management of the investor who participated in the decision to invest." \( Id. \) at 29.


\[78\] In comparing the accounting profession and the legal profession with regard to third-party liability, one author notes that:

[1] third-party accountant liability is deemed appropriate because courts consider it reasonable for the public to expect accountants to serve nonclients. But it is considered to be quite another matter for the public to expect attorneys to divide their loyalties between clients and nonclients. Thus, as long as courts hold fast to the image of the attorney as the client's loyal fiduciary, it is plausible to expect attorneys to continue to receive relatively favorable treatment in third-party lawsuits.
Yet, securities lawyers are faced with an additional burden. The Commission has charged securities lawyers with a public trust to assist in the enforcement of its disclosure regimen; as a result, these lawyers owe a duty not only to the issuer, but also to the investing public. In addition to the duty imposed upon securities lawyers by the Commission, courts have held securities lawyers to a heightened standard.

The legal profession plays a unique and pivotal role in the effective implementation of the securities laws. Questions of compliance with the intricate provisions of these statutes are ever present and the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he or she renders an opinion on such matters.

In detailing the duties of securities lawyers in the registration of securities, one author has duly noted that a lawyer's "responsibility . . . includes not only gathering, verifying, and presenting the information to be disclosed, but also making literally thousands of intricate and complex determinations of what information is legally 'material' and thus necessary for actual disclosure to prospective investors." With regard to the role of the securities lawyer in registered public offerings, opinions provided by such lawyers appear more limited. Legal opinions are given to underwriters regarding the "validity of the securities," "the absence of conflicts with specified agreements and instruments," and "violations of law in connection with the issuance of the securities" rather than directly to the investing public by way of the Registration Statement.


See supra note 77, at 399 (quoting SEC v. Spectrum, Ltd., 489 F.2d 535, 541-42 (2d Cir. 1973)).

See id. at 388. Additionally, the securities lawyer has a far larger role than researcher, fact checker, writer, and editor of the disclosure book. He or she is also the production manager for the entire disclosure process, from development of the disclosure plan to the direction and implementation of the disclosure process, to final publication of the presumably nonfiction work disseminated by or on behalf of the issuer to prospective investors.

Richard R. Howe, The Duties and Liabilities of Attorneys in Rendering Legal Opinions, 1989 COLUM. BUS. L. REV. 283, 286 (1989). Opinions given to underwriters typically provide that in reviewing the Registration Statement and prospectus, the attorneys did not encounter any
These opinions assist underwriters to comply with due diligence. As such, "these opinions are not addressed to the public and the public is not entitled to rely upon them." In re ZZZZ Best Securities Litigation presents an attempt by investors to include lawyers as persons liable under section 11. The plaintiffs claimed that a lawyer who consents to the inclusion of his opinion in a Registration Statement should be considered an expert under section 11. In denying the plaintiffs' claim, the United States District Court for the Central District of California explained that section 11 liability does not attach to lawyers who merely assist in preparing a Registration Statement. In fact, the court noted that "[l]iability for persons not especially enumerated in the statute should generally not be found." Under the facts of this case, the court found that because the opinion included in the Registration Statement was required under Regulation S-K, it was unnecessary to hold the attorney liable under section 11 simply for complying with the Regulation S-K requirement. The court further noted that subjecting such attorneys to section 11 liability "would create an entire field of professionals not specifically enumerated by Congress.”

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misstatements or omissions of material fact. Id. at 287.

83 Id.

84 Id.


86 See id. at 93,083.

87 Id. Lawyers who have limited involvement in the registration process, are not automatically considered "experts" for the entire Registration Statement. See id. at 93,082; Cf. Med Safe Nw., Inc. v. Medvial, Inc., 2001 Fed. Sec. L. Rep. (CCH) ¶ 91,301, at 95,706 (10th Cir. filed Jan. 5, 2001) (citing Pinter v. Dahl, 486 U.S. 622, 651 (1988)) (holding that section 12 "liability does not attach to lawyers whose only involvement is only the performance of their professional services").


89 Id. The court also rejected the plaintiffs’ claim that the lawyers should be subject to aider and abettor liability under section 11, noting "that there is no aider and abettor liability under §11 of the 1933 Act because the statute has specifically limited the categories of persons that can be held liable." Id. But see In re Am. Cont'l Corp./Lincoln Savings & Loan Sec. Litig., 794 F. Supp. 1424, 1453 (D. Ariz. 1992) (holding "that an attorney who provides a legal opinion used in connection with an SEC registration statement is an expert within the meaning of Section 11").

90 In re ZZZZ Best Sec. Litig., 1989 Fed. Sec. L. Rep. (CCH) at 93,083.
2. The Underwriter

Another professional who may be held liable under section 11 of the Securities Act is the underwriter.91 The underwriter performs several financial services for an issuer, including "capital raising, counseling and support services."92 The underwriter's basic responsibility is to market the issuer's securities for distribution among investors.93 In terms of section 11 liability, one author has aptly noted "[b]y including underwriters [as possible defendants], Congress recognized that underwriters customarily are active in preparing the document used to sell the issue, and should thus be responsible for it."94

Although the underwriter is not considered an "expert" under section 11,95 at least one court has noted that "underwriters are subjected to liability because they hold themselves out as professionals who are able to evaluate the financial condition of the issuer."96 Underwriters are subjected to this type of liability because the public relies on the assessments provided by underwriters regarding an issuer's financial condition.97

An underwriter, unlike other professionals involved in registering securities, may decrease its risk of liability through involvement in a syndicate.98 The lead underwriter undertakes the highest risk because it must "[investigate] . . . the issuer's financial strength and future earnings potential" so as to "determine both the price of the securities and whether the prospectus is complete and not materially misleading."99

As noted by the court in Escott v. BarChris Construction Corp.,100 underwriters play an integral role in the registration of securities. Underwriters are responsible to investors in that they are "responsible for

91See Dana B. Klinges, Expanding the Liability of Managing Underwriters Under the Securities Act of 1933, 53 FORDHAM L. REV. 1063, 1063 (1985) ("Underwriters, as key participants in [the offering] process, are often sued under the [Securities] Act.") (citations omitted). In addition, institutional investors have been held liable under section 11 because such investors were considered "statutory underwriters" and had "participat[ed]" in an underwriting. See O'Hare, supra note 19, at 220.
92Greene, supra note 1, at 761 n.30.
93See id. at 762-63.
94Id. at 765.
95See id. at 806 ("[U]nderwriters are not considered 'experts' as that term is used in section 11.").
96O'Hare, supra note 19, at 242 (quoting McFarland v. Memorex Corp., 493 F. Supp. 631 (N.D. Cal. 1980)).
97See id.
98See Klinges, supra note 91, at 1066.
99Id.
the truth of the prospectus." As a result, underwriters must delve into the corporate structure of a company before distributing the proposed securities. Underwriters must gain a full understanding of the corporate operations so as to apprise themselves of what an investor might consider in deciding whether to purchase securities. The Escott court, in discussing the due diligence defense invoked by the underwriters, described the function of the underwriter as to registered securities under section 11:

To effectuate the statute's purpose, the phrase "reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "date presented" to them by the company... In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel.

In re Software Toolworks, Inc. Securities Litigation involved a class action filed against an issuer, auditor, and the underwriters alleging section 11 violations. With respect to the underwriters, plaintiffs claimed that the underwriters "blindly relied" on reports provided by the auditor and should have recognized the "red flags" indicating inconsistencies. In response, the court explained that:

[a]n underwriter need not conduct due diligence into the "expertised" parts of a prospectus, such as certified financial statements. Rather, the underwriter need only show that it "had no reasonable ground to believe, and did not believe... that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

101 Id. at 697.
102 Id.
103 50 F.3d 615 (9th Cir. 1994).
104 See id. at 623.
105 Id. (quoting 15 U.S.C. § 77k(b)(3)(C) (2000)).
The court disagreed with the plaintiffs, finding that the underwriters did not "blindly rely" on the auditor's representations. Instead, the court found that the underwriters, upon discovering inconsistencies, took adequate measures to ensure the accuracy of the auditor's representations. Specifically, the underwriters confronted the auditor, requested that the auditor provide a written confirmation and contacted other accounting firms to verify the auditor's accounting methods.

IV. COMMENTARY

A. Are Accountants Being Exploited by Increased Liability?

The purpose behind the Securities Act is to protect the investing public. The Securities Act provides for registration of securities with a view toward disclosure. Pertinent information is disseminated to investors by way of the Registration Statement and prospectus. The individual investors, or their brokers, consider such information in making investment decisions. Against this background, it becomes evident that information contained in the Registration Statement must be accurate. Financial statements that reflect favorably upon an issuer likely are to entice investors to purchase securities in the company. An issuer relies heavily on an accounting firm to certify its financial stability, yet it is the company who provides the financial information to the accounting firm for auditing purposes.

1. An Added Burden

It seems as though the accountant becomes inundated with responsibility in the area of securities regulation. In providing opinions for issuers as to their financial well-being, accountants rely primarily on information gained from the issuer itself. Although an accountant may undertake an investigation into the financial health of the issuer, the information obtained more than likely has been compiled by the issuer's management. Presumably, the issuer's management is apprised of the

106 Id. at 624.
107 See In re Software Toolworks, Inc., Sec. Litig., 50 F.3d at 624.
108 Id.
109 See Young, supra note 11, at 2156 ("It is an explicit component of the auditor-client relationship that the financial statements are the responsibility of the company's management.") (footnotes omitted). Audits undertaken in compliance with GAAS analyze "management-generated" data. See id. The author further notes that while officers and directors are now being viewed as having increasingly more responsibility with regard to financial statements, auditors
inner workings of the company and, therefore, is in the best position to compile the initial financial reports which the accounting firm will then audit. As a result, an accounting firm places a great degree of trust in the issuer. This seems problematic in that the auditor may be held liable under section 11 of the Securities Act by auditing financial information originally prepared by the issuer which contains a material misstatement. An added burden is placed on the accountant not only to complete an accurate financial assessment, but also to undertake a reasonable investigation into the veracity of the information presented by the issuer's management.\textsuperscript{110}

The reliance that an accounting firm must place on its clients creates uncertainty for the firm. While the accountant should be allowed to trust his client to some degree, if the corporation misleads the accountant or withholds pertinent information, the audit will ultimately result in fraud, and consequently, liability will be imputed directly to the accounting firm. The question then arises as to whether the accountant should "argue" with the issuer or perhaps retract his opinion. This is also problematic, as the accountant works for the issuer, who will ultimately make any final decision regarding the securities.\textsuperscript{111}

2. The Limitations of the Accountant's Opinion: Who is the Client?

Because the accountant owes a duty to the public, it becomes difficult to ascertain who is the client. Although the accountant provides financial analyses for the issuer, it has been argued that the accountant's first priority is to the public.\textsuperscript{112} If the accountant is analyzing financial data about the issuer, provided by the issuer, for the issuer, how can the client be anyone but the issuer? Viewed in this light, the accountant should not be held liable to investors for material misstatements or omissions in the

\textsuperscript{110}Other professionals are equally at risk in terms of reliance on representations made by management regarding the issuer's stability. See Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968). In discussing the duties of the underwriter with respect to the Securities Act, the court explained that "the positions of the underwriter and the company's officers are adverse. It is not unlikely that statements made by company officers to an underwriter to induce him to underwrite may be self-serving. They may be unduly enthusiastic. . . . [T]hey may, on occasion, be deliberately false." \textit{Id.}

\textsuperscript{111}Cf. Marc I. Steinberg, \textit{The Securities and Exchange Commission's Administrative, Enforcement, and Legislative Programs and Policies—Their Influence on Corporate Internal Affairs}, 58 NOTRE DAME L. REV. 173, 230-31 (1982) (noting that with respect to the securities lawyer, "[t]he Commission . . . [has] pointed out that . . . the client must make the final decision . . . the client's pressure on its lawyer for the minimum disclosure required by law is, by itself, not an appropriate basis for finding that a lawyer must resign or take some extraordinary action").

\textsuperscript{112}See supra Part II.B discussing the role of the accountant.
Registration Statement. Instead, the accountant should be liable only to the issuer.

In addition, at least one commentator has noted that the professionals involved in the Registration of Securities should be viewed as employees of the issuer and should be liable to the issuer and not the investing public.\footnote{See Shulman, supra note 3, at 239.} This is a plausible argument considering that it is the issuer who is attempting to distribute securities to the public. Because the financial certifications provided by the accountant are attenuated from the public offering, accountants should not be subject to civil liability under section 11.

3. Accountants as Compared to Other Securities Professionals

The opinions which securities lawyers provide in the registration process are limited in scope.\footnote{See supra Part III.A.1 discussing the limited role of the securities lawyer.} One of the primary functions of the securities lawyer is to assist the underwriter in complying with due diligence. Despite the involvement of the securities lawyer in the overall scheme of disclosure to investors, the securities lawyer is not promoting investment in any particular security. Instead, the role of the securities lawyer is to ascertain whether all of the legal aspects of the registration are in order and to provide opinions to the underwriter in that respect.\footnote{See supra note 81 and accompanying text explaining the types of opinions provided by securities lawyers for underwriters.} An argument can be made that the role of the accountant is just as limited in scope.

Although the accountant is charged with overseeing a portion of the Registration Statement which is considered "expertised," in the full scheme of the registration process the accountant is merely providing an opinion as to the financial welfare of the issuer. The accountant is neither providing an opinion as to whether an investor should invest in certain securities, nor selling the securities directly to investors.

Unlike the underwriter, who certifies the securities for distribution among the investing public, the accountant's role revolves solely around the financial status of the issuer. The accountant's role is more attenuated from the distribution of securities than that of the underwriter. Underwriters rely on reports from other professionals, such as accountants, in order to compile extensive disclosure documents required under the Securities Act. It is the underwriter who vouches for the validity of the offered securities and encourages investment. Because of the underwriter's intimate
involvement with the distribution of securities, accountants can be distinguished from underwriters for purposes of section 11 liability. As such, neither securities lawyers nor accountants should be held to the same standard of liability as underwriters.

V. CONCLUSION

The Securities Act of 1933 was enacted to regain investor confidence in the stock market by requiring that issuers provide certain disclosures to the investing public. Issuers are strictly liable to investors for material misstatements and omissions in the Registration Statement. Holding issuers liable to investors directly correlates with the purpose behind the Securities Act. Likewise, the underwriter, as the second link in the chain of distribution, should also be exposed to liability, limited only by the due diligence defense.

A question arises, though, when one considers the role of the accountant in the registration of securities. The accountant analyzes financial representations provided by issuers. This limited role appears more attenuated from public disclosure than the roles of the issuer and underwriter. Concerning investor protection, both the issuer and the underwriter are more involved with the offering and distribution of securities—the issuer and underwriter attest to the validity of the security. Conversely, an opinion as to the financial well-being of the company, as provided by the accountant, is only one aspect to be considered when making an investment decision.

While the purpose behind section 11 is to protect investors, adequate protection is afforded by permitting civil actions against the issuers themselves as well as the underwriting syndicate. Because of the limited and attenuated role of the accountant in the offering of securities, attaching liability to the accountant seems disproportionate. Perhaps section 11 should be more narrowly tailored to exclude causes of action against those who merely assist in the registration process.

_Candida P. José_

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116 It is the underwriter who markets and distributes the securities. Moreover, the reputation of an underwriter alone may be apt to entice an investor into purchasing a security.