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Scienter Pleading and Rule 10b-5: Empirical Analysis and Behavioral Implications

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SCIENTER PLEADING AND RULE 10b-5: EMPIRICAL ANALYSIS AND BEHAVIORAL IMPLICATIONS

Dain C. Donelson[†] & *Robert A. Prentice*[‡]

ABSTRACT

Pleading requirements are the keys to the courthouse. Nowhere is this more true than with rule 10b-5 class action securities fraud claims. Provisions of the Private Securities Litigation Reform Act of 1995 impose special pleading burdens upon plaintiffs regarding the scienter element and bar them from discovery when defendants file a motion to dismiss. This Article begins with a doctrinal history of the scienter element of a rule 10b-5 claim that indicates that many key legal questions remain unsettled and that application of legal rules to specific factual allegations regarding a particular type of defendant—external auditors—is extraordinarily muddled. To determine whether the impression arising from this extensive but nonsystematic examination of the case law is accurate, we also empirically examine rule 10b-5 claims against auditors and confirm that few facts are consistently viewed by the courts as indicating the presence (or absence) of scienter. This lack of clarity in the law and its application makes it difficult for either plaintiffs or defendants to evaluate the settlement value of claims. Furthermore, the law's excessive vagueness affords judges virtually untrammelled discretion. The literature of behavioral psychology and related fields indicates that excessive discretion exacerbates problems that arise from unconscious judicial bias.

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CONTENTS

INTRODUCTION.....	443
I. A HISTORY OF THE SCIENTER REQUIREMENT	445
A. <i>The Early Questions</i>	445
1. Is section 10(b) a scienter-based or negligence-based statute?	445
2. Is recklessness sufficient to satisfy the scienter standard?	446
3. What form of recklessness is required to satisfy the scienter requirement?	448
B. <i>The PSLRA's Role</i>	449
1. How strict is the pleading standard under the PSLRA?	450
2. What is a “strong inference”?.....	451
3. How does a plaintiff properly plead and prove scienter?	452
a. <i>Motive and Opportunity</i>	453
b. <i>Circumstantial Evidence</i>	454
C. <i>Scienter and Outside Auditors</i>	454
1. Should outside auditors receive special treatment in application of the scienter standard?	455
a. <i>Existence of Special Treatment for Auditors</i>	455
b. <i>Rationale for Special Treatment for Auditors</i>	457
c. <i>Scope of Special Treatment for Auditors</i>	460
2. How does the motive and opportunity test apply to external auditors?	462
3. How does the circumstantial evidence test apply to auditors?	465
a. <i>Size of Mistakes</i>	466
b. <i>Multiple GAAP and GAAS Errors</i>	467
c. <i>Restatements</i>	467
d. <i>Auditor Access, Nonaudit Services, and Alumni</i>	468
e. <i>Auditor Resistance to Client Practices</i>	470
f. <i>Rapid Discovery of Fraud by Third Parties</i>	471
4. The Importance of Red Flags	471
a. <i>Generally Reliable Red Flags</i>	474
b. <i>Not Necessarily Red Flags</i>	474
II. AN EMPIRICAL ANALYSIS OF SCIENTER CASE LAW RELATED TO AUDITOR DEFENDANTS.....	477
A. <i>Introduction and Sample Description</i>	477
B. <i>Variable Definitions</i>	478
C. <i>Univariate Correlations</i>	481
D. <i>Multivariate Analysis</i>	482
E. <i>Sensitivity Analysis</i>	486
III. IMPLICATIONS.....	487
A. <i>Uncertainty</i>	487
B. <i>Judicial Discretion</i>	488
1. Judges' Bounded Rationality.....	490
2. The Impact of Decisional Heuristics and Biases.....	491
a. <i>Overconfidence</i>	492
b. <i>Self-Serving Bias</i>	493
c. <i>Hindsight Bias and Fraud-by-Hindsight Doctrine</i>	497
d. <i>Fundamental Attribution Error and Motivated Exculpation</i>	500
C. <i>Exacerbating Judicial Bias</i>	506
CONCLUSION.....	508

INTRODUCTION

Many important and contentious issues surround private class action securities fraud lawsuits under section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934.¹ Pleading requirements “are the key that opens access to courts”² for these and other lawsuits, yet the law in this area has long been and continues to be best described as “muddled.”³ The confused state of the law is more than just theoretically important because empirical studies of differential pleading standards among the circuits in rule 10b-5 cases indicate that certain of these differences strongly affect both dismissal rates⁴ and the types of

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1. This Article takes no position on the question of whether such lawsuits are generally good or bad. Certainly, many believe they are damaging to the economy and serve no good end. *See, e.g., Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009: Hearing Before the Subcomm. on Crime & Drugs of the S. Comm. on the Judiciary*, 111th Cong. 216–22 (2009) (statement of Adam C. Pritchard, Professor of Law, University of Michigan Law School) (arguing that private class actions move a lot of money around, but add little to deterrence at the margin); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 84 (1991) (arguing that attorneys are the principal beneficiaries of this litigation).

Others have found evidence of benefits flowing from active private antifraud litigation. *See, e.g., FRANK B. CROSS & ROBERT A. PRENTICE, LAW AND CORPORATE FINANCE* 182 (2007) (reporting results of empirical study finding, among other things, that “in the securities law enforcement context, it is the private right of action and not government prosecution which has the greatest financial value”); Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207, 237 (2009) (finding that key positive financial outcomes such as stock market capitalization, trading volumes, and number of IPOs correlate with private enforcement—but also with public enforcement—of securities laws); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Works in Securities Laws?*, 61 J. FIN. 1, 27–28 (2006) (finding various benefits flowing from active private enforcement of public securities laws); Justin Hopkins, *Does Shareholder Litigation Affect Financial Reporting Choices?* 4–5 (Apr. 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=1872068> (finding that a court decision that reduced the risk of shareholder litigation led to more financial restatements and earnings management, especially among firms facing a higher risk of litigation).

2. *Phillips v. Cnty. of Allegheny*, 515 F.3d 224, 230 (3d Cir. 2008).
3. Ann Morales Olazábal & Patricia Sanchez Abril, *The Ubiquity of Greed: A Contextual Model for Analysis of Scienter*, 60 FLA. L. REV. 401, 412 (2008) (noting the “muddled quality of the jurisprudence in this area”).
4. *See* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 937, 976 (finding that the Private Securities Litigation Reform Act affected dismissal rates, and that the stringency of the pleading standard applied by a particular circuit was especially impactful); A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private*

cases that are filed, effectively screening out cases with smaller claim amounts.⁵

Similar confusion reigns in an important strand of these cases that is the primary focus of this Article—those section 10(b)/rule 10b-5 claims brought against external auditors. Pervasive confusion is not terribly unusual in the case law generated by federal securities litigation,⁶ but neither is it a good thing. A doctrinal analysis of courts' scienter decisions in these rule 10b-5 auditor cases highlights the existence of these many important and contentious issues but does little to resolve them. A primary purpose of this Article is to determine whether or not empirical analysis can shed some light on these issues and, if so, help to clarify the pragmatic contours of the all-important scienter requirement in private federal securities fraud litigation.

In a narrow but important area, this Article addresses two of the most important balancing acts in the law. How can plaintiffs be granted adequate access to the courthouse without unduly burdening defendants with frivolous litigation? And how can judges be allowed adequate discretion to dispose quickly of unpromising claims without giving them untrammelled discretion to advance their own unconscious biases?

Part I of this Article undertakes a traditional historical and doctrinal analysis of the statutory and case-based development of the law of scienter in rule 10b-5 litigation. It provides background and context, addressing the scienter issue generally, but also focusing on the case law involving auditor defendants specifically. Part II reports the methods and results of an empirical analysis of the scienter-related case law in rule 10b-5 litigation against external auditors. Both the doctrinal and the empirical analyses indicate that the law of pleading scienter against external auditors in rule 10b-5 cases is so vague and inconsistent that, as a practical matter, judges have virtually unfettered discretion to reach any conclusion they deem appropriate. Using the insights of behavioral psychology and related fields, Part III analyzes the unfortunate implications of such nearly limitless discretion.

Securities Litigation Reform Act, 2 J. EMPIRICAL LEGAL STUD. 125, 142 (2005) (finding that different pleading standards among circuits affected motion to dismiss outcomes).

5. Perino, *supra* note 4, at 916–17 (noting that stricter pleading standards may cause plaintiffs' attorneys to focus on cases with higher damages).
6. See, e.g., Stefan J. Padfield, *Immaterial Lies: Condoning Deceit in the Name of Securities Regulation*, 61 CASE W. RES. L. REV. 143, 179 (2010) (noting “unnecessary confusion about the definition of materiality”); Ferry Eden Lopez, Comment, *At a Loss with Loss Causation: Resolving the Ninth Circuit's Loss Causation Decisions in Metzler Investment GMBH v. Corinthian Colleges and In re Gilead Sciences*, 43 U.C. DAVIS L. REV. 1737, 1743 n.24 (2010) (noting evidence of confusion over what constitutes loss causation, even after latest Supreme Court case on the issue).

I. A HISTORY OF THE SCIENTER REQUIREMENT,
ESPECIALLY AS REGARDS AUDITOR DEFENDANTS

A. *The Early Questions*

1. Is section 10(b) a scienter-based or negligence-based statute?

Section 10(b)⁷ forbids securities fraud in violation of SEC rules, such as rule 10b-5.⁸ The role of scienter in rule 10b-5 cases has been filled with controversial questions over the years and remains so. The initial question was whether Section 10(b) is a scienter-based or negligence-based statute. Some lower courts initially held that negligence alone could violate the statute,⁹ while other courts strongly

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7. Section 10(b) reads, in pertinent part:

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 securities exchange—

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement . . . , 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.

15 U.S.C. § 78j (2006).

8. Rule 10b-5 reads:

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 securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2012).

9. *See, e.g., Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963) (“[T]he statute was meant to cover more than deliberately and dishonestly misrepresenting or omitting material facts”); *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961) (disagreeing with the assertion that the plaintiff must prove “genuine fraud” instead of “a mere misstatement or omission”).

disagreed.¹⁰ That issue, at least (and, perhaps, at most) is now firmly settled. In 1976, the Supreme Court established in *Ernst & Ernst v. Hochfelder* that section 10(b) and rule 10b-5 are intent-based liability provisions.¹¹

2. Is recklessness sufficient to satisfy the scienter standard?

Hochfelder left open an immediate, critical question that remains unsettled nearly forty years later.¹² The Supreme Court has at least thrice reserved without deciding the issue of whether recklessness suffices to satisfy the scienter standard.¹³

If the Supreme Court ever rules on this issue, it should embrace the recklessness standard for at least three reasons. First, for more than three decades the lower courts have been virtually unanimous in holding that recklessness suffices.¹⁴ Second, the common law of fraud has long recognized recklessness as sufficient to satisfy the scienter

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10. See, e.g., *Clegg v. Conk*, 507 F.2d 1351, 1362 (10th Cir. 1974) (requiring more than “simple negligence not involving some fraudulent purpose or species of scienter”); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (“[P]roof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5.”).
 11. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Relying upon legislative history and principles of statutory interpretation, the Court concluded in *Hochfelder*, a case involving an auditor defendant, that “[w]hen a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct.” *Id.* at 214.
 12. *Hochfelder* also left unsettled the question of whether the scienter requirement applied in SEC actions as well. The Supreme Court quickly held that it did. *Aaron v. SEC*, 446 U.S. 680, 701–02 (1980) (“[T]he Commission is required to establish scienter as an element of a civil enforcement action to enjoin violations of [section 10(b) and Rule 10b-5].”).
 13. See, e.g., *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1323–24 (2011) (assuming without deciding that the “deliberate recklessness” standard applied by the lower court was sufficient to establish scienter); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3 (2007) (noting that courts of appeals have differed in the degree of recklessness required and that “[t]he question whether and when recklessness satisfies the scienter requirement is not presented in this case”); *Hochfelder*, 425 U.S. at 193 n.12 (“In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.”).
 14. See Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action*, 40 ARIZ. L. REV. 1003, 1026 (1998) (“[A]ll Circuits that have considered the issue have held that recklessness suffices . . .”).

requirement,¹⁵ and section 10(b) was enacted to strengthen, not weaken, investor protection as compared to the common law.¹⁶ Third, in 1995

15. *See, e.g.*, *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979) (“At common law, recklessness satisfied the scienter requirement for fraud.” (citing *Derry v. Peek*, (1889) 14 App. Cas. 337 (H.L.) 374 (appeal taken from Eng.))); RESTATEMENT OF TORTS § 526(b) cmt. e (1938) (“[A] misrepresentation . . . is fraudulent if [the maker] is conscious that he has merely a belief in its existence and recognizes that there is a chance, more or less great, that the fact may not be as it is represented.”); WILLIAM L. PROSSER, HANDBOOK OF THE LAW OF TORTS § 107, at 701 (4th ed. 1971) (noting “general agreement” that intent is present when there is “reckless disregard” for the truth).
16. Section 10(b) is based on the common law of fraud. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 547 (5th Cir. Unit A Mar. 1981) (noting that rule 10b-5 claims are derived from the common law deceit action), *aff’d in part, rev’d in part on other grounds*, 459 U.S. 375 (1983); *Harris v. Am. Inv. Co.*, 523 F.2d 220, 224 (8th Cir. 1975) (“[C]ommon law fraud concepts underlie the securities laws and provide guidance as to their reach and application”); *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 142 F. Supp. 2d 589, 595 (D.N.J. 2001) (noting that, although the tort is statutory in origin, it is grounded in common law fraud and deceit); *In re Cendant Corp. Litig.*, 60 F. Supp. 2d 354, 368 (D.N.J. 1999) (noting that even though the tort is statutory in origin, it stems from the common law of fraud). The Supreme Court often accesses the common law for guidance regarding the meaning of section 10(b). *See, e.g.*, *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005) (noting that courts have implied a private damages action that resembles a common law tort action); *Basic Inc. v. Levinson*, 485 U.S. 224, 231, 244 n.22 (1988) (noting that statutory actions were designed to add to the common law protections provided to investors); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (commenting that “rigid common-law barriers” have been avoided when construing securities laws); *Chiarella v. United States*, 445 U.S. 222, 227–28 (1980) (“At common law, misrepresentation made for the purpose of inducing reliance upon [a] false statement is fraudulent.”).

Significantly, section 10(b) was meant to strengthen, not weaken that common law protection. *See, e.g.*, *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1968) (noting that section 10(b) should be interpreted so as to liberalize the common law in order to effectuate its remedial purpose). The Supreme Court has agreed, holding as an example that “[a] fundamental purpose” of the federal securities laws, including section 10(b), was to replace the common law fraud regime’s caveat emptor rule in order “to achieve a high standard of business ethics in the securities industry.” *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

Regarding auditors, Congress replaced the very protective state common-law *Ultramares* view that auditors could not be liable for *negligence* to third parties unless those third parties were named in the engagement letter, with the broad negligence liability of section 11 of the 1933 Act, which makes auditors potentially liable to all investors in a public offering if the auditors cannot prove their due diligence. *See Securities Act of 1933 § 11*, 15 U.S.C. § 77k (2006) (listing auditors and other experts as statutory defendants in lawsuits where false statements

Congress enacted the Private Securities Litigation Reform Act (PSLRA), which contains liability provisions premised upon the existence of recklessness-based section 10(b) liability.¹⁷ Enactment of provisions that have no meaning without recklessness-based liability surely signals congressional approval of that liability.¹⁸

3. What form of recklessness is required to satisfy the scienter requirement?

Most lower courts have concluded that for recklessness to suffice, it must be nearer true scienter than to gross negligence on the *negligence* → *gross negligence* → *recklessness* → *scienter* continuum.¹⁹ Lower courts commonly require not just recklessness, but “severe” recklessness.²⁰

in registration statements injure investors); *Ultramares Corp. v. Touche*, 174 N.E. 441, 444–45 (N.Y. 1931) (adopting the privity view of auditors’ third-party liability for negligence). *See generally* John Hanna & Edgar Turlington, *Protection of the Public Under the Securities Exchange Act*, 21 VA. L. REV. 251, 279 (1935) (“It is certainly safer now for the man who wishes through his savings to obtain a stake in corporate property in this country than it was before the [1934] Act was passed.”).

17. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.). The PSLRA adopted proportionate, rather than joint and several, liability for defendants who are not found to have knowingly violated the securities laws. In other words, defendants with actual intent remain jointly and severally liable while defendants who are only reckless benefit from being only proportionately liable (although this protection is limited by two exceptions involving “uncollectible shares” stemming from the existence of insolvent co-defendants). *See* 15 U.S.C. § 78u-4(f) (2006).
18. *See* Robert A. Prentice, *Scheme Liability: Does it Have a Future After Stoneridge?*, 2009 WIS. L. REV. 351, 356 (claiming that Congress’s enactment of proportionate liability “would have been completely pointless if a private right to sue multiple defendants did not exist”).
19. *See, e.g.*, *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 199 (1st Cir. 1999) (describing the distinction between recklessness and negligence as “not just a difference in degree, but also in kind”); *Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003, 1014 (S.D. Cal. 2000) (“[N]o degree of negligence can satisfy the substantive element of scienter, or raise a strong inference of scienter . . .”).
20. For instance, the 11th Circuit has held that “severe recklessness” meets the scienter standard, noting that

[s]evere recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.

B. *The PSLRA's Role*

Although *Hochfelder* and succeeding lower-court cases established a high standard of liability, Silicon Valley high-tech firms and large accounting firms believed that they were the victims of too many frivolous class action securities fraud lawsuits pursuant to rule 10b-5 and other federal securities law provisions.²¹ Their lobbying procured the 1995 enactment of the PSLRA,²² a massively pro-defendant reform provision.²³ For current purposes, the most significant features of the PSLRA were its heightened pleading requirement, especially for the scienter element,²⁴ and its provision that the filing of a motion to dismiss on grounds of failure to adequately plead scienter (or other elements) stays discovery and therefore may prevent plaintiffs from procuring evidence to support their claims.²⁵

After the PSLRA, notice pleading was out, replaced by a requirement that any complaint pursuant to rule 10b-5 satisfy two specificity obstacles. Plaintiffs must “specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”²⁶ And civil damage plaintiffs also must “state with particularity facts giving rise

Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1282 n.18 (11th Cir. 1999) (quoting McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989)).

According to some courts, “[t]his level of recklessness requires that defendants make statements that they know, or have access to information suggesting, are materially inaccurate.” Ferris, Baker Watts, Inc. v. Ernst & Young, LLP, 395 F.3d 851, 854 (8th Cir. 2005) (citing Advanced Data Concepts v. Navarre Corp. (*In re Navarre Corp. Sec. Litig.*), 299 F.3d 735, 746 (8th Cir. 2002)).

21. Other provisions targeted by the PSLRA include sections 11 and 12 of the 1933 Securities Act, 15 U.S.C. §§ 77k, 77l (2006).
22. Private Securities Litigation Reform Act of 1995, Pub L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).
23. The PSLRA, among other things, replaced joint and several liability with proportional liability, 15 U.S.C. § 78u-4(f) (2006); recognized a statutory “bespeaks caution” defense, § 78u-5(c)(1); heightened loss causation proof requirements, § 78u-4(b)(4); and created stricter damages rules, § 78u-4(e).
24. § 78u-4(b)(2).
25. § 78u-4(b)(3)(B).
26. § 78u-4(b)(1).

to a *strong inference* that the defendant acted with the required state of mind.”²⁷

The PSLRA set a precedent. In 2007 and 2009, in *Bell Atlantic Corp. v. Twombly*²⁸ and *Ashcroft v. Iqbal*,²⁹ the Supreme Court raised the pleading bar across all federal court cases by requiring plaintiffs to articulate a “plausible” basis for their claims, even before they can use discovery to seek support for them.³⁰ The PSLRA also raised several questions.

1. How strict is the pleading standard under the PSLRA?

Because the facts that give rise to a strong inference of scienter must be alleged with particularity, many courts hold that plaintiffs must plead “the who, what, when, where, and how: the first paragraph of any newspaper story.”³¹ Put another way, a complaint “must (1) specify the statements that . . . were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent.”³² Other courts, however, hold that plaintiffs “need not . . . plead the ‘date, place or time’ of the fraud, so long as they use an ‘alternative means of injecting precision and some measure of substantiation into their allegations of fraud.’”³³ And some of these courts have cautioned

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27. § 78u-4(b)(2) (emphasis added). *See generally* Ferris, Baker Watts, Inc. v. Ernst & Young, LLP, 395 F.3d 851, 854 (8th Cir. 2005) (applying the heightened pleading standard Congress enacted as part of the PSLRA); Fla. State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 654 (8th Cir. 2001) (same).
28. *Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007).
29. *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).
30. Allegations of acts that are “merely consistent” with a defendant’s liability fails to cross the important threshold between possibility and *plausibility*. *Twombly*, 550 U.S. at 557. “The plausibility standard is not akin to a ‘probability requirement,’ but it asks for more than a sheer possibility that a defendant has acted unlawfully.” *Iqbal*, 556 U.S. at 678 (quoting *Twombly*, 550 U.S. at 556).
31. *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999) (quoting *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990)).
32. *ATSI Commc’ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007); *see also In re MRU Holdings Sec. Litig.*, 769 F. Supp. 2d 500, 508 (S.D.N.Y. 2011) (applying the four requirements of the complaint).
33. *Rolo v. City Investing Co. Liquidating Trust*, 155 F.3d 644, 658 (3d Cir. 1998) (quoting *Seville Indus. Mach. Corp. v. Southmost Mach. Corp.*, 742 F.2d 786, 791 (3d Cir. 1984)); *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 142 F. Supp. 2d 589, 604 (D.N.J. 2001) (quoting the same text from *Rolo*).

against requiring plaintiffs to plead with too much precision issues that defendants may have concealed.³⁴

These disagreements are critical because, as noted above, the PSLRA's discovery stay, which goes into effect upon the filing of any motion to dismiss, can make it extremely difficult for plaintiffs to obtain the necessary factual details required by most courts in order to successfully plead scienter.³⁵ A strict scienter pleading standard can create a very significant roadblock to a plaintiff's prosecution of a rule 10b-5 claim.

2. What is a "strong inference"?

The PSLRA requires plaintiffs to plead scienter with sufficient particularity to establish a "strong inference" that the intent requirement is met, but the lower courts could not agree on the meaning of a "strong inference."³⁶ The Supreme Court attempted to settle the issue in *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, where it held that a court's responsibility in applying the PSLRA pleading standard

is not to scrutinize each allegation in isolation but to assess all the allegations *holistically*. In sum, the reviewing court must ask: When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter *at least as strong as any opposing inference*?³⁷

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34. See, e.g., *Rolo*, 155 F.3d at 658 ("Courts should, however, apply the rule with some flexibility and should not require plaintiffs to plead issues that may have been concealed by the defendants." (citing *Christidis v. First Pa. Mortg. Trust*, 717 F.2d 96, 99-100 (3d Cir. 1983)); *Schoenfeld*, 142 F. Supp. 2d at 604 (quoting the same text from *Rolo*).
35. See Barbara Black, *Eliminating Securities Fraud Class Actions Under the Radar*, 2009 COLUM. BUS. L. REV. 802, 816 (arguing that the PSLRA's "tightened pleading standards and bar on discovery," coupled with other factors, will cause *underdeterrence* of fraud); Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L. REV. 537, 578 (1998) ("[W]hen vigorously applied, the combination of a strict pleading standard with a *stay* of discovery creates a pleading barrier so high that few complaints will survive it." (emphasis added)).
36. Paul A. Griffin & Joseph A. Grundfest, *When Does Insider Selling Support a "Strong Inference" of Fraud?*, 9 Asia-Pac. J. Acct. & Econ. 159, 160 (2002) ("There is substantial disagreement within the judiciary over the proper legal interpretation of this 'strong inference' standard.").
37. *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 326 (2007) (emphasis added) (citation omitted). This strict approach is generally consistent with the Supreme Court's holdings in *Iqbal* and *Twombly* that to survive motions to dismiss complaints must contain sufficient factual information that, if accepted as true (as they must be) would state a

Given a potential range of competing inferences, the Court essentially ruled that a “tie goes to the plaintiff,” for an inference of scienter need not be *stronger* than competing inferences for the complaint to survive a motion to dismiss; it need only be just as strong.³⁸ As indicated, the Court also demanded a holistic, rather than merely a piecemeal, examination of the evidence.³⁹

3. How does a plaintiff properly plead and prove scienter?

Another and more significant issue that predated the PSLRA but became even more contentious after its passage regards how a plaintiff properly pleads and proves scienter. Many lower courts had previously developed two primary means for plaintiffs to prove that a defendant acted with requisite scienter. One involved proof of motive and opportunity while the other involved the use of circumstantial evidence. These remain the two primary ways of establishing scienter in the wake of the PSLRA, at least according to many courts.⁴⁰

claim “plausible on its face.” *Ashcroft v. Iqbal*, 566 U.S. 662, 678 (2009) (citing *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). Facial plausibility is achieved when plaintiffs plead factual details that allow courts to draw reasonable inferences that defendant is liable for the alleged conduct. *Id.*

38. Michael J. Kaufman & John M. Wunderlich, *The Judicial Access Barriers to Remedies for Securities Fraud*, 75 LAW & CONTEMP. PROBS. 55, 56 (2012) (“*Tellabs* did not eliminate the use of circumstantial evidence in pleading, but rather held that when two inferences are equally plausible, the tie goes to the plaintiff.”).
39. See *Tellabs*, 551 U.S. at 326 (“[T]he court’s job is not to scrutinize each allegation in isolation but to assess all the allegations holistically.”). Victor Quintanilla argued that *Tellabs*, by “broaden[ing] the epistemic goal of decision-making by requiring federal courts to compare and contrast culpable and non-culpable explanations for behavior” will have laudable effects. Victor D. Quintanilla, *(Mis)Judging Intent: The Fundamental Attribution Error in Federal Securities Law*, 7 N.Y.U. J.L. & BUS. 195, 245 (2010). But Victoria Su surveyed the case law and suggested that the “holistic” approach suggested by the Court in *Tellabs* simply gives the circuit courts sufficient latitude to simultaneously pretend to follow *Tellabs* and yet retain their pre-*Tellabs* tests for scienter. See Victoria Su, Note, *Scienter After Tellabs*, 5 BROOK. J. CORP. FIN. & COM. L. 527, 547 (2011) (discussing various courts’ adjustments in the wake of *Tellabs*).
40. “In the Second Circuit, [at least,] a ‘strong inference’ of scienter can be established by alleging facts either ‘(1) showing that the defendants had both motive and opportunity to commit the [alleged] fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness.’” *In re Bear Stearns Cos. Sec., Derivative & ERISA Litig.*, 763 F. Supp. 2d 423, 499 (S.D.N.Y. 2011) (quoting *ATSI Commc’ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007)); see also *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) (discussing the two alternatives for establishing a “strong inference”); *In re Agape Litig.*, 773 F. Supp. 2d 298, 308 (E.D.N.Y. 2011) (same).

a. *Motive and Opportunity*

Motive⁴¹ and opportunity can be established by plaintiffs alleging facts indicating that defendant benefitted in a “concrete and personal way”⁴² from the alleged fraud.⁴³ Motives that would be common to all actors in the defendants’ position will not suffice.⁴⁴ Thus, if plaintiffs plead merely that corporate insiders manipulated the numbers because they wished to maintain a high market price for their company’s stock, that would not suffice, even though it would certainly be reasonable to believe that defendants would wish to achieve that goal, because almost all insiders would have that same motivation.⁴⁵ In other words, this allegation would not help distinguish the motives of fraudsters from the motives of all corporate insiders.⁴⁶

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41. Intent and motive are related, but separate. Intent refers to the state of mind with which an act is committed, whereas motive is what prompts the person to act. *See* Maurice E. Stucke, *Is Intent Relevant?*, 8 J.L. ECON. & POL’Y 801, 809 (2012).
 42. *Novak v. Kasaks*, 216 F.3d 300, 307 (2d Cir. 2000).
 43. *See id.* (“Motive would entail concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged.” (quoting *Shields*, 25 F.3d at 1130)); *Wilson v. Dalene*, 699 F. Supp. 2d 534, 558 (E.D.N.Y. 2010) (“Motive and opportunity can be established by demonstrating that defendants benefitted ‘in a concrete and personal way’ from the alleged fraud.” (quoting *Trinity BUI v. Indus. Enters. of Am., Inc.*, 594 F. Supp. 2d 364, 370 (S.D.N.Y. 2009))); *In re DRDGOLD Ltd. Sec. Litig.*, 472 F. Supp. 2d 562, 570 (S.D.N.Y. 2007) (discussing requirements for an allegation of motive); *Queen Uno Ltd. v. Coeur D’Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1359 (D. Colo. 1998) (adopting an approach where plaintiffs, in order to prove a strong inference of fraudulent intent, can plead both motive and opportunity).
 44. *See Kalnit v. Eichler*, 264 F.3d 131, 139 (2d Cir. 2001) (“Motives that are generally possessed by most corporate directors and officers do not suffice.”); *In re Lehman Bros. Sec. & ERISA Litig.*, 799 F. Supp. 2d 258, 293 (S.D.N.Y. 2011) (containing similar language); *Wilson*, 699 F. Supp. 2d at 559 (same); *In re DRDGOLD*, 472 F. Supp. 2d at 570 (same).
 45. *See Kalnit*, 264 F.3d at 139 (“Insufficient motives, we have held, can include (1) the desire for the corporation to appear profitable and (2) the desire to keep stock prices high to increase officer compensation.” (citing *Novak*, 216 F.3d at 307–08)); *Wilson*, 699 F. Supp. 2d at 559 (discussing insufficient corporate motives); *In re Merrill Lynch & Co., Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 262 (S.D.N.Y. 2003) (same).
 46. Insider trading by individual defendants is often deemed to satisfy the motive requirement, but only if it is unusual in amount or otherwise suspicious. *See Avon Pension Fund v. GlaxoSmithKline PLC*, 343 Fed. App’x 671, 673 (2d Cir. 2009) (summary order) (“[U]nusual insider trading activity during the class period may permit an inference of bad faith and scienter” (quoting *Acito v. IMCERA Grp., Inc.*, 47 F.3d 47, 54 (2d Cir. 1995))); *In re PEC Solutions, Inc. Sec. Litig.*, 418 F.3d 379, 390 (4th Cir. 2005) (noting that insider trading may support an inference of scienter if unusual and suspicious); *Greebel v. FTP*

b. *Circumstantial Evidence*

The second primary means of alleging scienter involves circumstantial evidence that points to more than mere negligence by defendants.⁴⁷ It is difficult to read a person's mind, so circumstantial evidence is the key to proof, or lack thereof, in most types of fraud litigation.⁴⁸ Securities fraud cases are no different. The Supreme Court itself has observed that "the proof of scienter required in fraud cases is often a matter of inference from circumstantial evidence."⁴⁹ That said, catch-all or blanket allegations will not meet the particularity requirement.⁵⁰ But circumstantial evidence can pile up so as to render incredible a non-fraudulent explanation.

C. *Scienter and Outside Auditors*

The focus of this Article is the scienter requirement as applied to rule 10b-5 claims against external auditors. It is clear that the scienter requirement does not demand that auditor defendants desire to injure people, but only that they be able to foresee that certifying misleading financial statements that do not conform to GAAP (generally accepted accounting practices) can influence and thereby injure investors.⁵¹ Beyond that, not much is settled.

Software, Inc., 194 F.3d 185, 197–98 (1st Cir. 1999) ("Unusual trading or trading at suspicious times or in suspicious amounts by corporate insiders has long been recognized as probative of scienter.").

47. Fact finders tend to strongly prefer direct evidence over circumstantial evidence, even though their prejudice against circumstantial evidence is arguably unwarranted and their reliance on direct evidence may overvalue its trustworthiness. *See, e.g.*, Eyal Zamir et al., *Seeing is Believing: The Anti-Inference Bias* 3–4, (Apr. 21, 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=1989561> ("Commentators generally agree that the prejudice against circumstantial evidence is unwarranted. . . . Factfinders tend to undervalue the reliability and probative value of circumstantial evidence, . . . and to overvalue the trustworthiness and weight of direct evidence, such as eyewitness testimonies." (citations omitted)).
48. *See Clarke v. United States*, 132 F.2d 538, 540–41 (9th Cir. 1943) ("It is rare when direct proof of the devising of the scheme may be given. In most cases it must be inferred.").
49. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 n.30 (1983).
50. *See, e.g.*, *Advanced Data Concepts v. Navarre Corp.* (*In re Navarre Corp. Sec. Litig.*), 299 F.3d 735, 741 (8th Cir. 2002) ("[W]e disregard 'catch-all' or 'blanket' assertions that do not live up to the particularity requirements of the statute." (quoting *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001))).
51. *See, e.g.*, *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 221 (2d Cir. 2000) (finding requisite scienter based on foreseeability of harm to investors); *In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 496 (S.D.N.Y. 2005) (discussing the *AUSA* decision).

1. Should outside auditors receive special treatment in application of the scienter standard?

a. Existence of Special Treatment for Auditors

To protect auditors from liability, lower courts are often especially demanding of plaintiffs attempting to plead fraud against auditors.⁵² The Sixth Circuit, for example, has stated that “the meaning of recklessness in securities fraud cases is especially stringent when the claim is brought against an outside auditor.”⁵³ Therefore, according to some courts, liability attaches in a rule 10b-5 case only when the auditor acts with “at least deliberate recklessness.”⁵⁴ Other courts say that auditors’ wrongdoing must “approximate an actual intent” to aid the client’s fraud in order to satisfy the recklessness standard.⁵⁵ Others require that the evidence clearly show that the

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52. In the Second Circuit, courts tend to say that the scienter pleading requirement for auditors is “demanding.” *See, e.g., In re Lehman Bros. Sec. & ERISA Litig.*, 799 F. Supp. 2d 258, 302 (S.D.N.Y. 2011) (“The standard for evaluating assertions of an auditor’s scienter . . . is demanding.” (internal quotation marks omitted)); *In re IMAX Sec. Litig.*, 587 F. Supp. 2d 471, 483 (S.D.N.Y. 2008) (“The standard for pleading auditor scienter is demanding.”); *In re Scottish Re Grp. Sec. Litig.*, 524 F. Supp. 2d 370, 385 (S.D.N.Y. 2007) (“The standard for pleading auditor scienter is demanding.” (quoting *In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 657 (S.D.N.Y. 2007))). It is “more exacting” than the standard for other securities fraud defendants. *In re Fannie Mae 2008 Sec. Litig.*, 742 F. Supp. 2d 382, 412 (S.D.N.Y. 2010).
 53. *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 693 (6th Cir. 2004) (citing *In re SmarTalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp. 2d 505, 514 (S.D. Ohio 2000)). Much more than a simple audit failure is required for the auditor to be liable. “It is well-settled that violations of GAAP and GAAS, standing alone, do not create an inference of scienter, much less a strong one.” *Id.* at 694 (citing *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 553 (6th Cir. 1999)).
 54. *See, e.g., In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 985 (9th Cir. 1999) (“The PSLRA requires, to repeat, that [plaintiff] state with particularity facts giving rise to a strong inference of the required state of mind, i.e., at least deliberate recklessness.” (citing 15 U.S.C. § 78u-4(b)(2) (1997))); *Kelley v. Rambus, Inc.*, 384 Fed. App’x 570, 573 (9th Cir. 2010) (“Kelley’s claims under Section 10(b) and Rule 10b-5 fail to sufficiently allege ‘particular facts giving rise to a strong inference of deliberate recklessness.’” (quoting *In re Silicon Graphics*, 183 F.3d at 979)); *In re Verifone Holdings Sec. Litig.*, No. C 07-6140 MHP, 2011 U.S. Dist. LEXIS 24964, at *18–21 (N.D. Cal. Mar. 8, 2011) (explaining the plaintiff’s burden).
 55. *See, e.g., Rothman v. Gregor*, 220 F.3d 81, 98 (2d Cir. 2000) (“For ‘recklessness on the part of a non-fiduciary accountant’ to satisfy securities fraud scienter . . . [i]t must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company.” (quoting *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 120–21 (2d Cir. 1982))); *La. Mun. Police Emps. Ret. Sys. v. KPMG LLP*, 822 F.

auditor either aided the fraud or was so egregiously irresponsible that no other accountant would have acted in the same manner.⁵⁶ Still other courts have held that when the recklessness standard for auditors is combined with the stringent PSLRA pleading provisions, “a simple rule emerges: to allege that an independent accountant or auditor acted with scienter, the complaint must allege specific facts showing that the deficiencies in the audit were so severe that they strongly suggest that the auditor *must have been aware* of the corporation’s fraud.”⁵⁷ These approaches nearly eliminate recklessness as a basis of auditor liability, although it is unanimously recognized by lower courts as sufficient for all other rule 10b-5 defendants.

The special treatment provided to auditors is generally accepted, with Professor Coffee going so far as to opine that auditors have “virtual immunity” under federal securities laws.⁵⁸ Perhaps the strongest evidence that auditors are subject to special treatment is the fact that auditors are rarely named as defendants in securities class actions, even when their clients are accused of accounting fraud.⁵⁹

Supp. 2d 711, 721 (N.D. Ohio 2011) (noting that recklessness must approximate intent to establish scienter); *Lehman Bros.*, 799 F. Supp. 2d at 302 (same); *Fannie Mae*, 742 F. Supp. 2d at 412 (same).

56. See, e.g., *PR Diamonds*, 364 F.3d at 693–94 (“The [plaintiff] must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.” (quoting *Miller v. Pezzani* (*In re* Worlds of Wonder Sec. Litig.), 35 F.3d 1407, 1426 (9th Cir. 1994))); *La. Mun. Police*, 822 F. Supp. 2d at 721 (quoting *PR Diamonds*).
57. *SmarTalk*, 124 F. Supp. 2d at 514 (emphasis added) (citing *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1570 (9th Cir. 1990) (en banc)); see also *PR Diamonds*, 364 F.3d at 694 (quoting *SmarTalk*); *In re Crocs, Inc. Sec. Litig.*, 774 F. Supp. 2d 1122, 1154 (Colo. 2011) (same).
58. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1550 (2006). While the PSLRA accorded securities fraud defendants special protection, the wave of Enron-era scandals soon followed and many thought that enactment of the Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, in 2002 might shift things dramatically back in the other direction. But a recent study indicates that auditor liability risk after 2002 has actually *decreased*. See Ross D. Fuerman, *Auditors and the Post-2002 Litigation Environment*, 24 RES. ACCT. REG. 40, 44 (2012) (“Analysis of 1169 lawsuits filed between 2001 and 2008 found that auditor litigation severity decreased after 2002. . . . Thus, there appears to have occurred, after 2002, a reduction in auditor liability risk, compared to the 2001–2002 period.”).
59. For instance, Cornerstone Research finds that auditors were named at an annual rate of only 1%–6% of securities class action cases between 2006 and 2010, while GAAP violations were alleged in 26%–57% of

b. *Rationale for Special Treatment for Auditors*

This differential treatment of auditors is not justified by any language in section 10(b) or rule 10b-5. Nor is it supported by any policy considerations contained in the '34 Act's legislative history.⁶⁰ The Supreme Court has not issued any rulings that would directly justify this differentiation. Nor do the PSLRA's provisions or legislative history provide any clear support for a differential treatment of auditors regarding the pleading of scienter, although the impact of many of its provisions was very kind to them.⁶¹

cases. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2010 YEAR IN REVIEW 32 fig.29 (2011), available at http://securities.stanford.edu/clearinghouse_research/2010_YIR/Cornerstone_Research_Filings_2010_YIR.pdf. Similar results were obtained in earlier time periods as well. *E.g.*, Ross D. Fuerman, *Auditors and the Post-Litigation Reform Act Environment*, 14 RES. ACCT. REG. 213 (2000) (“[A]uditors are named defendants in a lower percentage of class actions in 1998 than in previous years . . .”).

60. While the PSLRA's scienter pleading requirements nowhere distinguish between corporate defendants and accountants, courts have imposed clear distinctions. *See* Sherrie R. Savett, *Securities Class Actions Since the 1995 Reform Act: A Plaintiff's Perspective*, in SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2005, at 17, 62–63 (PLI Law & Practice, Course Handbook Ser. No. B-1505, 2005) (discussing scienter pleading requirements with respect to accountants); Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097, 1175–76 (2007) (“Some of the district court opinions have all but foreclosed the possibility that plaintiffs could ever successfully plead scienter of an external auditor based on motive and opportunity.”). At least one court agrees. *See In re AOL Time Warner, Inc. Sec. & “ERISA” Litig.*, 381 F. Supp. 2d 192, 239 n.49 (S.D.N.Y. 2004) (“Ernst & Young's protestations notwithstanding, Rule 9(b) does not contemplate a higher standard for pleading fraud by an independent auditor than for pleading fraud by any other 10(b) defendant.”). Some courts have resisted creating a two-tiered standard that favors auditors. *See, e.g.*, *N.M. State Inv. Council v. Ernst & Young LLP*, 641 F.3d 1089, 1095 (9th Cir. 2011) (“[T]his Court has previously advised against developing ‘separate[] rules of thumb for each type of scienter allegation.’” (quoting *S. Ferry LP, # 2 v. Killinger*, 542 F.3d 776, 784 (9th Cir. 2008))).

61. Although GAAP violations are generally featured in a significant portion of securities fraud class actions (e.g., 44% in 2005 and 68% in 2006), from 1995 to 2006 auditors were named as defendants in just 8.4% of such suits. *See* Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 COLUM. L. REV. 1641, 1682 (2006).

These developments occurred parallel to a diminished emphasis by the SEC on monitoring of accounting firms that lasted until Sarbanes-Oxley was enacted in 2002. *See* John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 290 (2004) (“[F]rom some point in the 1980s until the late 1990s, the SEC shifted its enforcement focus away from actions against the Big Five accounting firms towards other priorities.”);

The grounds for being especially solicitous of external auditors are typically unexplained even in court opinions that explicitly grant this extra protection. One reason some courts have given to justify special treatment for auditors is the notion that “there are limits to the scope of liability for failure adequately to monitor the allegedly fraudulent behavior of others.”⁶² Although these differential standards for outside auditors may be defended as generally consistent with a special solicitousness that the Supreme Court has exhibited for secondary actors in securities fraud cases, the rationale is also undermined by these same cases. While it might once have been seriously argued that auditors had to worry about facing liability for failing to adequately monitor their clients’ fraudulent conduct, today they can be liable for rule 10b-5 civil damages only for making false statements themselves. The 1994 *Central Bank* case eliminated any auditor civil damage liability for aiding and abetting clients’ fraud.⁶³ The 2008 *Stoneridge* case held that auditors cannot be liable even for their own fraudulent statements that helped fool third parties if investors did not rely directly upon those fraudulent statements.⁶⁴ And, most recently, *Janus Capital* held that a defendant’s (including presumably an outsider auditor’s) own fraudulent statements cannot be actionable unless that defendant’s fraudulent activities were known to investors at the time they made their investment decisions.⁶⁵

Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. L. REV. 17, 60 (2003) (“Although the [SEC] . . . [has] the formal authority to discipline accountants, that authority is rarely exercised.”); Cassell Bryan-Low, *SEC May Take Tougher Stance on Accountants in Audit Failures*, WALL ST. J., Dec. 13, 2002, <http://online.wsj.com/article/SB103973735229267033.html> (“During the past 25 years, the SEC has sued large accounting firms fewer than 10 times for audit failures”); see also A.C. Pritchard, *The Irrational Auditor and Irrational Liability*, 10 LEWIS & CLARK L. REV. 19, 54 (2006) (“Under the PSLRA, defendants who are only tangentially involved in the fraud will not face potentially bankrupting liability, so accountants do not have to serve as quasi-guarantors for the solvency of their clients.”).

62. *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000). Because *Central Bank*, *Stoneridge*, and *Janus Capital* make it clear that auditors cannot be liable under section 10(b) or rule 10b-5 for simply failing to adequately monitor the frauds of others, this rationale is less persuasive.
63. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 184, 188–89 (1994).
64. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 166–67 (2008).
65. *Janus Capital Grp., Inc., v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011). Between the Supreme Court and the PSLRA, external auditors are already receiving substantial protection from liability, which mitigates any need to accord them special scienter protection. On the other hand, the audit firms can respond that notwithstanding these

A second rationale for giving auditors special protection from securities liability is based primarily upon the assumptions that (a) auditors are rational actors and (b) a short-term profit earned by looking the other way while a client commits fraud would be outweighed by the profits auditors can gain by maintaining a good reputation.⁶⁶ Although there are persuasive reasons to doubt both of these assumptions,⁶⁷ courts have continued to apply them without ever addressing the substantial body of evidence that undermines them.⁶⁸

cases, they still face SEC civil and Department of Justice criminal liability for aiding and abetting fraud and for making fraudulent statements from the shadows. They could argue that this liability is enough to motivate them to act properly, even though they are specially protected from liability in private damage actions. Whatever the merits of this debate, most courts grant auditors special protection when *scienter* is at issue.

66. The most prominent proponent of this point of view is Judge Easterbrook. See *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (Easterbrook, J.) (“An accountant’s greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years’ audits could not approach the losses [defendant] would suffer from a perception that it would muffle a client’s fraud.”). Many other courts have found these assumptions persuasive. See, e.g., *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 282 (3d Cir. 2006) (“The fact that the [auditors] earned fees for their services does not establish that they acted with any culpable intent.”); *Miller v. Pezzani (In re Worlds of Wonder Sec. Litig.)*, 35 F.3d 1407, 1427 n.7 (9th Cir. 1994) (rejecting the argument that “the auditor had become ‘entangled’ with [defendant] by offering discounts on its fees”); *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) (“[W]e will not indulge irrational inferences of the firm’s fraudulent intent based on these generic allegations.”); *Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003, 1007 (S.D. Cal. 2000) (“[A] large independent accountant will rarely, if ever, have any rational economic incentive to participate in its client’s fraud.”).
67. See Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, HARV. BUS. REV., Nov. 2002, at 96, 99 (arguing that accountants have strong reasons to stay in clients’ good graces especially because “accounting firms have increasingly treated audits as ways to build relationships that allow them to sell their more lucrative consulting services”); Mark, *supra* note 60, at 1174–1205 (arguing that the *DiLeo* line of cases are wrongly decided); Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 218 (2000) (“[I]t is inappropriate to assume . . . (a) that auditors and audit firms are rational in the sense of the rational utility maximizer of the traditional economic model, and (b) that it is always irrational for auditors and audit firms to act recklessly or fraudulently.”). All of these articles mine the literature of behavioral psychology and related fields to argue that auditors and audit firms, like most individuals and organizations, do not act rationally much of the time. Even if they did, there are many very practical reasons, including the lack of real competition among audit firms, the tremendous costs to audit clients of switching firms, and the short-term advantages that individual auditors could gain

Class action attorneys argue that there are significant collateral consequences to the application of an unreasonably high pleading standard regarding accountants, including that “the corporation and corporate insiders can then blame the absentee accountants, using the classic ‘empty chair defense,’ a powerful jury argument for avoiding management liability.”⁶⁹ But these pleas have failed to sway most courts, which continue to cloak auditors with special protection.

c. Scope of Special Treatment for Auditors

Representative of the special protections accorded by most courts to external auditors when scienter pleading is at issue is the common, but arguably extreme, “no audit at all” test. This most pro-auditor formulation requires dismissal of a complaint unless it alleges that the defendant auditors’ actions amounted to “no audit at all”⁷⁰ or, at

by making decisions that might undermine the long-term reputation of their firms, that make it rational for auditors to sometimes violate the rules. *See id.* at 202–07 (explaining that there is more price competition than quality competition among auditors and providing an example of how several firms had used temporary workers for tax returns while charging premium prices). David Kahn and Gary Lawson have observed that

it is hard to dispute the evidence of what actually happens. “Despite the clear logic of the gatekeeper rationale, experience over the 1990s suggests that professional gatekeepers do acquiesce in managerial fraud, even though the apparent reputational losses seem to dwarf the gains to be made from the individual client.” Or, as King Arthur said to the Black Knight in Monty Python and the Holy Grail when the Black Knight refused to acknowledge that both of his arms had been cut off: “Look!”

David B. Kahn & Gary S. Lawson, *Who’s the Boss? Controlling Auditor Incentives Through Random Selection*, 53 EMORY L.J. 391, 405 (2004) (footnotes omitted) (quoting John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid”*, 57 BUS. LAW. 1403, 1405 (2002); MONTY PYTHON AND THE HOLY GRAIL (Python (Monty) Pictures 1975)).

68. The “reputation always outweighs fees” argument has been accepted even when the defendant firm was very small (allegedly “a couple of guys in a strip mall down in . . . New Jersey”). *In re MRU Holdings Sec. Litig.*, 769 F. Supp. 2d 500, 519 (S.D.N.Y. 2011). One familiar with Bernard Madoff’s auditor, who collected healthy fees for years without ever doing a substantive audit, certainly might wonder about the strength of the reputational constraint upon small firms. *See* DIANA B. HENRIQUES, *THE WIZARD OF LIES* 254–55 (2011) (investing along with other members of his accounting firm in Madoff’s brokerage firm while he had falsely certified that he had done professional auditing services).
69. Melvyn I. Weiss & Elizabeth A. Berney, Essay, *Restoring Investor Trust in Auditing Standards and Accounting Principles*, 41 HARV. J. ON LEGIS. 29, 31–32 (2004).
70. *See, e.g.*, Ferris, Baker Watts, Inc. v. Ernst & Young, LLP, 395 F.3d 851, 855 (8th Cir. 2005) (applying without necessarily adopting the “no audit at all” standard); *Thomas H. Lee Equity Fund V, L.P. v. Grant Thornton*

most, to a “pretended audit.”⁷¹ As most commonly phrased, this test, which might be called the *Price Waterhouse* test,⁷² provides that plaintiffs must plead and prove

that the accounting practices were so deficient that the audit amounted to *no audit at all*, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.⁷³

LLP (*In re Refco Inc. Sec. Litig.*), No. 07 Civ. 8663 (JSR), 2011 U.S. Dist. LEXIS 33554, at *39–40 (S.D.N.Y. Mar. 28, 2011) (discussing how “no audit at all” is one way to prove scienter); *In re Franklin Bank Corp. Sec. Litig.*, 782 F. Supp. 2d 364, 402 (S.D. Tex. 2011) (“It must be established not merely that there was a deviation from accounting principles, but that the accounting practices were so deficient that the audit amounted to no audit at all”); *In re Bear Stearns Cos. Sec., Derivative, & ERISA Litig.*, 763 F. Supp. 2d 423, 511 (S.D.N.Y. 2011) (describing the “no audit at all” standard as the applicable standard); *In re IMAX Sec. Litig.*, 587 F. Supp. 2d 471, 483 (S.D.N.Y. 2008) (using the “no audit at all” standard as another way to describe the applicable standard); *Maiden v. Merge Techs.*, No. 06-C-349, 2008 U.S. Dist. LEXIS 84083, at *11–12 (E.D. Wis. Oct. 20, 2008) (finding that advising against side agreements did not amount to “no audit at all”); *In re Scottish Re Grp. Sec. Litig.*, 524 F. Supp. 2d 370, 385 (S.D.N.Y. 2007) (describing the “no audit at all” standard as “demanding”); *In re Wet Seal, Inc. Sec. Litig.*, 518 F. Supp. 2d 1148, 1163 (C.D. Cal. 2007) (explaining that deliberate GAAP violations do not rise to “no audit at all”); *Lewis v. Straka*, No. 05C1008, 2007 U.S. Dist. Lexis 59054, at *5 (E.D. Wis., Aug. 13, 2007) (noting that a strong inference of scienter for an auditor would have to amount “no audit at all”).

71. *See, e.g.*, *Rothman v. Gregor*, 220 F.3d 81, 98 (2d Cir. 2000) (noting that scienter can be established by a “pretended audit”); *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979) (stressing that a “plaintiff need not produce direct evidence of a defendant’s state of mind” and that circumstantial evidence such as a “pretended audit” may often be the principal means of proving bad faith); *In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 496 (S.D.N.Y. 2005) (showing how circumstantial evidence such as a “pretended audit” can prove scienter); *In re AOL Time Warner, Inc. Sec. & “ERISA” Litig.*, 381 F. Supp. 2d 192, 239 (S.D.N.Y. 2004) (“Recklessness requires a showing that the auditor’s practices ‘amount[ed] at best to a pretended audit.’” (quoting *Rothman*, 220 F.3d at 98)).
72. While the courts have applied the “no audit at all” standard primarily in class action cases for damages, they have also applied it to SEC actions. *E.g.*, *SEC v. Gold*, No. 05-CV-4713 (JS) (MLO), 2006 U.S. Dist. LEXIS 87042, at *12 (E.D.N.Y. Aug. 18, 2006); *SEC v. KPMG LLP*, 412 F. Supp. 2d 349, 379 (S.D.N.Y. 2006). Indeed, it apparently originated in just such a case, *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992).
73. *Miller v. Pezzani (In re Worlds of Wonder Sec. Litig.)*, 35 F.3d 1407, 1426 (9th Cir. 1994) (emphasis added); *see also* *PR Diamonds, Inc. v. Chandler*,

As phrased, this is an extremely malleable standard. Note that this formulation of the standard allows courts to apply anywhere from a nearly impossibly high bar (“no audit at all”) to a standard that is arguably so low as to improperly require only negligence rather than scienter (“no reasonable accountant would have made the same decision”).⁷⁴

2. How does the motive and opportunity test apply to external auditors?

As noted earlier, most courts allow plaintiffs pleading scienter to point to both the motive and opportunity of defendants and the circumstantial evidence indicating that they have acted fraudulently. Regarding the motive and opportunity test, auditors generally cannot profit by millions of dollars from corporate fraud like company insiders can, so their economic incentives to commit fraud are arguably not nearly as strong as those of their clients and their clients’ employees. Therefore, unless auditors take bribes or engage in insider trading, two presumably rare events (especially given professional independence strictures against an auditor’s owning stock in a client⁷⁵), it seems very difficult for plaintiffs to plead scienter by auditor defendants via the motive and opportunity test.⁷⁶ This is

364 F.3d 671, 693–94 (6th Cir. 2004) (using the same standard); *Dannenberg v. Painewebber, Inc.* (*In re Software Toolworks, Inc. Sec. Litig.*), 50 F.3d 615, 627 (9th Cir. 1994) (also using that standard).

74. When this standard is applied, courts may conclude that liability may arise if an auditor’s “judgment—at the moment exercised—was sufficiently egregious such that a reasonable accountant reviewing the facts and figures should have concluded that [those] financial statements were misstated and that as a result the public was likely to be misled.” *In re IKON Office Solutions, Inc., Sec. Litig.*, 277 F.3d 658, 673 (3d Cir. 2002); *see also* *Malack v. BDO Seidman, LLP* (*In re Am. Bus. Fin. Servs. Noteholders Litig.*), No. 08-0784, 2008 U.S. Dist. LEXIS 61450, at *24 (E.D. Pa. Aug. 11, 2008) (quoting language from *IKON* above).
75. CODE OF PROFESSIONAL CONDUCT AND BYLAWS § 101.02 (Am. Inst. of Certified Pub. Accountants 2011).
76. This is not to say that accountants never get into trouble for insider trading. Despite the seeming irrationality of risking their professional reputation, they do engage in insider trading from time to time. *See, e.g.*, *Rosenthal v. N.Y. Univ.*, No. 10-4168-cv, 2012 U.S. App. LEXIS 9817, at *11–12 (2d Cir. May 16, 2012) (affirming university’s decision not to grant an MBA candidate his degree after he admitted abusing his position as a professional accountant to conduct insider trading); *United States v. Ruggiero*, 56 F.3d 647, 655–56 (5th Cir. 1995) (finding a senior auditor and his acquaintance had engaged in insider trading); *SEC v. Svoboda*, 409 F. Supp. 2d 331, 337 (S.D.N.Y. 2006) (describing how a bank’s independent accountant traded in securities after receiving inside information); *In re Ng*, Exchange Act Release No. 67,423, Accounting and Auditing Enforcement Release No. 3393, Administrative Proceeding File No. 3-14947 (July 12, 2012) (ordering defendant to cease and desist from causing any violations of section 10(b) and barring him from acting as an accountant); *In re*

Peterson, Exchange Act Release No. 67,282, Accounting and Auditing Enforcement Release No. 3391, Administrative Proceeding File No. 3-14931 (June 27, 2012) (suspending accountant due to insider trading); *In re Konyndyk*, Exchange Act Release No. 65,882, Accounting and Auditing Enforcement Release No. 3339, Administrative Proceeding File No. 3-14651 (Dec. 5, 2011) (trading in call options during the week before company announced it would acquire another company by tender offer); *SEC v. Deskovick*, Litigation Release No. 21,890, 100 SEC Docket 2519 (Mar. 18, 2011) (tipping close friend over potential sale and merger); *SEC v. Acord*, Litigation Release No. 21132, 96 SEC Docket 1084 (July 15, 2009) (abusing positions of trust and confidence by buying \$329,000 worth of stock before the company's acquisition); *SEC v. Chavarria*, Litigation Release No. 20,313, 91 SEC Docket 2137 (Sept. 28, 2007) (engaging in unlawful insider trading by purchasing securities in advance of an earnings release); *SEC v. Abide*, Litigation Release No. 19,776, 88 SEC Docket 1596 (July 27, 2006) (making and directing others to make improper accounting entries to conceal improperly capitalized expenses); *SEC v. Herwitz*, Litigation Release No. 19,499, 86 SEC Docket 2542, 2542 (Dec. 19, 2005) (settling insider trading action against a former president of an accounting firm); *United States v. Robles*, Litigation Release No. 17,778, 78 SEC Docket 1782 (Oct. 8, 2002) (discussing a criminal suit where an accountant was convicted of nine counts of securities fraud, four counts of tender offer fraud, and one count of conspiracy); *SEC v. Iacovelli*, Litigation Release No. 17,280, 76 SEC Docket 1275 (Dec. 19, 2001) (reselling 315,000 shares to realize illegal profits of \$272,182); *SEC v. Martin*, Litigation Release No. 17141, 75 SEC Docket 1950 (Sept. 20, 2001) (exchanging tax planning advice for insider information); *SEC v. Dornfeld*, Litigation Release No. 16,869, 74 SEC Docket 520 (Jan. 23, 2001) (trading in advance of public announcement of merger); *SEC v. Humphries*, Litigation Release No. 16,361, 71 SEC Docket 216 (Nov. 18, 1999) (acting on insider information about a potential merger between Exxon and Mobil); *SEC v. Hedén*, 51 F. Supp. 2d 296 (S.D.N.Y. 1999) (freezing the defendant's accounts and his family's account, which he used interchangeably, because the SEC was likely to succeed on the merits of an insider trading investigation); *SEC v. Drabinsky*, Litigation Release No. 16,033, 68 SEC Docket 2925 (Jan. 21, 1999) (assisting company's directors in manipulating income and cash flows and engaging in insider trading of the company's securities); *SEC v. Beers*, Litigation Release No. 15,823, 67 SEC Docket 1558 (July 30, 1998) (buying 1,000 shares of stock while in possession of material, nonpublic information); *SEC v. Kotecha*, Litigation Release No. 15,765, 67 SEC Docket 648 (June 3, 1998) (using inside information to open and close positions in call and put options in a company's stock); *SEC v. Hirsch*, Litigation Release No. 15,607, 66 SEC Docket 575 (Jan. 6, 1998) (giving non-public information to brother who shared that information with multiple people); *SEC v. Sargent*, Litigation Release No. 14,854, 61 SEC Docket 1552 (Mar. 25, 1996) (receiving and acting on material, nonpublic information); *SEC v. Evans*, Litigation Release No. 14,767, 60 SEC Docket 2694 (Dec. 28, 1995) (finding a senior accountant had tipped off his brother and his friend after doing due diligence in preparation for a three-way merger); *SEC v. Blair*, Litigation Release No. 13,956, 55 SEC Docket 2765 (Feb. 3, 1994) (asking former fiancée to make stock purchases for him and providing funds to do so); *SEC v. Weinstein*, Litigation Release No. 13,336, 52 SEC Docket 946 (Aug. 11, 1992) (ordering an accountant to pay civil damages in excess of \$214,000 due to insider trading); *SEC v. Adams*, Litigation Release No. 11,439, 38

particularly true because the courts reject as insufficient the pleading of auditors' most obvious economic motive for intentionally overlooking an audit client's fraud—they wish to keep the client as a client and retain the audit-related and consulting-related revenue flowing from that client. Although at least one court seemed amenable to the notion that preserving the existence of an accountant-client relationship might provide evidence of motive,⁷⁷ virtually all other courts view this as a “general motive” that applies to all auditor defendants and is therefore worthless for pleading scienter against a specific auditor in a specific case.⁷⁸

SEC Docket 498 (May 20, 1987) (accountants improperly communicated information).

77. *See In re Leslie Fay Cos. Sec. Litig.*, 835 F. Supp. 167, 174 (S.D.N.Y. 1993) (holding that the existence of an accountant-client relationship, in addition to an “unlikely degree of mere carelessness” on the part of the accountant gives rise to an inference of motive).
78. Loss aversion, the fact that people dread losses more than they anticipate gains, provides psychological evidence for the conclusion that auditors might well be strongly motivated to please a current client to avoid losing the client to another audit firm. *See generally* ROBIN M. HOGARTH, EDUCATING INTUITION 166–67 (2001) (describing loss aversion). The Supreme Court has intuited accurately that an accountant would be more likely to commit fraud to keep a current client happy than to acquire a new client. *Edenfield v. Fane*, 507 U.S. 761, 772 (1993). *But see Miller v. Pezzani (In re Worlds of Wonder Sec. Litig.)*, 35 F.3d 1407, 1427 n.7 (9th Cir. 1994) (rejecting this argument as “utterly without merit”); *Shields v. Citytrust Bankcorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994) (“In looking for a sufficient allegation of motive, we assume that the defendant is acting in his or her informed economic self-interest.”); *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (describing how it would have been irrational for the firm to have participated in the fraud); *In re AOL Time Warner, Inc. Sec. & “ERISA” Litig.*, 381 F. Supp. 2d 192, 239 (S.D.N.Y. 2004) (“[C]ompensation and maintenance of a profitable business relationship for auditing services do not constitute a sufficient motive for scienter”); *Queen Uno Ltd. v. Coeur D’Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1360 (D. Colo. 1998) (characterizing allegations that Ernst & Young was motivated to commit fraud to ensure continued receipt of audit fees from client as “absurd”); *ICD Holdings S.A. v. Frankel*, 976 F. Supp. 234, 245 n.51 (S.D.N.Y. 1997) (“[T]he fact that the professional service firms like [defendant] receive fees for their services is insufficient to supply the motive essential to the motive-and-opportunity theory”); *Duncan v. Pencer*, No. 94 Civ. 0321 (LAP), 1996 U.S. Dist. LEXIS 401, at *33 (S.D.N.Y. 1996) (holding it would be “economically irrational” for a large accounting firm to “condone a client’s fraud in order to preserve a fee that, at best, is an infinitesimal percentage of its annual revenues and, by doing so, jeopardize its reputation and license, as well as subject itself to potential damages literally tens of thousands of times as large as its fee”).

Of course, the fact that all auditors generally would like to keep clients and attendant income and that individual auditors would all like to keep their jobs does not mean that sometimes audit firms and

3. How does the circumstantial evidence test apply to auditors?

As Professor Coffee has pointed out, with strict judicial assumptions that auditors do not act with reckless or fraudulent motives in place, “the plaintiff faces a ‘Catch 22’ dilemma in suing the auditor: it cannot plead fraud with particularity until it obtains discovery, and it cannot obtain discovery under the PSLRA until it pleads fraud with particularity.”⁷⁹ This often makes it impossible for plaintiffs to collect the circumstantial evidence that is the only remaining route to pleading scienter against an auditor.

So, how does the circumstantial evidence test apply to auditors? Where motive is not alleged and plaintiffs rely entirely on circumstantial evidence to support allegations of recklessness, the evidence presented must be *proportionally greater*, according to some courts,⁸⁰ although most courts do not explicitly require this greater proportionality. In accounting cases, catch-all or blanket allegations often comprise mere claims of misreported numbers or GAAP and GAAS (generally accepted auditing standards) violations; courts nearly unanimously hold that such allegations, standing alone, will not suffice.⁸¹ “[T]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, *without more*, does not establish scienter.”⁸²

individual auditors do not commit fraud for these purposes. See *Oppenheimer-Palmieri Fund v. Peat Marwick Main & Co.* (*In re Crazy Eddie Sec. Litig.*), 812 F. Supp. 338, 344 (E.D.N.Y. 1993) (explaining that auditor told client officer that he did not investigate a suspicious transaction because he might have had to leave account).

79. Coffee, *supra* note 67, at 1410 n.35.

80. See, e.g., *Beck v. Mfrs. Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987) (“Where motive is not apparent, it is still possible to plead scienter by identifying circumstances indicating conscious behavior by the defendant, though the strength of the circumstantial evidence must be correspondingly greater.” (citations omitted)); *In re Fannie Mae 2008 Sec. Litig.*, 742 F. Supp. 2d 382, 397 (S.D.N.Y. 2010) (noting that without an apparent motive, circumstantial evidence of scienter must be correspondingly higher); *Zucker v. Sasaki*, 963 F. Supp. 301, 309 (S.D.N.Y. 1997) (noting that circumstantial evidence must be proportionally greater).

81. See, e.g., *Kushner v. Beverly Enters., Inc.* 317 F.3d 820, 831 (8th Cir. 2003) (“Allegations of GAAP violations are insufficient to state a securities fraud claim unless coupled with evidence of corresponding fraudulent intent.”); *Migliaccio v. K-tel Int’l, Inc.* (*In re K-tel Int’l, Inc. Sec. Litig.*), 300 F.3d 881, 890 (8th Cir. 2002) (“Allegations of GAAP violations are insufficient, standing alone, to raise an inference of scienter.” (quoting *Advanced Data Concepts v. Navarre Corp.* (*In re Navarre Corp. Sec. Litig.*), 299 F.3d 735, 745 (8th Cir. 2002))); *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000) (“[A]llegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim.”); *Stevelman v. Alias Research, Inc.*, 174 F.3d 79, 84 (2d Cir. 1999) (“Allegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent,

What “more” might suffice for plaintiffs attempting to plead scienter? Consider the following factors that are often raised by plaintiffs as circumstantial evidence of auditor scienter.

a. Size of Mistakes

Allegations of mere accounting errors are generally viewed as providing no evidence of scienter or recklessness by the external auditor. But what if those errors were really large? A fifty dollar error is one thing;⁸³ a fifty million dollar error is arguably something else entirely. But in any given case it is likely unclear ahead of time whether a court will decide that a large accounting error provides circumstantial evidence of scienter or not. Many courts hold that even large errors provide evidence of negligence, not of scienter.⁸⁴ The Seventh Circuit said in *DiLeo v. Ernst & Young* that “[f]our billion dollars is a big number, but even a large column of big numbers need not add up to fraud.”⁸⁵ But other courts have held that a sufficiently large error can indeed provide evidence of at least recklessness.⁸⁶

are not sufficient to state a securities fraud claim.” (quoting *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 270 (2d Cir. 1996))).

82. *Worlds of Wonder*, 35 F.3d at 1426 (emphasis added) (quoting *Malone v. Microdyne Corp.*, 26 F.3d 471, 479 (4th Cir. 1994)); *see also* *Dannenberg v. Painewebber, Inc.*, (*In re* Software Toolworks, Inc. Sec. Litig.), 50 F.3d 615, 627 (9th Cir. 1994) (quoting same language); *Limited, Inc. v. McCrory Corp.*, 645 F. Supp. 1038, 1045 (S.D.N.Y. 1986) (“An inference of fraud does not arise from the mere fact that an auditor ‘certified’ an inaccurate financial statement.”).
83. It is unsurprising that courts find that small errors are evidence of negligence rather than of fraud. *See, e.g.*, *Lewis v. Straka*, No. 05C1008, 2007 U.S. Dist. LEXIS 59054, at *8 (E.D. Wis. Aug. 13, 2007) (“The amount that was misreported was a very small amount; the most that can reasonably be inferred from the misreporting is mistake rather than fraud.”).
84. *See, e.g., id.* at *4 (“[L]arge losses do[] not create a strong inference of scienter.”). Huge errors do not indicate scienter or raise a strong inference of scienter under the PSLRA, some courts hold, because “no degree of negligence” can create rule 10b-5 liability. *Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003, 1014 (S.D. Cal. 2000).
85. *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990).
86. *See, e.g.*, *N.M. State Inv. Council v. Ernst & Young LLP*, 641 F.3d 1089, 1100 (9th Cir. 2011) (holding that while “magnitude alone is not sufficient to support a finding of scienter, large GAAP and GAAS violations can play a role in finding scienter”); *In re Spiegel, Inc. Sec. Litig.*, 382 F. Supp. 2d 989, 1020 (N.D. Ill. 2004) (finding a strong inference of scienter where defendants missed an understatement of \$3 billion in debt and an overstatement of \$240 million in revenue because “[t]he more serious the error, the less believable are defendants’ protests that they were completely unaware of [the company’s] true financial status” (quoting *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1256 (N.D. Ill. 1997))); *Carley Capital Grp. v. Deloitte & Touche L.L.P.*, 27

A compromise approach is embodied in court opinions holding that the magnitude of a client's fraud can support an inference of scienter regarding the external auditor, *but only* "when the plaintiff pleads specific and detailed facts showing that the magnitude *either enhanced the suspiciousness of specifically identified transactions, or made the overall fraud glaringly conspicuous.*"⁸⁷

b. *Multiple GAAP and GAAS Errors*

There are disagreements regarding the evidentiary import of multiple errors as well as of large errors. Again, a single GAAP or GAAS error is one thing, but multiple errors might well constitute something else. In some cases, courts hold that multiple GAAP and GAAS violations are simply evidence of careless auditing.⁸⁸ But again, there is confusion. In other cases multiple GAAP or GAAS errors have been deemed evidence of actionable recklessness.⁸⁹

c. *Restatements*

Even when GAAP violations lead to a restatement of financial statements, most courts agree that while "subsequent restatement[s] do indeed provide some circumstantial evidence from which to infer

F. Supp. 2d 1324, 1339–40 (N.D. Ga. 1998) ("While alleging a misapplication of [GAAP] standing alone is insufficient, such allegation when combined with a drastic overstatement of financial results can give rise to a strong inference of scienter. . . . [T]he totality and magnitude of the . . . accounting violations [may] constitute strong circumstantial evidence of reckless or conscious misbehavior."); *Rehm*, 954 F. Supp. at 1255–56 ("[T]hat defendants had to record a massive year-end increase of \$5 million in credit loss reserves and slash its reported yearly earnings from \$3.530 million to \$325,000 weighs heavily in favor of a finding of reckless disregard.").

87. *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 142 F. Supp. 2d 589, 609 (D.N.J. 2001) (quoting *Reiger*, 117 F. Supp. 2d at 1013); *see also In re Baan Co. Sec. Litig.*, 103 F. Supp. 2d 1, 21 (D.D.C. 2000) (noting that the magnitude of a GAAP error can play a role in a court's inferring scienter); *Reiger*, 117 F. Supp. 2d at 1009 n.5 (relying on "boilerplate 'red flags'" regarding "weak internal accounting controls" was not enough to infer scienter).
88. *See, e.g., Crosscil Inc. v. Gabriel Capital, L.P. (In re Merkin Sec. Litig.)*, 817 F. Supp. 2d 346, 358 (S.D.N.Y. 2011) ("GAAP or GAAS violations, standing alone, are insufficient to state a claim for relief against an accountant under the federal securities laws."); *In re Buca Inc. Sec. Litig.*, No. 05-1762 (DWF/AJB), 2006 U.S. Dist. LEXIS 75224, at *46 (D. Minn., Oct. 16, 2006) ("GAAP violations, viewed collectively with Plaintiff's allegations regarding the magnitude of the restatement and the alleged inadequate internal controls also are insufficient to give rise to a strong inference of scienter.").
89. *See, e.g., In re Bear Stearns Cos. Sec., Derivative & ERISA Litig.*, 763 F. Supp. 2d 423, 518 (S.D.N.Y. 2011) (holding that multiple GAAP or GAAS errors could not occur absent recklessness).

scienter, ‘GAAP violations without more, do not establish scienter.’⁹⁰ But, yet again, other courts hold that a large restatement *can* provide circumstantial evidence of scienter.⁹¹ They are more likely to so hold when the accounting issue involved was simple,⁹² than when it was complex.⁹³ And if the fraud was well hidden from the auditor by the client, even a massive restatement will not necessarily signal auditor scienter.⁹⁴

d. Auditor Access, Nonaudit Services, and Alumni

Many courts conclude that the fact that an auditor had full access to and detailed knowledge of its clients’ affairs and records also fails to give rise to an inference of scienter.⁹⁵ But if courts rely heavily on

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90. *In re* Cyberonics, Inc. Sec. Litig., 523 F. Supp. 2d 547, 553 (S.D. Tex. 2007) (quoting Cent. Laborers’ Pension Fund v. Integrated Elec. Servs., 497 F.3d 546, 552 (5th Cir. 2007)); *see also* *In re* Bio-Tech. Gen. Corp. Sec. Litig., No. 02-6048 (HAA), 2006 U.S. Dist. LEXIS 81268, at *27–28 (D.N.J., Oct. 26, 2006) (“While the restatement indicates that a mistake was made, that does not by itself show *recklessness* in the initial recordation”); *Davis v. SPSS, Inc.*, 385 F. Supp. 2d 697, 719 (N.D. Ill. 2005) (holding that restatements and other evidence of GAAP violations were merely evidence of errors, not of fraud).
 91. *See, e.g.,* *Lewis v. Straka*, No. 05-C-1008, 2006 U.S. Dist. LEXIS 76716, at *33 (E.D. Wis. Oct. 12, 2006) (“[A] large restatement may be circumstantial evidence of scienter.”); *Spiegel*, 382 F. Supp. 2d at 1035 (holding that allegations of ignored red flags are relevant in proving scienter).
 92. *See, e.g., In re* Microstrategy, Inc. Sec. Litig., 115 F. Supp. 2d 620, 652 (E.D. Va. 2000) (noting that a “large restatement” that involved violation of “relatively straightforward accounting principles” constituted evidence of scienter by auditor).
 93. *See, e.g., In re* Acterna Corp. Sec. Litig., 378 F. Supp. 2d 561, 583 (D. Md. 2005) (holding that a large restatement is not evidence of auditor’s scienter where the accounting issue called for “complicated analysis”).
 94. *See, e.g., In re* Royal Ahold N.V. Sec. & Erisa Litig., 351 F. Supp. 2d 334, 392 (D. Md. 2004) (“While this case does involve a massive financial restatement, this fact alone cannot establish scienter”); *In re* Livent, Inc. Sec. Litig., 78 F. Supp. 2d 194, 217 (S.D.N.Y. 1999) (“It does not seem reasonable to infer recklessness on the part of an auditor solely from the magnitude of a fraud”).
 95. *See, e.g., Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003, 1009 (S.D. Cal. 2000) (“[A]n independent accountant’s relationship and acquired familiarity with its client does not impute the accountant with knowledge of every idiosyncratic detail associated with the client’s business.”); *Queen Uno Ltd. v. Coeur D’Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1360 (D. Colo. 1998) (“It is equally implausible to assert that because an accountant had access to a company’s internal data, it by implication was aware of any fraudulent scheme, no matter how far-reaching. Such a broad based rule would, as other courts have noted, subject any accountant or high-ranking company official to liability for even the most obscure allegation of fraud.”).

the fact that auditors have been fooled by clients or had information withheld by their clients to support a conclusion that there was a lack of scienter, as they often do,⁹⁶ then it seems that complete access should militate in favor of a scienter finding, at least where there are sizable errors.⁹⁷

Similarly, plaintiffs sometimes allege that other ties between the auditor and client, including former employees of the auditor now employed by the client and the provision of nonaudit services, help establish scienter. But courts generally hold that the provision of nonaudit services for a client with a failed audit is evidence only of negligence.⁹⁸ The *Enron* case appears to be an exception to this general rule, as it includes a detailed discussion of Andersen's change in policies regarding both nonaudit services and waiting periods for employees to become employees of the audit client.⁹⁹ While it is difficult to generalize from the *Enron* case due to its unique nature and the numerous alleged auditor improprieties, Congress notably restricted both nonaudit services to public audit clients and movement by employees of auditors and their clients in the Sarbanes-Oxley Act of 2002.¹⁰⁰

A case concerning an audit firm alumnus that is emblematic of the difficulty in establishing scienter is *AUSA Life Insurance Co. v. Ernst & Young*, where the court found not only numerous GAAP

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96. See, e.g., *Dimplex v. Scovill, Inc.*, No. 88 Civ. 7983 (LMM), 1993 U.S. Dist. LEXIS 11224, at *5 (S.D.N.Y. Aug. 12, 1993) (agreeing that auditor Deloitte was as much a victim of the fraud as were plaintiffs).
97. See *In re Spiegel, Inc. Sec. Litig.*, 382 F. Supp. 2d 989, 1036 (N.D. Ill. 2004) ("Plaintiffs have alleged that KPMG personnel had extensive access to Spiegel and its financial records and failed to notice or react to substantial accounting problems at Spiegel which ultimately led to its bankruptcy."). In *In re WorldCom, Inc. Securities Litigation*, 352 F. Supp. 2d 472, 499 (S.D.N.Y. 2005), the court emphasized that Arthur Andersen had touted its approach as one where it understood in depth its clients' business model and the court held that this made it difficult for Andersen to claim that it was not willfully blind to the host of accounting irregularities of its client WorldCom.
98. See, e.g., *Danis v. USN Commc'ns Inc.*, 121 F. Supp. 2d 1183, 1194 (N.D. Ill. 2000) ("Even if this knowledge could be established, it would merely support an inference of negligence.").
99. See *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 677 (S.D. Tex. 2002) ("Andersen had to split its auditing and consulting practices, to ban current financial incentives that connected the auditors' compensation to their sales of consulting services, to refrain from reporting internal audit work on audit clients, and to adopt a waiting period before Arthur Andersen partners could become employees of a client.").
100. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 201(a), 209, 116 Stat. 745, 772, 775 (codified at 15 U.S.C. §§ 78j-1, 7234 (2006)).

violations, but actual knowledge and acquiescence by the audit firm in the violations.¹⁰¹ The court found that Ernst & Young acquiesced in the fraud due to the “close personal relationship” between the Ernst & Young’s lead audit partner and the client’s chief executive, his former partner.¹⁰² Despite the findings of both *actual knowledge of the fraud* and the personal relationship as reason for the acquiescence, the court stated (without actually resolving the issue) that the scienter issue was “a close question.”¹⁰³ The case was initially dismissed on loss causation grounds, but the Second Circuit reversed and also found the facts presented to be sufficient to establish scienter.¹⁰⁴ But the fact that any judge could find the issue of scienter in such a case to be questionable exemplifies the inherent malleability of the standard.¹⁰⁵

e. Auditor Resistance to Client Practices

When auditors call clients’ attention to improper auditing practices, sometimes courts view this as evidence that they are trying to do a good job and indicative of an absence of scienter, even if the auditors proceed to certify that the financial statements accord with GAAP.¹⁰⁶ But in other cases courts have held that even threatening to issue a going concern opinion does not necessarily insulate an auditor from liability if the auditor has proceeded to certify the financial statements with knowledge of these issues,¹⁰⁷ although it “cut[s] strongly in [the auditor’s] favor.”¹⁰⁸

101. *See* AUSA Life Ins. Co. v. Ernst & Young, 991 F. Supp. 234, 246 (S.D.N.Y. 1997) (“[I]rregularities resulted in substantial overstatement of JWP’s income in each of the years 1988 through 1990, with E&Y’s knowledge and acquiescence. The annual no-default letters issued by E&Y were also false in that they certified that JWP’s books had been kept in accordance with GAAP, which E&Y knew was untrue.”), *rev’d*, 206 F.3d 202 (2d Cir. 2000).

102. *Id.* at 248. The court went on to state that “the record suggests that, in their confrontations with [the chief executive officer, the audit partner,] and his associates exhibited a level of tolerance and timidity inappropriate for an independent auditor. The ‘watch dog’ behaved more like a lap dog.” *Id.*

103. *Id.*

104. AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 220 (2d Cir. 2000).

105. Notably, the facts of the case were part of the motivation for revising auditor independence standards. *See* Revision of the Commission’s Auditor Independence Requirements, 65 Fed. Reg. 76008, 76031 n.262 (Dec. 5, 2000) (to be codified at 17 C.F.R. pts. 210, 240).

106. *See* Maiden v. Merge Techs., No. 06-C-349, 2008 U.S. Dist. LEXIS 84083, at *13 (E.D. Wis. Oct. 20, 2008) (“In fact, Merge admits that its former management circumvented accounting controls to execute the fraud.”).

107. *See, e.g., In re Spiegel, Inc. Sec. Litig.*, 382 F. Supp. 2d 989, 1037 (N.D. Ill. 2004) (“Nor is KPMG entitled to dismissal because it threatened to issue a going concern statement”); *Drabkin v. Alexander Grant &*

f. Rapid Discovery of Fraud by Third Parties

When a third party such as a new CFO or a successor audit firm quickly discovers a fraud that the external auditor has overlooked for years, many courts find evidence supporting scienter.¹⁰⁹ But other courts find this not to be especially persuasive evidence of scienter.¹¹⁰

4. The Importance of Red Flags

Today, no concept is more important to the scienter issue in auditor litigation than the red flag. Although a heightened pleading standard, such as the “no audit at all” test, often appears on its face to be nearly insurmountable, courts have held that “[a] complaint might reach this ‘no audit at all’ threshold by-alleging [sic] that the auditor disregarded specific ‘red flags’ that ‘would place a reasonable auditor on notice that the audited company was engaged in wrongdoing to the detriment of its investors.’”¹¹¹

Co., 905 F.2d 453, 455 (D.C. Cir. 1990) (“Issuing a going concern opinion may not insulate an accounting firm from liability . . .”).

108. *Drabkin*, 905 F.2d at 455.

109. *See, e.g., In re Bear Stearns Cos. Sec., Derivative, & ERISA Litig.*, 763 F. Supp. 2d 423, 517 (S.D.N.Y. 2011) (reporting that plaintiffs alleged that two parties discovered Bear Stearns’ financial statements’ overvaluation of assets and underestimation of risk exposure in a single weekend); *In re New Century*, 588 F. Supp. 2d 1206, 1231 (C.D. Cal. 2008) (holding that the fact that a new CEO discovered accounting violations within months of taking the position provided evidence for an inference that KPMG’s audit had been deliberately reckless).

110. *See, e.g., PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 695 (6th Cir. 2004) (the fact that consultants quickly found internal control weaknesses is not necessarily evidence of recklessness); *Puskala v. Koss Corp.*, 799 F. Supp. 2d 941, 951 (E.D. Wis. 2011) (“This means that he must have known that the company’s internal controls were completely unreliable, not just that he was negligent in failing to ensure that effective controls were in place.”).

111. *Bear Stearns*, 763 F. Supp. 2d at 511 (quoting *In re IMAX Sec. Litig.*, 587 F. Supp. 2d 471, 483 (S.D.N.Y. 2008)); *see also* N.M. State Inv. Council v. Ernst & Young LLP, 641 F.3d 1089, 1102 (9th Cir. 2011) (“Considering the number, magnitude, and multi-year financial impacts of these grants, it is certainly reasonable to infer scienter just as strongly as an innocent inference.”); *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 279–80 (3d Cir. 2006) (“At the pleading stage, . . . allegations of GAAS violations, coupled with allegations that significant ‘red flags’ were ignored, can suffice to withstand a motion to dismiss.”); *In re AOL Time Warner, Inc. Sec. & “ERISA” Litig.*, 381 F. Supp. 2d 192, 240 (S.D.N.Y. 2004) (“Allegations of ‘red flags,’ when coupled with allegations of GAAP and GAAS violations, are sufficient to support a strong inference of scienter.” (citing *In re Complete Mgmt. Inc. Sec. Litig.*, 153 F. Supp. 2d 314, 334 (S.D.N.Y. 2001))); *In re First Merchs. Acceptance Corp. Sec. Litig.*, No. 97 C 2715, 1998 U.S. Dist. LEXIS 17760, at *32–33 (N.D. Ill. Nov. 4, 1998) (“[T]he allegations in the

A reading of court opinions supports a hypothesis that when courts desire to dismiss a case, they often focus upon the “no audit at all” branch of the *Price Waterhouse* test, ignoring its other alternatives (i.e., egregious refusal to see, no reasonable accountant, etc.).¹¹² And, in so doing, they are strict in how they define the notion of a red flag. Some cases hold that when auditors ignore red flags and uncritically accept their clients’ explanations on all accounting issues, their actions constitute “no audit at all.”¹¹³ Courts refuse to find “fraud by hindsight,”¹¹⁴ but if red flags are present at the time of the audit and the defendant auditors ignore them or investigate them

complaint, including the magnitude of the misstatements, the specific GAAP and GAAS violations and the ‘red flags’ together support an inference that Deloitte’s audit ‘amounted to no audit at all or an egregious refusal to see the obvious or investigate the doubtful.’”); *In re Leslie Fay Cos. Sec. Litig.*, 871 F. Supp. 686, 699 (S.D.N.Y. 1995) (“Because [the accountant] was immersed in [the company’s] operations while performing its audit, and because the ‘red flags’ would be clearly evident to any auditor performing its duties, one could reasonably conclude that [the accountant] must have noticed the ‘red flags,’ but deliberately chose to disregard them to avoid antagonizing [the company] and incidentally frustrating its fraudulent scheme.”).

112. *See, e.g.*, *Thomas H. Lee Equity Fund V, L.P. v. Grant Thornton LLP (In re Refco Inc. Sec. Litig.)*, No. 07 Civ. 8663 (JSR), 2011 U.S. Dist. Lexis 33554, at *39–40 (S.D.N.Y. Mar. 28, 2011) (noting that the “no audit at all” cases “do not hold that the plaintiff *must* show that the auditor’s conduct amounted to no audit at all,” but that they may also show “an egregious refusal to see the obvious, *or* to investigate the doubtful, *or* that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts” (quoting *In re Scottish Re Grp. Sec. Litig.*, 524 F. Supp. 2d 370, 385 (S.D.N.Y. 2007))); *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992)); *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 142 F. Supp. 2d 589, 609 (D.N.J. 2001) (noting that although the court was not willing to hold that the defendant had done no more than a pretended audit, the number and magnitude of red flags could lead to a finding of “an egregious refusal to see the obvious or investigate the doubtful such that no reasonable accountant would have made the same decisions if confronted with the same facts”).
113. *Malack v. BDO Seidman, LLP (In re Am. Bus. Fin. Servs. Noteholders Litig.)*, No. 08-0784, 2008 U.S. Dist. LEXIS 61450, at *12 (E.D. Pa. Aug. 11, 2008).
114. *Maiden v. Merge Techs.*, No. 06-C-349, 2008 U.S. Dist. LEXIS 84083, at *13 (E.D. Wis. Oct. 20, 2008) (citing *Higginbotham v. Baxter Int’l, Inc.*, 495 F.3d 753, 759–60 (7th Cir. 2007)); *see also Higginbotham*, 495 F.3d at 759–60 (“Hindsight is the only basis of the proposed inference—and, as the Court observed in *Tellabs*, citing a famous opinion by Judge Friendly, there is no ‘fraud by hindsight.’” (quoting *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 320 (2007))).

insufficiently, then plaintiffs may be held to be neither second guessing nor alleging fraud by hindsight.¹¹⁵

In applying the red-flag approach to judging the adequacy of scienter pleading against auditors, courts tend to look for allegations of “in your face facts,’ that cry out ‘how could [defendant auditor] not have known that the financial statements were false.’”¹¹⁶ Because red flags must be viewed in context and as a part of the totality of the situation, it is perhaps painting with too broad a brush to subject to side-by-side comparison courts’ treatments of specific types of red flags. Nonetheless, to do so seems to provide further evidence of the confusion in the case law and the need for empirical examination.

Red flags, say some courts, are the audit risks or “risk factors” that auditors are to consider under GAAS when performing an audit.¹¹⁷ As in other areas of scienter analysis, courts have considerable discretion in characterizing events as red flags and in drawing conclusions from them, which means that results are often inconsistent.¹¹⁸

115. *See, e.g., Bear Stearns*, 763 F. Supp. 2d at 511 (requiring “sufficiently identified red flags, that is, particular facts, the disregard of which establishes recklessness sufficient to establish scienter”); *Malack*, 2008 U.S. Dist. LEXIS 61450, at *26 (denying defendant’s motion to dismiss based on “repeated decisions not to investigate multiple red flags”); *Katz v. Image Innovations Holdings*, 542 F. Supp. 2d 269, 275 (S.D.N.Y. 2008) (“[R]ed flags . . . alerted or should have alerted GSK, absent recklessness, to the fictitious sales.”).

116. *N.M. State Inv. Council*, 641 F.3d at 1103 (quoting *In re Oxford Health Plans, Sec. Litig.*, 51 F. Supp. 2d 290, 294 (S.D.N.Y. 1999)).

117. *See, e.g., McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005) (discussing factors that are “red flags”); *Bear Stearns*, 763 F. Supp. 2d at 512 (“‘Red Flags,’ or audit risks, are the various ‘risk factors’ that auditors must consider under GAAS when performing an audit.” (quoting *In re AOL Time Warner, Inc. Sec. & “ERISA” Litig.*, 381 F. Supp. 2d 192, 240 n.51 (S.D.N.Y. 2004))); *In re Sunterra Corp. Sec. Litig.*, 199 F. Supp. 2d 1308, 1333 (M.D. Fla. 2002) (“‘Red flags’ are those facts which come to the attention of an auditor which would place a reasonable auditor on notice that the audited company was engaged in wrongdoing to the detriment of its investors.” (citing *Van de Velde v. Coopers & Lybrand*, 899 F. Supp. 731, 736 (D. Mass. 1995))).

118. *See* Sanford P. Dumain, *Class Action Suits, Auditor Liability, and the Effect of the Private Securities Litigation Reform Act of 1995*, in ACCOUNTANTS’ LIABILITY 205, 300 (A.L.L.-A.B.A. Course of Study ed., 2006) (noting that district courts exercise considerable individual discretion in how they evaluate red flags, “often creating unpredictable and arguably inconsistent results”); *see also In re Spear & Jackson Sec. Litig.*, 399 F. Supp. 2d 1350, 1363 (S.D. Fla. 2005) (noting inconsistencies among courts regarding types of events they view as red flags indicating evidence of fraud).

a. *Generally Reliable Red Flags*

Whistleblowers. Apparently reliable tips from knowledgeable whistleblowers are usually treated as a red flag that cannot be ignored by auditors. *In re Sunbeam Securities Litigation* is a case where plaintiffs satisfied pleading requirements by pointing to numerous red flags, including not only GAAP and GAAS violations, but also allegations that the auditor failed to properly investigate internal controls, *was tipped off by a Sunbeam employee regarding accounting improprieties*, and ignored a press article alleging Sunbeam had manipulated the financial statements.¹¹⁹ In *In re Lehman Bros. Securities & ERISA Litigation*, the court threw out most claims for lack of red flags, but did allow one claim to proceed based on a Lehman insider telling auditor Ernst & Young (which then did nothing) that Lehman was using “Repo 105’s” (barely disguised loan transactions) to temporarily take \$50 billion in debt off its books at the end of every quarter.¹²⁰

Resignation of previous auditor. Another red flag courts have naturally accorded weight is the mid-audit resignation of a previous external auditor, typically the defendant’s predecessor.¹²¹

b. *Not Necessarily Red Flags*

Most categories of potential red flags are treated inconsistently, sometimes viewed as red flags that should have put auditors on notice of fraud that they ignored at their peril and sometimes not.

Knowledge of weak internal controls. An auditor’s knowledge of a client’s poor internal controls usually carries little weight with courts.¹²² Like simple allegations of departures from GAAP, these

119. *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1344–46 (S.D. Fla. 1999).

120. *In re Lehman Bros. Sec. & ERISA Litig.*, 799 F. Supp. 2d 258 (S.D.N.Y. 2011); *see also* *Oppenheimer-Palmieri Fund v. Peat Marwick Main & Co.* (*In re Crazy Eddie Sec. Litig.*), 812 F. Supp. 338, 344 (E.D.N.Y. 1993) (ignoring an anonymous whistleblower’s tip was part of the evidence of scienter underlying securities fraud that was predicate to a RICO claim).

When whistleblower complaints are adequately responded to, of course, evidence of scienter is eliminated. *See* *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines*, 534 F.3d 779, 790 (D.C. Cir. 2008) (director defendants insulated from liability where they reviewed and discussed the allegations made by a whistleblower).

121. *See* *Malack v. BDO Seidman, LLP* (*In re Am. Bus. Fin. Servs. Noteholders Litig.*), Case No. 08-0784, 2008 U.S. Dist. LEXIS 61450, at *9 (E.D. Pa. Aug. 11, 2008) (discussing implications of the resignation of a predecessor auditor).

122. *See, e.g.,* *Ley v. Visteon Corp.*, 543 F.3d 801, 816 (6th Cir. 2008) (finding that knowledge of weak internal controls, even coupled with large GAAP errors, was not sufficient to establish scienter).

allegations may well be deemed “boilerplate allegations” of red flags.¹²³ When accounting firms notice poor controls and extend their normal audit procedures in order to compensate, this action is obviously evidence that militates against a finding of scienter.¹²⁴ On the other hand, some courts do hold that knowledge of weak controls can, *in tandem with other facts*, support a finding of scienter.¹²⁵

End of quarter transactions. Another seemingly obvious red flag is the presence of large end-of-quarter transactions.¹²⁶ But not all courts agree. For instance, in *DSAM Global Value Fund v. Altris Software, Inc.*, the plaintiff alleged that the client recorded as “start-up fees” two revenue transactions, one for \$250,000 and the other for \$338,220 on the last day of the fiscal year, never previously having recorded a start-up fee exceeding \$5,000.¹²⁷ The plaintiffs also alleged that twelve other revenue transactions were questionable for a variety of reasons, including no signed agreement, no license fee specified, no payment required within twelve months, unexpired customer cancellation privileges, and incomplete performance by the software firm.¹²⁸ Despite these questionable transactions, the auditor issued a clean opinion. The client later admitted to GAAP violations and issued a restatement.¹²⁹ Even assuming the claims were true, however, the court stated that a failure to investigate in such a situation “established only a negligent audit rather than scienter.”¹³⁰

Aggressive accounting practices. Some courts have found red flags where a client’s accounting practices were arguably in violation of

123. *See* Reiger v. Price Waterhouse Coopers LLP, 117 F. Supp. 2d 1003, 1009 n.5 (S.D. Cal. 2000) (referring to the fact that the audited company had weak internal controls as “boilerplate ‘red flags’”).

124. *See In re IKON Office Solutions, Inc.*, Sec. Litig., 277 F.3d 658, 672 (3d Cir. 2002) (refusing to infer scienter where defendant chose not to rely on its internal audit findings).

125. *See* N.M. State Inv. Council v. Ernst & Young LLP, 641 F.3d 1089, 1095 (9th Cir. 2011) (finding that, in tandem with many other factors, evidence of auditor’s knowledge of weak internal controls helped plaintiffs get over the scienter pleading bar).

126. *See, e.g., In re AOL Time Warner, Inc. Sec. & “ERISA” Litig.*, 381 F. Supp. 2d 192, 240 (S.D.N.Y. 2004) (stating that “late-in-the-quarter revenue recognition has been found sufficient to support a claim of scienter”); *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018, 1044 (C.D. Cal. 2003) (“The most significant of these red flags was the fact that on numerous occasions, major transactions took place within the last few days of the quarter.”).

127. *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 389 (9th Cir. 2002).

128. *Id.* at 390.

129. *Id.* at 389–90.

130. *Id.* at 390.

GAAP or more aggressive than their competitors' practices.¹³¹ But other courts have found this to be evidence only of negligence, unless the auditor was actively involved in advising the client regarding the overly aggressive accounting practices, in which case the courts are more likely to hold that the auditor was guilty of scienter for overlooking the aggressiveness.¹³²

Unusual accounting practices. When auditors find evidence of unusual accounting practices, sometimes courts view a failure to further investigate as mere negligence,¹³³ but other times view it as a red flag that was ignored, signaling scienter.¹³⁴

Other sloppy auditing practices. Courts have held that "lack of evidential matter and numerous unsupported entries" were "red flags" indicative of fraud when the auditor ignored them.¹³⁵ Contrariwise, other courts have held that failure to gather evidential matter and otherwise comply with GAAS did not necessarily constitute evidence of misconduct beyond simple negligence.¹³⁶

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131. *See In re Bear Stearns Cos. Sec., Derivative & ERISA Litig.*, 763 F. Supp. 2d 423, 512 (S.D.N.Y. 2011) (holding that securities complaint alleging that violation of GAAP constituted reckless disregard of red flags was sufficient to withstand a motion to dismiss); *Malack v. BDO Seidman, LLP (In re Am. Bus. Fin. Servs. Noteholders Litig.)*, Case No. 08-0784, 2008 U.S. Dist. LEXIS 61450, at *11 (E.D. Pa. Aug. 11, 2008) (finding the defendant's insistence on a material decrease in the discount rate to a rate lower than the bottom end of its peer range was one of several red flags that the court found significant).
132. *See, e.g., In re IMAX Sec. Litig.*, 587 F. Supp. 2d 471, 484-85 (S.D.N.Y. 2008) (finding that auditor's violation of GAAP not itself sufficient to survive a motion to dismiss, unless the auditor was extensively involved in the client's process by which revenue recognition policy is developed).
133. *See, e.g., Dimplex v. Scovill, Inc.*, 88 Civ. 7983 (LMM), 1993 U.S. Dist. LEXIS 11224, at *5 (S.D.N.Y. Aug. 12, 1993) (holding that an auditor's failure to pursue certain "smelly" documents" and to follow up on "discrepancies and exceptions" was evidence of negligence only).
134. *See, e.g., In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 498 (S.D.N.Y. 2005) (stating that facts indicating wrongdoing by management constitute red flags).
135. *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 142 F. Supp. 2d 589, 609 (D.N.J. 2001).
136. *See In re Crocs, Inc. Sec. Litig.*, 774 F. Supp. 2d 1122, 1154 (D. Colo. 2011) (finding allegations of failure to follow GAAS and secure adequate evidential material may constitute only negligence and emphasizing that plaintiffs did not allege that any Deloitte employee was present at any specific meeting in which the fraudulent scheme was discussed); *Montalvo v. Tripos, Inc.*, No. 4:03CV995SNL, 2005 U.S. Dist. LEXIS 22753, at *19 (E.D. Mo. Sept. 30, 2005) (finding that allegations that GAAP and GAAS violations occurred only establish negligence where plaintiffs failed to identify "facts giving rise to deliberate intent or reckless conduct to defraud").

This Part concludes that courts are deeply divided regarding the scienter standard to be applied in auditor cases, the acts that constitute circumstantial evidence of scienter, and the acts that do or do not raise red flags that potentially convert evidence of auditor carelessness into evidence of auditor scienter. Though these conclusions are based on an extensive reading of the case law, they are scarcely complete or systematic. Therefore, Part II undertakes a rigorous empirical analysis designed to either confirm or contradict the initial conclusion that the case law is so malleable that it can support most conclusions in most cases, granting judges nearly complete discretion in ruling on motions to dismiss.

II. AN EMPIRICAL ANALYSIS OF SCIENTER CASE LAW RELATED TO AUDITOR DEFENDANTS

A. *Introduction and Sample Description*

Previous empirical studies have generally supported the conclusion reached in Part I, that there is great uncertainty in the law regarding scienter pleading under rule 10b-5. Grundfest and Pritchard, in studying the early years of post-PSLRA pleading, found little predictability in court decisions:

Judges can also value ambiguity to the extent that it allows them greater latitude to exercise discretion, more room within which to compromise with colleagues, and increased opportunity to avoid resolutions that they view as unjust or incorrect by whatever metric they might apply. Judge Posner, for example, suggests that judges often vote “their policy preferences and personal convictions,” within the confines of the “rules” of judging, as part of the judging “game.”¹³⁷

Does an empirical study of rule 10b-5 scienter cases *involving auditors* support or undermine this picture? To examine this issue, we collect data from securities class action complaints where the auditor is named. Our initial sample comes from the RiskMetrics Securities Class Actions Services database and includes cases naming auditors as defendants where the original case was filed between 1996 and 2005 and the auditor portion of the case was resolved by December 2011. We utilize this time period because all cases are under the same legal framework under the PSLRA, and cases against auditors often take numerous years to resolve. We then match cases involving auditors to complaints from the Stanford Securities Class Action Clearinghouse.

137. Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 681 (2002) (quoting RICHARD A. POSNER, *OVERCOMING LAW* 131 (1995)).

In order to keep data collection manageable and to ensure that the defendant firms have reasonably similar resources, we limit our sample to cases against the Big 4 (formerly, Big 5 and Big 6) audit firms that involve claims under rule 10b-5. The sample includes a total of 144 cases involving the major audit firms.

B. Variable Definitions

Due to our limited sample size, we cannot code every possible allegation by plaintiffs and still maintain sufficient degrees of freedom to conduct analyses. We do, however, define numerous commonly used allegations and utilize common themes (Notice, Risk, and Independence) to group certain variables and define other variables individually.

The Notice group variable includes allegations that the auditor was informed or had notice of the alleged fraud, from either the press (Press) or a firm employee (Employee), such as a whistleblower. The Risk group includes several variables that commonly imply that a client's audit is higher risk than normal, including poor internal controls (Controls), financial distress (Distress), unusual or questionable transactions, particularly at the end of financial reporting periods (Transactions), and executive turnover (Turnover). The final group is Independence, which includes allegations that the auditor was "too close" to the client, including the provision of nonaudit services (NAS), the employment of alumni from the audit firm at the client, and allegations of unlimited or unusually high auditor access to the client (Access).¹³⁸

The individual variables are broken out separately for two reasons. First, the "Benchmark" variable, defined as the client firm displaying an unusual propensity to hit earnings or revenue benchmarks or debt covenants, does not fit well within another group. Second, other individual variables may have implications beyond simply being a red flag. For instance, in addition to providing the auditor notice that the client may have an incentive to commit fraud, the "Offering" variable indicates that section 11 liability is likely also present.¹³⁹ "SEC" and "Restatement" can be viewed as providing relatively "hard evidence" that something was wrong in the client's financial statements.¹⁴⁰ In particular, the Restatement variable

138. Prior research finds that nonaudit service fees result in a higher probability of settlement. See Jaime J. Schmidt, *Perceived Auditor Independence and Audit Litigation: The Role of Nonaudit Services Fees*, 87 ACCT. REV. 1033, 1055 (2012).

139. Section 11 of the 1933 Act is, of course, a negligence-based liability provision. See 1933 Securities Act, § 11, 15 U.S.C. § 77k (2006).

140. See Stephen J. Choi et al., *The Screening Effect of the Private Securities Litigation Reform Act*, 6 J. EMPIRICAL LEGAL STUD. 35, 43 (2009) (defining "prefiling hard evidence as a public announcement

provides an admission of an accounting misstatement, although courts generally hold that a restatement by itself is not indicative of scienter.¹⁴¹ “High audit fees” may provide evidence of scienter, but the inference behind this variable is substantially crowded due to its mechanical relation with litigation risk. A vast accounting literature finds that auditing firms price litigation risk into engagements.¹⁴² Thus, relatively high audit fees could indicate not only the idea that the client “bought off” the auditor or that the auditor could not afford to lose the client but also that the auditor was aware of potential litigation risk. The “GAAS” variable indicates that the plaintiff alleges that the audit process itself was deficient.

These variables are defined in detail in Table 1. Each variable is an indicator variable, equal to one if the definition is met, zero otherwise. The group heading variables are equal to one if any subvariable is equal to one, zero otherwise.¹⁴³ Table 1 also contains the relative frequency with which each type of allegation appears in the sample.

prior to the lawsuit filing of an accounting restatement . . . or an SEC investigation or enforcement action”).

141. *E.g.*, *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002).
142. *E.g.*, Dan A. Simunic & Michael T. Stein, *The Impact of Litigation Risk on Audit Pricing: A Review of the Economics and the Evidence*, 15 *AUDITING: J. PRAC. & THEORY* 119, 126 (Supp. 1996) (summarizing that empirical evidence shows U.S. audit fees increase with higher litigation risk).
143. Note that the “Group” percentage will not necessarily be the sum of the specific allegation percentages because many complaints make multiple allegations in the same area.

TABLE 1: VARIABLE DEFINITIONS

<i>Variables</i>	<i>Definition</i>	<i>Case %</i>
Notice		38.2%
Press	A press story questioned client accounting practices.	29.2%
Employee	A client firm employee told the auditor about fraud or questionable accounting practices.	15.3%
Risk		88.2%
Controls	Internal controls were deficient or inadequate.	69.4%
Distress	The client was in financial distress or filed for bankruptcy.	38.2%
Transactions	Questionable, complex, or unusual client transactions should have alerted the auditor of suspicious activity.	70.1%
Turnover	A high-level executive left the firm or was fired.	38.2%
Independence		59.0%
NAS	Nonaudit service (NAS) fees made the client very important to the audit firm.	36.8%
Alumni	Alumni of the audit firm are in prominent positions at the client, particularly in financial reporting.	15.3%
Access	The auditor had “unlimited” (or similar word) access to the client’s books and operations.	47.9%
Benchmark	The firm had unusual consistency meeting earnings or revenue benchmarks (year-to-year growth, analyst forecasts, etc.) or managed earnings to avoid missing debt covenants.	82.6%
Offering	The client had an equity offering, debt offering, or engaged in a merger or acquisition during the class period.	79.9%
SEC	The SEC investigated the firm’s accounting practices.	30.6%
Restatement	Financial statements from the alleged fraud period were later restated.	65.3%
High audit fees	Large audit fees made the client very important to the audit firm.	34.7%
GAAS	Violations of generally accepted auditing standards (GAAS) occurred during the audit.	70.1%

C. Univariate Correlations

TABLE 2: PEARSON CORRELATION MATRIX

	<i>Merit</i>	<i>Notice</i>	<i>Risk</i>	<i>Independence</i>	<i>Benchmark</i>	<i>Offering</i>	<i>SEC</i>	<i>Restatement</i>	<i>High Audit Fee</i>	<i>GAAS</i>
<i>Settle</i>	0.35	-0.04	0.00	-0.02	0.17	-0.06	0.15	0.26	0.23	-0.11
<i>Merit</i>		0.21	0.14	0.28	0.04	-0.06	0.32	0.28	0.24	0.04
<i>Notice</i>			0.29	0.28	0.10	-0.03	0.19	0.09	0.24	0.33
<i>Risk</i>				0.40	0.12	-0.02	0.15	0.09	0.27	0.47
<i>Independence</i>					0.03	-0.03	0.34	0.25	0.61	0.72
<i>Benchmark</i>						0.27	-0.01	-0.03	0.10	-0.06
<i>Offering</i>							-0.04	0.00	-0.11	-0.06
<i>SEC</i>								0.29	0.43	0.27
<i>Restatement</i>									0.29	0.10
<i>High Audit Fee</i>										0.48

Table 2 contains univariate (Pearson) correlations between the primary independent variables (as defined above) and two outcome variables. The first outcome variable is “Settle,” indicating the case survived the motion to dismiss. The second outcome variable is “Merit,” indicating the auditor settled the case for at least \$5 million,

the approximate cost of taking an average case to trial.¹⁴⁴ On a univariate basis, 118 (81.9%) of the cases survive the motion to dismiss and settle (Settle), while only 52 (36.1%) of the cases reach a settlement of at least \$5 million (Merit). Prior studies use similar definitions of meritorious outcomes with respect to the primary defendants in securities class actions.¹⁴⁵

The correlations in Table 2 reveal several interesting patterns. First, even on a univariate basis, the Settle variable is uncorrelated with many of the most common plaintiff allegations: Notice, Risk, Independence, Offering, and GAAS. The only independent variables significantly (at the 10% level, as noted by **bold** type) correlated with Settle are Benchmark, SEC, Restatement, and High Audit Fee. Second, the Merit variable is significantly correlated with more variables, indicating that settlement negotiations may take into account factors that do not appear to influence courts. While the Benchmark variable loses significance, the Notice and Risk variables become significant when correlated with Merit.

Among the independent variables, the correlations are as one would expect. For instance, SEC and Restatement are highly correlated (0.29), and all of the variables that relate to the auditor's conduct (Independence, High Audit Fee and GAAS) are highly correlated.

D. *Multivariate Analysis*

We now move to a multivariate setting to investigate which factors are most relevant to the court's decision. We utilize logistic regression because we have a binary dependent variable. Our first model is as follows:

$$\text{Prob}(\text{Settle} = 1) = F(\alpha + \beta_1 \text{Notice} + \beta_2 \text{Risk} + \beta_3 \text{Independence} + \beta_4 \text{Benchmark} + \beta_5 \text{Offering} + \beta_6 \text{SEC} + \beta_7 \text{Restatement} + \beta_8 \text{HighAuditFee} + \beta_9 \text{GAAS}) \quad (1)$$

"Settle" is a dichotomous variable that is set to one if a lawsuit withstands the motion to dismiss, and to zero otherwise. F is the

144. The audit firms disclosed that they spent an average of approximately \$3.5 million defending a rule 10b-5 securities class action case in 1991 dollars. J. Michael Cook et al., *The Liability Crisis in the United States: Impact on the Accounting Profession*, J. ACCT., Nov. 1992, at 19, 20. Adjusted for inflation, this is equivalent to roughly \$5 million per case over our sample period.

145. *E.g.*, Marilyn F. Johnson et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J.L. ECON. & ORG. 627, 646 (2007) (defining "'nuisance' settlements" as less than 0.5% of the firm's market value ten days before the end of the class period).

cumulative distribution function of the logistic distribution, and other variables are as defined above.

Model (2) is identical to model (1), but the dependent variable is “Merit,” which is set to one when the auditor settles for at least \$5 million, zero otherwise. This model is provided to provide corroborating evidence regarding whether the factors that the court takes into account also affect the settlement negotiation. The second model is as follows:

$$\begin{aligned}
 \text{Prob}(\text{Merit} = 1) = & F(\alpha + \beta_1 \text{Notice} + \beta_2 \text{Risk} + \beta_3 \text{Independence} + \\
 & \beta_4 \text{Benchmark} + \beta_5 \text{Offering} + \beta_6 \text{SEC} + \\
 & \beta_7 \text{Restatement} + \beta_8 \text{HighAuditFee} + \beta_9 \text{GAAS}) \quad (2)
 \end{aligned}$$

Models (3) and (4) are very similar to models (1) and (2), respectively, but break the Notice, Risk, and Independence variables into their sub-components. Models (3) and (4) are as follows:

$$\begin{aligned}
 \text{Prob}(\text{Settle} = 1) = & F(\alpha + \beta_1 \text{Press} + \beta_2 \text{Employee} + \beta_3 \text{Controls} + \\
 & \beta_4 \text{Distress} + \beta_5 \text{Transactions} + \beta_6 \text{Turnover} + \\
 & \beta_7 \text{NAS} + \beta_8 \text{Alumni} + \beta_9 \text{Access} + \beta_{10} \text{Benchmark} + \\
 & \beta_{11} \text{Offering} + \beta_{12} \text{SEC} + \beta_{13} \text{Restatement} + \\
 & \beta_{14} \text{HighAuditFee} + \beta_{15} \text{GAAS}) \quad (3)
 \end{aligned}$$

$$\begin{aligned}
 \text{Prob}(\text{Merit} = 1) = & F(\alpha + \beta_1 \text{Press} + \beta_2 \text{Employee} + \beta_3 \text{Controls} + \\
 & \beta_4 \text{Distress} + \beta_5 \text{Transactions} + \beta_6 \text{Turnover} + \\
 & \beta_7 \text{NAS} + \beta_8 \text{Alumni} + \beta_9 \text{Access} + \beta_{10} \text{Benchmark} + \\
 & \beta_{11} \text{Offering} + \beta_{12} \text{SEC} + \beta_{13} \text{Restatement} + \\
 & \beta_{14} \text{HighAuditFee} + \beta_{15} \text{GAAS}) \quad (4)
 \end{aligned}$$

Table 3 presents results from estimating these regressions:

TABLE 3: LOGISTIC REGRESSION RESULTS

Panel A: Regressions utilizing group variables

<i>Dependent Variable</i>	Model (1)		Model (2)	
	<i>Settle</i>	<i>t-stat</i>	<i>Merit</i>	<i>t-stat</i>
<i>Intercept</i>	1.30	1.34	-2.32**	2.49
<i>Notice</i>	-0.33	0.62	0.84*	1.94
<i>Risk</i>	0.38	0.44	1.03	1.29
<i>Independence</i>	-0.79	1.20	-1.19*	1.67
<i>Benchmark</i>	1.15*	1.85	0.08	0.14
<i>Offering</i>	-1.12	1.45	-0.14	0.26
<i>SEC</i>	0.51	0.75	1.11**	2.47
<i>Restatement</i>	1.39**	2.56	1.11**	2.32
<i>High Audit Fee</i>	1.75**	2.38	1.00*	1.76
<i>GAAS</i>	-1.09	1.40	-0.44	0.64
<i>n</i>	144		144	
<i>Pseudo R²</i>	0.295		0.272	

*, **, and *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, in two-tailed tests

Panel B: Regressions utilizing all individual variables

<i>Dependent Variable</i>	<i>Model (3)</i>		<i>Model (4)</i>	
	<i>Settle</i>	<i>t-stat</i>	<i>Merit</i>	<i>t-stat</i>
<i>Intercept</i>	1.41	1.48	-1.96**	2.27
<i>Press</i>	0.20	0.33	1.20**	2.43
<i>Employee</i>	-0.42	0.56	0.16	0.27
<i>Controls</i>	0.03	0.05	0.81	1.45
<i>Distress</i>	0.29	0.50	0.20	0.43
<i>Transactions</i>	-0.33	0.49	-0.45	0.74
<i>Turnover</i>	-0.19	0.29	0.76*	1.65
<i>NAS</i>	-0.66	0.85	0.11	0.18
<i>Alumni</i>	1.26	1.10	-0.01	0.02
<i>Access</i>	-0.78	1.08	-1.35**	2.03
<i>Benchmark</i>	1.28*	1.85	0.29	0.48
<i>Offering</i>	-1.10	1.42	-0.21	0.38
<i>SEC</i>	0.37	0.52	1.09**	2.20
<i>Restatement</i>	1.35**	2.30	0.85*	1.72
<i>High Audit Fee</i>	2.16**	2.48	1.04	1.47
<i>GAAS</i>	-0.96	1.16	-0.71	0.97
<i>n</i>	144		144	
<i>Pseudo R²</i>	0.318		0.356	

*, **, and *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, in two-tailed tests

Models (1) and (3) produce consistent results, with only Benchmark, Restatement, and High Audit Fee being significant. Thus, courts do not appear to be influenced by most of the allegations in plaintiffs' complaints, and in particular there is little consistency in the treatment of red flags. Courts specifically state that restatements, without accompanying red flags, are not indicative of fraud.¹⁴⁶ High Audit Fee is also consistent with increased litigation risk being correlated with auditors being sued,¹⁴⁷ which is not particularly surprising. Thus, Benchmark is the only variable that could be interpreted as a red flag that is significant.

When examining which cases reach settlements that likely reflect a meritorious underlying case, the results from estimating models (2) and (4) suggest that other factors also play a role. For instance, in model (2), Notice and SEC are also significant. The results from estimating model (4) suggest that reports in the press (Press) are driving the relationship between Notice and Merit. The statistical significance of SEC and Notice/Press seem reasonable with respect to the meritorious outcome of cases. The fact that these are significant in reaching a material settlement, but not in the dismissal decisions of courts, lends some support to the view that court decisions are not systematic.

Similar to earlier results, Restatement remains significant in all specifications, although High Audit Fee is significant only in model (2). Interestingly, Independence is marginally significant in model (2), and the results from model (4) suggest that this is driven by a significantly negative relation between Access and Merit. While this relation is difficult to explain logically, it could be that cases where the plaintiff makes allegations consistent with the Access variable are relatively weaker and do not present other facts consistent with fraud.

E. Sensitivity Analysis

It is of course possible that other factors affect case outcomes. For instance, professors Pritchard and Sale examined how case outcomes in securities class actions against the primary defendants vary by circuit, focusing on the Second and Ninth Circuits where the highest numbers of cases are filed.¹⁴⁸ Again, our relatively small sample size does not lend itself to this type of within-circuit analysis as even the Second Circuit (29 cases) and Ninth Circuit (24 cases) have relatively few cases. However, we do examine whether the circuit in which the

146. *E.g.*, *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002).

147. *See, e.g.*, *Simunic & Stein*, *supra* note 142, at 126 (summarizing that empirical evidence shows that U.S. audit fees increase with higher litigation risk).

148. *Pritchard & Sale*, *supra* note 4.

case is filed could affect the motion to dismiss decision by including indicator variables for the three circuits with at least 15 cases (in addition to the Second and Ninth, the Eleventh Circuit has a relatively high filing rate with 15 cases). None of these circuit indicator variables is significant, and the coefficients on other variables are not significantly affected.

In addition, as noted above, the Offering variable could be an imperfect proxy for section 11 liability. We code a separate indicator variable for whether a case has a section 11 claim, and reexamine the outcome of the motion to dismiss decision. We include this variable in lieu of the Offering variable. We find that this variable is marginally significant ($p = 0.087$) in the equivalent of model (1), but marginally insignificant in the equivalent of model (3) ($p = 0.120$).

III. IMPLICATIONS

Part I's reading of numerous cases pursuant to a doctrinal analysis indicates that the courts largely agree that auditor defendants in rule 10b-5 cases should receive special protection in the form of higher pleading standards, but it also reveals that there is substantial court disagreement regarding what form that special protection should take, what facts provide circumstantial support for a claim of auditor scienter, and what facts might constitute red flags indicating that auditors who ignored them were more than merely negligent. These conclusions are reaffirmed by Part II's empirical conclusions that few factors are consistently viewed by the courts as indicative (or not) of auditor scienter. What are the practical implications of these findings?

A. *Uncertainty*

The uncertainty of rule 10b-5 pleading doctrine and its application has greatly bothered auditors. Part of their complaint is overblown. Whether or not judges view these actions such as ignoring red flags as indicative of scienter, these actions certainly indicate unsound (even if only negligent) auditing practices. Auditors are not saying: "We thought it was okay to do these things." What they are saying is: "We know we shouldn't do these things, but we would like to be more certain about the adverse consequences of doing things we know we shouldn't." This is a legitimate complaint, but not a terribly sympathetic one.¹⁴⁹

149. Auditors also complain that potential damages turn "on factors outside the auditor's control." CTR. FOR AUDIT QUALITY, REPORTS OF THE MAJOR PUBLIC COMPANY AUDIT FIRMS TO THE DEPARTMENT OF THE TREASURY ADVISORY COMMITTEE ON THE AUDITING PROFESSION 33 (2008), *available at* <http://www.thecaq.org/publicpolicy/data/TRData2008-01-23-FullReport.pdf>. That is a bit of an overstatement, at least regarding the topic of this Article. If auditors perform good audits and

On the other hand, auditors are on firm ground when they complain that unpredictable scienter doctrine makes it very difficult for them to judge the settlement value of a case.¹⁵⁰ And this is obviously a very significant concern as well for plaintiffs and, of course, plaintiffs' attorneys. Plaintiffs' attorneys, in particular, make very substantial economic investments when they file rule 10b-5 class action lawsuits,¹⁵¹ and it is difficult for them to gauge the wisdom of such a filing when it is unclear how courts will treat the known scienter evidence. For both plaintiffs and defendants, the uncertainty of scienter pleading doctrine has decidedly unsatisfactory consequences.

B. *Judicial Discretion*

When applicable legal rules are in great dispute and their application in specific cases is unconstrained, as both the doctrinal and empirical portions of this Article indicate is the case for the rule 10b-5 scienter pleading standard, judges enjoy plentiful discretion in deciding whether to dispose of rule 10b-5 private suits for damages in their early stages.

This might be a good thing. Hart and Sacks have noted regarding the general application of law that “[d]iscretion is a vehicle of good far more than of evil. It is the only means by which the intelligence and good will of a society can be brought to bear directly upon the solution of hitherto unsolved problems.”¹⁵² Arthur Miller has agreed: “I love judicial discretion. . . . We have to give [district judges] some elbow room objectively, individualistically, and contextually.”¹⁵³

do not make material mistakes, the excessive malleability of scienter pleading law is unlikely to cause them a significant problem.

150. Audit firms are often “confronted with . . . lawsuit[s] in which [they] face[] an uncertain outcome at trial and potentially catastrophic liability if [they were to] lose[.]. Settlement is therefore often viewed as the only sensible alternative, because no firm has the resources to take a case to trial when the downside risk is a multi-billion dollar or even a multi-hundred million dollar, catastrophic judgment.” *Id.* at 35.
151. For class action plaintiffs’ attorneys, the filing of a lawsuit is an investment decision, and typically a very expensive one. See John C. Coffee, Jr., *Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 684–90 (1986) (explaining that plaintiffs’ attorneys have more reason to be hesitant to invest in an action than their clients because attorney fee awards tend to decline as recovery size increases); Ronald A. Dabrowski, Note, *Proportionate Liability in Rule 10b–5 Reckless Fraud Cases*, 44 DUKE L.J. 571, 590–91 (1994) (“Plaintiff’s attorneys view securities class actions as high-risk-high-reward investments”).
152. HENRY M. HART, JR. & ALBERT M. SACKS, *THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW* 158 (William N. Eskridge, Jr. & Philip P. Frickey eds., 1994).
153. Arthur Miller, Remarks at the Public Hearings of the Third Circuit Task Force on the Selection of Class Counsel (June 1, 2001), *quoted in* Richard

An extraordinarily subjective scienter test with lots of play in the joints allows trial judges who have a gut feeling that an overall claim is nonmeritorious to dispose of the case very early on, with a savings of resources to society, to defendants, and even to plaintiffs. Allowing such discretion could lead to superior resolutions of disputes.¹⁵⁴ One may read a bevy of these opinions and conclude that few of them seem plainly erroneous on their face. That is a good sign.

Of course, judges are lawyers, and it would be a poor lawyer who, given the opportunity to select from a range of pliable legal rules and to pick and choose among factual allegations, could not cobble together a reasonably persuasive argument for whichever choice he or she made. After analyzing what seemed to be a particularly questionable prodefendant decision by the Fourth Circuit in *Public Employees' Retirement Ass'n of Colorado v. Deloitte & Touche, LLP*,¹⁵⁵ Steinberg and Appel noted that the “no audit at all” standard “can be applied to shield virtually *any* decision requiring an auditor’s judgment or discretion in the performance of the audit, beyond purely technical accounting treatments.”¹⁵⁶

Still, if federal judges are honest, objective, and rational, granting them great discretion, as current scienter pleading law does, seems largely unobjectionable. But while few question federal judges’ subjective honesty, there are substantial grounds upon which to challenge their rationality and objectivity.

L. Marcus, *Slouching Toward Discretion*, 78 NOTRE DAME L. REV. 1561, 1561 (2003); see also Robert G. Bone, *Who Decides? A Critical Look at Procedural Discretion*, 28 CARDOZO L. REV. 1961, 1964 (2007) (noting that discretion in case management is to some degree “inevitable and desirable,” but arguing for reducing that discretion); Marcus, *supra*, at 1562 (noting that “discretion is an inescapable aspect of legal decision-making” (citing Keith Hawkins, *The Use of Legal Discretion: Perspectives from Law and Social Science*, in THE USES OF DISCRETION 11, 11–12 (Keith Hawkins ed., 1992))).

154. See Su, *supra* note 39, at 546 (“[T]here are benefits to giving judges some interpretive latitude. A determination of scienter sometimes requires judges to look beyond the facts to the nuances of the case. Proving the mental state of a defendant is already difficult; thus, by allowing judges to look holistically at all of the claims to get the bigger picture, they are able to come to a more equitable conclusion.” (footnote omitted)).
155. *Pub. Emps. Ret. Ass’n of Colo. v. Deloitte & Touche, LLP*, 551 F.3d 305 (4th Cir. 2009).
156. Marc I. Steinberg & Dustin L. Appel, *A Prolonged Slump for “Plaintiff-Pitchers”: The Narrow “Strike Zone” for Securities Plaintiffs in the Fourth Circuit*, 88 N.C. L. REV. 1923, 1972–73 (2010).

1. Judges' Bounded Rationality

Although economists have traditionally modeled people as rational actors,¹⁵⁷ this is only roughly accurate. Herbert Simon won a Nobel Prize in economics by establishing that people are rational, but only boundedly so.¹⁵⁸ An important part of the new knowledge that undermines the rational actor model is the heuristics and biases literature created by Nobel Prize-winner Daniel Kahneman and Amos Tversky and their intellectual progeny. There is now a vast amount of research in this field establishing a large number of related (and sometimes overlapping) heuristics, biases, and other cognitive errors that ensure that people generally fall short of full rationality when they make decisions.

Because judges are people, it makes sense to assume that they are subject to these forces. And, as empirical studies demonstrate, they are. Professors Guthrie and Rachlinski, along with Federal Magistrate Judge Andrew Wistrich found evidence that judges are subject to a range of heuristics, biases, and cognitive limitations, including anchoring and adjustment,¹⁵⁹ framing,¹⁶⁰ the representativeness heuristic,¹⁶¹ the egocentric (overconfidence) bias,¹⁶² and the hindsight bias.¹⁶³

157. See Quintanilla, *supra* note 39, at 198–99 (“[O]ur legal intuitions are shaped by the assumption that humans are self-interested beings who behave as free moral agents and who make rational choices. Woven throughout our jurisprudence is the theory that humans are motivated to act out of self-interest and that every individual is rational and selfish.” (footnote omitted)).

158. Robert Trivers recently wrote that the “alleged science called economics . . . has resolutely failed to ground itself in underlying knowledge, at a cost to all of us.” ROBERT TRIVERS, *THE FOLLY OF FOOLS* 8 (2011).

159. People have a tendency to focus on an initial number or position, even if it is completely irrelevant to the decision to be made, and then to fail to adjust adequately in the face of new information. See RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* 23–24 (2008) (discussing the effect of anchoring on the decision making process).

160. People often change their decisions in completely inconsistent ways depending upon how the question put to them is framed. See Jeffrey J. Rachlinski, *Heuristics and Biases in the Courts: Ignorance or Adaptation?*, 79 OR. L. REV. 61, 99 (2000) (“Like anchoring, framing seems to lie beyond the ability of courts to identify, regardless of whether the issue involves a judge or a jury.”); Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCI. 453, 453 (1981) (“Rational choice requires that the preference between options should not reverse with changes of frame. Because of imperfections of human perception and decision, however, changes of perspective often reverse the relative apparent size of objects and the relative desirability of options.”).

161. The representativeness heuristic is “reliance on the degree of apparent similarity between the features of the events to the features of the

Hastie and Viscusi have also found evidence that judges are subject to the hindsight bias.¹⁶⁴ And in a different study, Guthrie, Rachlinski, and Wistrich found that judges, like most everyone else, tend to jump to conclusions without adequate reflection.¹⁶⁵ As these authors observed, “intuition is generally more likely than deliberation to lead judges astray.”¹⁶⁶ What is the impact of judges’ bounded rationality when they are called upon to rule upon the allegations of scienter in rule 10b-5 cases?

2. The Impact of Decisional Heuristics and Biases

Different heuristics and biases in different contexts will nudge decision making in different directions. As it happens, most of the

category in judging whether an event is a member of a particular category.” Rachlinski, *supra* note 160, at 82. It causes problems “because people tend to rely on the representativeness heuristic to the exclusion of other information relevant to categorical judgments,” such as base rate information. *Id.* at 83. Judges are subject to the representative heuristic. *See id.* at 101 (gathering evidence suggesting that judges often fall prey to the representativeness heuristic).

162. The egocentric bias is another term for overconfidence; judges manifest it in various ways, including by being poorly calibrated regarding their chances of being overturned on appeal. Chris Guthrie et al., *Inside the Judicial Mind*, 86 CORNELL L. REV. 777, 814 (2001) [hereinafter Guthrie et al., *Judicial Mind*] ; *see also* Chris Guthrie et al., *The “Hidden Judiciary”: An Empirical Examination of Executive Branch Justice*, 58 DUKE L.J. 1477, 1518–20 (2009) (finding substantial evidence of judges’ overconfidence in their judging abilities).
163. The hindsight bias is the tendency to conclude that things that have happened were more foreseeable than they actually were. *See* Guthrie et al., *Judicial Mind*, *supra* note 162, at 784 (finding evidence of hindsight bias in an empirical study of judicial decision making); Jeffrey J. Rachlinski et al., *Inside the Bankruptcy Judge’s Mind*, 86 B.U. L. REV. 1227, 1229–30 (2006) (finding conflicting evidence on the extent of the hindsight bias).
164. *See* Reid Hastie & W. Kip Viscusi, *What Juries Can’t Do Well: The Jury’s Performance as a Risk Manager*, 40 ARIZ. L. REV. 901, 917 (1998) (finding “massive hindsight bias” by jurors and lesser but still substantial hindsight bias by judges).
165. *See* Chris Guthrie et al., *Blinking on the Bench: How Judges Decide Cases*, 93 CORNELL L. REV. 1, 17, 27–28 (2007) (“[T]hese results suggest that judges tended to favor intuitive rather than deliberative faculties. . . . When awarding damages, assessing liability based on statistical evidence, and predicting outcomes on appeal, judges seemed inclined to make intuitive judgments.”).
166. *Id.* at 5; *see also id.* at 29 (“[A]n excessive reliance on intuition will lead to erroneous judicial decisions.”); Tversky & Kahneman, *supra* note 160, at 1124 (arguing that intuitive thinking can “lead to severe and systematic errors”).

relevant heuristics and biases in the current context will probably benefit securities fraud defendants to the detriment of plaintiffs.

a. *Overconfidence*

People's minds are "overconfidence machine[s]." ¹⁶⁷ In impossibly high percentages, most people believe that they are above-average drivers, ¹⁶⁸ above-average auditors, ¹⁶⁹ above-average eyewitnesses, ¹⁷⁰ and pretty much above-average everything else. People chronically overestimate their own knowledge and ability to make accurate judgments. ¹⁷¹

To the extent that judges are affected by the overconfidence bias, and they are, ¹⁷² granting them excessive discretion to dispose of cases at the pleading stage could be detrimental to a search for justice. ¹⁷³ It

167. DAVID BROOKS, *THE SOCIAL ANIMAL* 218 (2011).

168. See RISTO NÄÄTÄNEN & HEIKKI SUMMALA, *ROAD-USER BEHAVIOR AND TRAFFIC ACCIDENTS* 237 (1976) (concluding that road users give safety concerns too little attention when considering high-risk driving behaviors); Caroline E. Preston & Stanley Harris, *Psychology of Drivers in Traffic Accidents*, 49 J. APPLIED PSYCHOL. 284, 286 (1965) (discussing results of questionnaires where drivers with and without accident histories all rated themselves closer to expert than poor); Ola Svenson, *Are We All Less Risky and More Skillful than Our Fellow Drivers?* 47 ACTA PSYCHOLOGICA 143 (1981) (discussing driver bias in an experiment where drivers judged themselves safer and more skillful than the average driver).

169. See Jane Kennedy & Mark E. Peecher, *Judging Auditors' Technical Knowledge*, 35 J. ACCT. RES. 279 (1997) (concluding from an empirical study that auditors are overconfident in their own abilities).

170. See John S. Shaw, III & Kimberley A. McClure, *Repeated Postevent Questioning Can Lead to Elevated Levels of Eyewitness Confidence*, 20 LAW & HUM. BEHAV. 629, 650 (1996) (finding that overconfidence, but not accuracy, rises with repeated questioning).

171. See Lyle A. Brenner et al., *Overconfidence in Probability and Frequency Judgments: A Critical Examination*, 65 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 212, 218 (1996) (reporting study finding overconfidence as well as poor use of base-rate information and vulnerability to representativeness heuristic). Will Rogers has been famously quoted as saying, "It's not what we don't know that gives us trouble. It's what we know that ain't so." Hillel J. Einhorn, *Overconfidence in Judgment*, in 4 NEW DIRECTIONS FOR METHODOLOGY OF SOCIAL AND BEHAVIORAL SCIENCE 1, 14 (Richard A. Shweder ed., 1980).

172. See JoEllen Lind, *The End of Trial on Damages? Intangible Losses and Comparability Review*, 51 BUFF. L. REV. 251, 296 (2003) (explaining why "overconfidence may be a particular problem with federal appeals courts").

173. See PIERO CALAMANDREI, *EULOGY OF JUDGES* 21 (John Clarke Adams & C. Abbott Phillips, Jr. trans., 1942) ("I fear the judge who is too sure

will tend to cause judges to conclude that they can with some measure of prescience predict more accurately than is actually the case whether plaintiffs, if given the opportunity to engage in discovery, could find evidence supporting their scienter allegations.¹⁷⁴

b. *Self-Serving Bias*

One of the most influential of the heuristics and biases is the *self-serving bias*, the tendency people have to gather information, process information, and even remember information in such a manner as to advance their own self-interests or their own preexisting views.

Top Enron executives were paid huge bonuses based on *projected* profits in deals they put together. Psychological studies show that they were prone to seek out information that would support the highest plausible valuations.¹⁷⁵ This is called the confirmation bias,¹⁷⁶ and it accounts for people with conservative political views being more likely to watch Fox News while liberals are more likely to watch MSNBC.¹⁷⁷

The self-serving bias also affects how people process information. Thus, supporters of competing political candidates watching the same

of himself, who reaches his decision quickly, jumping immediately to conclusions without deliberation or repentance.”).

174. See Jeffrey J. Rachlinski, *Processing Pleadings and the Psychology of Prejudgment*, 60 DEPAUL L. REV. 413, 428 (2011) (“Overconfidence in judgment can lead judges to believe that they have more ability to predict the course of a lawsuit than is actually the case.”).
175. See Robert Prentice, *Enron: A Brief Behavioral Autopsy*, 40 AM. BUS. L.J. 417, 419–21, 428 (2003) (discussing how the difficulty in valuing commodities and the incentive to set favorable prices led to a self-serving bias and the acceptance of questionable valuations that contributed to higher earnings and bonuses at Enron) (citing BRIAN CRUVER, ANATOMY OF GREED 80 (2002)).
176. The confirmation bias is the tendency to seek out information that supports a hypothesis and to ignore or downplay conflicting information. See Mark W. Dirsmith et al., *Of Paradigms and Metaphors in Auditing Thought*, 2 CONTEMP. ACCT. RES. 46, 56–57 (1985) (noting the irrational use of information by organizations (citing Henry Mintzberg et al., *The Structure of “Unstructured” Decision Processes*, 21 ADMIN. SCI. Q. 246 (1976))). This is particularly the case when the hypothesis is one already adopted by a person or that is consistent with the person’s self-interest. See SCOTT PLOUS, THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING 231–34, 238–40 (1993) (finding extensive evidence of self-fulfilling prophecies and confirmation bias among both men and women in a variety of scenarios).
177. See DREW WESTEN, THE POLITICAL BRAIN, at xiv, 100 (2007) (noting that the pleasure centers of people’s brains light up when they find information supporting their preexisting beliefs); see also *id.* at 100 (neuroimaging suggests that “our brains have a remarkable capacity to find their way toward convenient truths—even if they’re not all that true”).

debate each tend to conclude that “their guy” won.¹⁷⁸ A study showed that when a group favoring capital punishment and a group against capital punishment were each shown the same document with arguments for and against capital punishment, members of both groups tended to construe the document as favoring their diametrically opposed positions and, indeed, felt more fervently about their point of view after reading the document than before.¹⁷⁹

The self-serving bias even affects how people remember information.¹⁸⁰ Studies show people are more likely to recall evidence that supports their own point of view than evidence that opposes it.¹⁸¹

Because of the self-serving bias, doctors who own stakes in testing labs order significantly more tests than doctors who do not.¹⁸² And studies show that even auditors—who are trained to be independent, analytical, and skeptical—are strongly affected by the self-serving bias.¹⁸³

178. See, e.g., Robert P. Vallone et al., *The Hostile Media Phenomenon: Biased Perception and Perceptions of Media Bias in Coverage of the Beirut Massacre*, 49 J. PERSONALITY & SOC. PSYCHOL. 577 (1985) (showing that opposing groups on the political spectrum each thought that the media had been biased in favor of their opponent). And fans of opposing football teams who each watch a tape of the game are likely to think that the *other* team made the largest number of flagrantly inappropriate plays. See Albert H. Hastorf & Hadley Cantril, Case Report, *They Saw a Game: A Case Study*, 49 J. ABNORMAL & SOC. PSYCHOL. 129, 131 (1954) (finding considerable bias among students in evaluations of opposing college football teams after a game between Dartmouth and Princeton).

179. WESTEN, *supra* note 177, at 101.

180. See TRIVERS, *supra* note 158, at 25 (noting how self-interest causes us to “continually create false personal narratives”).

181. See Ziva Kunda, *The Case for Motivated Reasoning*, 108 PSYCHOL. BULL. 480, 483 (1990) (discussing how people are subject to motivated reasoning, but cannot just believe anything, so under the “illusion of objectivity” they search their memories in a selective fashion to construct justifications for their desired conclusions).

182. See MARGARET HEFFERNAN, WILLFUL BLINDNESS 185 (2011) (interviewing physician David Ring, an orthopedic surgeon at a major American hospital, on the effects of money on the medical profession).

183. See C. Bryan Cloyd & Brian C. Spilker, *The Influence of Client Preferences on Tax Professionals’ Search for Judicial Precedents, Subsequent Judgments and Recommendations*, 74 ACCT. REV. 299, 301 (1999) (finding that after studying certain provided precedents, one-half of accountant subjects recommended a position known to be favored by their clients, even though a panel of experts concluded that there was only a 14% chance that the position would be sustained if litigated); Andrew D. Cuccia, Karl Hackenbrack & Mark W. Nelson, *The Ability of Professional Standards to Mitigate Aggressive Reporting*, 70 ACCT. REV. 227, 243–44 (1995) (finding self-serving bias in tax context); S. Salterio & L. Koonce, *The Persuasiveness of Audit Evidence: The Case*

The self-serving bias indicates that judges' holdings will be influenced by their preexisting political and policy beliefs, and many empirical studies indicate that this is the case.¹⁸⁴ Judges even

of Accounting Policy Decisions, 22 ACCT. ORGS. & SOC'Y 573, 585 (1997) (finding that if precedents all point in one direction, the auditor will go that way, but if precedents conflict auditors will tend strongly to favor client's preferred position, and noting that the finding "does suggest that conflicting precedents provide the basis for the auditor to side with the client which, in turn, may give the appearance of a lack of independence").

184. See, e.g., EILEEN BRAMAN, LAW, POLITICS & PERCEPTION: HOW POLICY PREFERENCES INFLUENCE LEGAL REASONING 5 (2009) (noting the existence and lack of awareness of judicial bias when judges engage "in the 'objective' consideration of evidence"); JEFFREY A. SEGAL & HAROLD J. SPAETH, THE SUPREME COURT AND THE ATTITUDINAL MODEL 63 (1993) (finding that a judge's own preferences and the influence of majoritarian impulses affect judicial decision making); CASS R. SUNSTEIN ET AL., ARE JUDGES POLITICAL?: AN EMPIRICAL ANALYSIS OF THE FEDERAL JUDICIARY 45 (2006) (analyzing a large data set of judicial voting decisions and finding that "ideological voting is emphatically present"); Orley Ashenfelter et al., *Politics and the Judiciary: The Influence of Judicial Background on Case Outcomes*, 24 J. LEGAL STUD. 257 (1995) (studying influence of judges' attitudes on civil rights cases); James J. Brudney et al., *Judicial Hostility Toward Labor Unions? Applying the Social Background Model to a Celebrated Concern*, 60 OHIO ST. L.J. 1675, 1761 (1999) (finding "numerous personal, political, and professional background factors" that affected judges' decisions in cases involving unions); Frank B. Cross & Emerson H. Tiller, *Judicial Partisanship and Obedience to Legal Doctrine: Whistleblowing on the Federal Courts of Appeals*, 107 YALE L.J. 2155, 2175 (1998) ("Partisanship clearly affects how appellate courts review agency discretion."); Tracey E. George, *Developing a Positive Theory of Decisionmaking on U.S. Courts of Appeals*, 58 OHIO ST. L.J. 1635 (1998) (finding ideological decision making on en banc circuit court panels); Deborah Jones Merritt & James J. Brudney, *Stalking Secret Law: What Predicts Publication in the United States Courts of Appeals*, 54 VAND. L. REV. 71 (2001) (reporting study finding that political affiliation helped predict votes in labor-management dispute dispositions); Thomas J. Miles & Cass R. Sunstein, *The Real World of Arbitrariness Review*, 75 U. CHI. L. REV. 761, 813 (2008) (finding significant differences between voting of Republican judges and Democratic judges); Richard E. Redding & N. Dickon Reppucci, *Effects of Lawyers' Socio-Political Attitudes on Their Judgments of Social Science in Legal Decision Making*, 23 LAW & HUM. BEHAV. 31, 43-48 (1999) (analyzing effect of background on judicial bias in death penalty cases); Richard L. Revesz, *Environmental Regulation, Ideology, and the D.C. Circuit*, 83 VA. L. REV. 1717, 1766 (1997) (finding empirical support for the theory that "D.C. Circuit judges employ a strategically ideological approach to judging"); Richard L. Revesz, *Congressional Influence on Judicial Behavior? An Empirical Examination of Challenges to Agency Action in the D.C. Circuit*, 76 N.Y.U. L. REV. 1100 (2001) (providing evidence linking political affiliation and ideological preferences of judges to judicial outcomes); David B. Spence & Paula Murray, *The Law, Economics, and*

misremember the facts of cases in ways that support their subconsciously endorsed racial stereotypes.¹⁸⁵

What this means for the current topic is that if judges are predisposed to believe that federal securities fraud lawsuits are often frivolous or that it would be irrational for auditors to audit recklessly, they will tend to unconsciously search through complaints and supporting documents for information that supports that point of view, to interpret the arguments and documents to support that point of view, and even to remember better the arguments and documents supporting that point as they write their opinions.¹⁸⁶ And that is the leaning of most federal judges, who “routinely express concern that securities class actions are often lawyer-driven suits brought in the hope of settling for their nuisance value.”¹⁸⁷ The more discretion judges have to dismiss cases early, the more likely they will do so.

Politics of Federal Preemption Jurisprudence: A Quantitative Analysis, 87 CALIF. L. REV. 1125, 1195 (1999) (finding in empirical study that decisions about federal preemption in environmental cases are the result of “actions of (partly) ideologically-motivated federal judges”).

185. See Jeffrey J. Rachlinski et al., *Does Unconscious Racial Bias Affect Trial Judges?*, 84 NOTRE DAME L. REV. 1195, 1232 (2009) (finding that judges “like the rest of us, possess implicit [racial] biases” but that they mostly managed to avoid their influence “when they were told of the defendant’s race” and actively guarded against their own prejudices).

186. Judges may well suffer from the same phenomenon that affected Carne Ross, one of Prime Minister Tony Blair’s underlings as the Iraq War began. Ross later admitted:

The speeches I drafted for the Security Council and my telegrams back to London were composed of facts filtered from the stacks of reports and intelligence that daily hit my desk. As I read these reports, facts and judgments that contradicted “our” version of events would almost literally fade into nothingness. Facts that reinforced our narrative would stand out to me almost as if highlighted, to be later deployed by me, my ambassador and my ministers like hand grenades in the diplomatic trench warfare. Details in otherwise complex reports would be extracted to be telegraphed back to London, where they would be inserted into ministerial briefings or press articles. A complicated picture was reduced to a selection of facts that became factoids, such as the suggestion that Hussein imported huge quantities of whisky or built a dozen palaces, validated by constant repetition: true, but not the whole truth.

Carne Ross, *War Stories*, FIN. TIMES, Jan. 29–30, 2005, at 21, 22 (emphasis added).

187. Mitu Gulati et al., *Fraud by Hindsight*, 98 NW. U. L. REV. 773, 782 (2004).

The increasing conservatism of the federal bench exacerbates this effect.¹⁸⁸

c. *Hindsight Bias and Fraud-by-Hindsight Doctrine*

The hindsight bias is the tendency to regard things that have occurred as having been relatively predictable and obvious.¹⁸⁹ Once people know of an outcome, they tend to systematically overestimate the likelihood that they could have anticipated that outcome in advance. The hindsight bias is exacerbated by the *curse of knowledge* effect (the difficulty people have in ignoring information that they have learned when they make decisions)¹⁹⁰ and the *outcome bias* (the tendency people have to judge a decision's quality by its outcome).¹⁹¹

188. See, e.g., Matthew D. Bunker et al., *Strict in Theory, But Feeble in Fact? First Amendment Strict Scrutiny and the Protection of Speech*, 16 COMM. L. & POL'Y 349, 378 (2011) (noting increasing conservatism of federal judges); Scott L. Cummings & Deborah L. Rhode, *Public Interest Litigation: Insights from Theory and Practice*, 36 FORDHAM URB. L.J. 603, 607 (2009) (same).

189. Baruch Fischhoff is one of the first to have studied the hindsight bias, which he described as follows:

In hindsight, people consistently exaggerate what could have been anticipated in foresight. They not only tend to view what has happened as having been inevitable but also to view it as having appeared "relatively inevitable" before it happened. People believe that others should have been able to anticipate events much better than was actually the case.

Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, in JUDGMENT UNDER UNCERTAINTY 335, 341 (Daniel Kahneman, Paul Slovic & Amos Tversky eds., 1982); see also Baruch Fischhoff & Ruth Beyth, "I Knew It Would Happen" *Remembered Probabilities of Once-Future Things*, 13 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 1, 3 (1975) ("[T]he remembered or reconstructed probability of an event will tend to be larger than the probability originally assigned to it if the event is believed to have occurred."); Scott A. Hawkins & Reid Hastie, *Hindsight: Biased Judgments of Past Events After the Outcomes Are Known*, 107 PSYCHOL. BULL. 311, 323 (1990) ("[R]esearch and theory on hindsight phenomena suggest that the decision maker is unlikely to even be aware of the influence of the to-be-disregarded information, much less able to undo its effects.").

190. See, e.g., Jane Kennedy, *Debiasing the Curse of Knowledge in Audit Judgment*, 70 ACCT. REV. 249, 266-67 (1995) (finding significant curse of knowledge effects among auditors and testing methods of mitigating the effects).

191. See Jonathan Baron & John C. Hershey, *Outcome Bias in Decision Evaluation*, 54 J. PERSONALITY & SOC. PSYCHOL. 569, 570 (1988) (explaining that an outcome bias exists when "people take outcomes into account in a way that is irrelevant to the true quality of the decision").

The hindsight bias is one of the most reliably replicated biases in existence,¹⁹² and there is little evidence that we can free judges or jurors from the effects of the bias simply by educating them regarding its existence and impact.¹⁹³ Most people, including when they act as jurors, are subject to the hindsight bias.¹⁹⁴

In general, the hindsight bias “makes defendants appear more culpable than they really are.”¹⁹⁵ If an auditor did not see something coming, but a judge pursuant to the hindsight bias concludes that he or she would have seen it coming and therefore that the auditor should have as well, the judge will be more likely to find recklessness where an innocent mistake occurred than if the hindsight bias did not exist.¹⁹⁶ And there is evidence that auditor defendants may suffer at the hands of this bias.¹⁹⁷

But while the hindsight bias will disadvantage defendants if courts do not compensate for it, in the context of securities fraud class actions there is substantial empirical evidence that courts have compensated. In fact, they have overcompensated. In 1978, Judge Henry Friendly promulgated the “fraud by hindsight” (FBH) doctrine, ruling that a complaint that does nothing more than allege

192. See Rachlinski, *supra* note 160, at 67 (“Every published empirical test of the hindsight bias replicates the phenomenon.”).

193. See Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 603 (1998) (“Psychologists have uncovered no way to instruct people on how to evaluate decisions in hindsight in a way that completely avoids the hindsight bias.”).

194. See Lee J. Gilbertson, et al., *A Study of Hindsight Bias: The Rodney King Case in Retrospect*, 74 PSYCHOL. REP. 383, 383–84 (1994) (studying verdict in first Rodney King case); Hastie & Viscusi, *supra* note 164, at 917 (“[D]ecisions involving evaluations of risk, especially where the judgment requires the decision maker to infer *ex ante* risk estimates from an *ex post* perspective, the typical juror appears to be subject to a massive hindsight bias.”); see also WRAY HERBERT, ON SECOND THOUGHT: OUTSMARTING YOUR MIND’S HARD-WIRED HABITS 47–48 (2010) (explaining the bias and giving examples).

195. Rachlinski, *supra* note 193, at 572.

196. See Donald C. Langevoort, Lecture, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629, 662 (1997) (noting that the potential for hindsight bias in securities fraud cases is “severe”).

197. See John C. Anderson et al., *The Presence of Hindsight Bias in Peer and Judicial Evaluation in Public Accounting Litigation*, 28 TORT & INS. L.J. 461 (1993) (comparing hindsight bias in auditor cases to other settings); Marianne M. Jennings et al., *Causality as an Influence on Hindsight Bias: An Empirical Examination of Judges’ Evaluation of Professional Audit Judgment*, 21 J. ACCT. & PUB. POL’Y. 143, 161 (1998) (finding that the impact of hindsight bias on judges evaluating causation is stronger in some situations than in others).

fraud by hindsight will not pass muster.¹⁹⁸ Judge Easterbrook then popularized the doctrine in *DiLeo v. Ernst & Young*¹⁹⁹ in 1990, leading it to be cited in nearly one-third of all published rule 10b-5 class action opinions²⁰⁰ and creating “a hurdle that plaintiffs in securities cases must overcome.”²⁰¹

In an impressive study, Gulati, Rachlinski, and Langevoort studied a large number of these cases. On the one hand, it might appear that the FBH doctrine is the courts’ way of neutralizing the prejudicial effects of the hindsight bias. But upon further contemplation, the authors suspected that it might actually be a means of disposing of cases quickly to manage dockets. They developed various markers and tested them empirically. All the evidence pointed to judges using the FBH doctrine to manage their dockets rather than to compensate for the adverse effects of the hindsight bias:

[O]ur analysis reveals that the FBH doctrine is not an effort to control the influence of the hindsight bias in securities litigation, but is part of an effort to manage securities cases. Although case management can take many forms, from limiting discovery to facilitating settlement, in this context, judges are seeking to manage securities cases through a thinly disguised effort to screen securities cases at an early stage of the proceedings.²⁰²

Part of the evidence of the prodefendant application of the FBH doctrine is that it is used almost exclusively in situations where the hindsight bias might benefit plaintiffs and almost never in situations where the bias might benefit defendants.²⁰³ In the study’s sample of cases, defendants won 70% of the time when the FBH was mentioned, versus only 47% of the time when it was not.²⁰⁴ The authors concluded:

What is clear . . . is that judges are actively managing the entry and exit of cases at the pleading stage. In a sense, then, the PSLRA’s heightened pleading standards and the FBH doctrine are not just about raising the bar to entry into court, but also

198. *Denny v. Barber*, 576 F.2d 465, 470 (2d Cir. 1978).

199. *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir. 1990).

200. Gulati et al., *supra* note 187, at 775.

201. *Id.*

202. *Id.* at 776–77 (footnote omitted).

203. *See id.* at 777 (“[E]ven though the hindsight bias can benefit or harm a plaintiff’s case, judges selectively target the FBH doctrine at instances in which the doctrine benefits plaintiffs.”).

204. *See id.* at 804 (noting that this difference was statistically significant).

about granting the judges more discretion in deciding who gains entry and who does not.²⁰⁵

d. Fundamental Attribution Error and Motivated Exculpation

If there is one overarching finding from psychological research over the past several decades, it is that the situational tends to dominate the dispositional.²⁰⁶ In other words, people's decision making is heavily influenced by the context in which they make decisions. They don't automatically make good decisions because they are good people or bad decisions because they are bad people. Rather, good people too often make bad decisions because of social or organizational pressures.²⁰⁷

But most people are not aware of the influence of these contextual factors and tend to attribute others' actions to their character, not to situational influences.²⁰⁸ "When observers draw inferences on the causes of another's behavior, they systematically fail to take into account situational factors."²⁰⁹ This is called the *fundamental*

205. *Id.* at 822.

206. See Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CALIF. L. REV. 1051, 1103 (2000) ("[D]espite rational choice theory's implicit prediction to the contrary, context matters in decision making."); Lee Ross & Donna Shestowsky, *Two Social Psychologists' Reflections on Situationism and the Criminal Justice System*, in IDEOLOGY, PSYCHOLOGY, AND LAW 612, 613 (Jon Hanson ed., 2012) ("[W]hen people are called upon to evaluate or predict the behavior of others, they tend to underestimate the impact of situational or environmental factors and to overestimate the impact of dispositional ones.").

207. See, e.g., Joseph L. Badaracco, Jr. & Allen P. Webb, *Business Ethics: A View from the Trenches*, 37 CAL. MGMT. REV. 8, 8 (1995) (finding that freshly-minted Harvard MBAs often felt "strong organizational pressures" to act unethically).

208. For example, when people read an essay written by another person, they tend to attribute that position to the author *even after being informed that the author was forced to take that position*. See Edward E. Jones & Victor A. Harris, *The Attribution of Attitudes*, 3 J. EXPERIMENTAL SOC. PSYCHOL. 1 (1967) (finding a tendency to attribute attitudes to behavior even in no-choice situations); see also Kenworthy Bilz & Janice Nadler, *Law, Psychology, and Morality*, in 50 PSYCHOLOGY OF LEARNING AND MOTIVATION: MORAL JUDGMENT AND DECISION MAKING 101, 104 (Daniel M. Bartels et al. eds., 2009) ("[T]he cognitive processes of actors are opaque but their behavior is apparent, and so people assume that the obvious explanation (people behave the way they do because that is the kind of people they are) governs, and they shape their own behavior and beliefs accordingly.").

209. Quintanilla, *supra* note 39, at 222 (citing LEE ROSS & RICHARD E. NISBETT, *THE PERSON AND THE SITUATION: PERSPECTIVES OF SOCIAL PSYCHOLOGY* 125-34 (1991)).

attribution error and it interacts with the hindsight bias to cause people to conclude not only that people should have made different judgments than they did but also that they made the wrong decision for bad reasons, not because situational factors impacted their decisions. Yet situational factors do tend to exert pervasive influence upon human decision making.²¹⁰

The fundamental attribution error is extremely persistent,²¹¹ and in the present context it can cause judges and jurors to conclude erroneously that a 10b-5 defendant acted with fraudulent intent.²¹² How does this happen, even to intelligent and educated judges?²¹³

210. See, e.g., Cass R. Sunstein, *Misfearing: A Reply*, 119 HARV. L. REV. 1110, 1123 (2006) (book review) (“[S]ocial psychologists have shown that social influences often amplify cognitive errors.”).

In contrast, when people judge *their own behavior*, they do not hesitate to take situational factors into account. See HOGARTH, *supra* note 78, at 154 (“In other words, [we tend to believe that] personality drives the behavior of others, but situation drives our own.”). For that reason, people ascribe less variability to others’ behavior than to their own. See PLOUS, *supra* note 176, at 186–87 (citing studies).

Another factor relevant to *scienter* is the tendency of people to judge the same behavior as more intentional and therefore more deserving of severe punishment when it will be performed in the future than when it has been performed in the past. See Zachary C. Burns et al., *Predicting Premeditation: Future Behavior Is Seen as More Intentional than Past Behavior* 3 (July 5, 2011), available at ssrn.com/abstract=1879558.

211. See PLOUS, *supra* note 176, at 180–81 (describing studies where people not only attributed helping behavior to others’ religiosity, consistent with the fundamental attribution error, but continued to do so even after reading a study that found no such connection).

212. Jeffrey J. Rachlinski, *Rulemaking Versus Adjudication: A Psychological Perspective*, 32 FLA. ST. U. L. REV. 529, 545 (2005) (noting that the adjudicative process, by placing the individual front and center, arguably “induces courts to attribute too much blame to individuals and not enough to social forces”). Quintanilla lauds the *Tellabs* decision as helping to mitigate the fundamental attribution error by requiring judges and juries to compare and contrast culpable and nonculpable alternatives. See Quintanilla, *supra* note 39, at 209–10.

213. One of the nation’s best minds and most prominent judges, Richard Posner of the Seventh Circuit, demonstrated the fundamental attribution error, as well as overconfidence, the self-serving bias, and arguably several other cognitive biases when he argued that the law-and-economics movement was winning hearts and minds because it was free of political biases, whereas competing theories were completely driven by political views. See Richard A. Posner, *The Sociology of Law: A View from Economics*, 2 EUR. J.L. & ECON. 265, 274 (1995) (“Economic theory itself (including the application of the theory to law), at least when employed for positive rather than normative analysis, has no political variance.”). In other words, Posner concluded that people who agreed with him were right because they were not political whereas people who disagreed with him were wrong because they were political. While this argument is often heard on Fox

Quattrone noted that people have two judgment systems working at the same time when they make decisions. “System I” processes are spontaneous and intuitive. They are automatic and rely heavily upon heuristics, some of which are discussed in this paper. “System II” is more deliberative, requiring effort and concentration.²¹⁴ This model was initially developed by Daniel Kahneman and Shane Frederick.²¹⁵

Quattrone developed a model of the mental processes behind the Fundamental Attribution Error based on the finding that people tend to spontaneously (using System I) attribute a connection between another’s dispositions and their behavior.²¹⁶ To take another step and

News and MSNBC, it does not deserve much credit, especially given studies showing that conservatives are more rigidly ideological than liberals. See John T. Jost et al., *Exceptions that Prove the Rule—Using a Theory of Motivated Social Cognition to Account for Ideological Incongruities and Political Anomalies: Reply to Greenberg and Jonas (2003)*, 129 PSYCHOL. BULL. 383, 390 (2003) (“[A]ll 13 studies provided at least some evidence for the rigidity-of-the-right hypothesis.”). Posner’s various versions of it have been strongly criticized. See Jon Hanson & David Yosifon, *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture*, 152 U. Pa. L. Rev. 129, 139 (2003) (“[M]any of the most prominent legal scholars actively reject the tenets of law and economics.”); Jon Hanson & David Yosifon, *The Situational Character: A Critical Realist Perspective on the Human Animal*, 93 GEO. L.J. 1, 79 (2004) (“Posner does more than just selectively reinterpret evidence to corroborate a favored theory. He also fundamentally adjusts the underlying theory, while falsely claiming that its pre-altered version has been confirmed.”). Empirical evidence and a little reflection make it obvious that the model “rational economic man” that lies at the heart of the law and economics movement is not an apolitical fact but an ideology. Barry Schwartz, *Crowding Out Morality: How the Ideology of Self-Interest Can Be Self-Fulfilling*, in IDEOLOGY, PSYCHOLOGY, AND LAW 160, 181 (Jon Hanson, ed. 2012) (“‘Rational economic man’ as a reflection of human nature is a fiction—an ideology.”).

214. See Guthrie et al., *supra* note 165, at 7–9 (explaining that System I processes occur spontaneously and do not consume much attention, while System II processes involve complex thought that assesses the quality of such intuition).
215. See Daniel Kahneman & Shane Frederick, *Representativeness Revisited: Attribute Substitution in Intuitive Judgment*, in HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT 49, 51–60 (Thomas Gilovich, Dale Griffin & Daniel Kahneman eds., 2002) (adopting the labels of “System 1” and “System 2” for their dual-process theory of cognitive processes). For more detail on System I and System II thinking, see generally DANIEL KAHNEMAN, THINKING, FAST AND SLOW (2011) and KEITH E. STANOVICH, WHO IS RATIONAL? (1999).
216. See George A. Quattrone, *Overattribution and Unit Formation: When Behavior Engulfs the Person*, 42 J. PERSONALITY & SOC. PSYCHOL. 593, 607 (1982) (finding this overattribution may “reflect a mixture of unit formation and insufficient adjustment”).

consider the situational factors surrounding the other's decision is effortful,²¹⁷ so System II may not kick in.²¹⁸ Gilbert found that people “tend to draw [System I] dispositional inferences, even when they are informed that behavior is linked to situational factors.”²¹⁹

The Fundamental Attribution Error leads people to tend to conclude that because X did a bad thing, X must be a bad person. Having evidence only of the bad act, and tending to ignore situational factors that may have affected X's decisions, people will tend to conclude that X's bad acts are representative of X's character. But when people believe that they know something about X's character and are not relying solely upon X's actions to draw inferences about X's character, a different dynamic results that, interestingly, may in the present setting push judges in a *prodefendant* direction.

Most courts presume that accountants would not do anything to endanger their reputations.²²⁰ The announced reason for this is a straightforward presumption of economic rationality—auditors' reputations are the key to their prosperity and it would not be rational for them to recklessly aid their clients' fraud and therefore undermine that reputation.²²¹ As indicated elsewhere in this Article, there are pervasive reasons to doubt this theory. First, most people are at best boundedly rational, and that includes auditors.²²² Second, there is sufficient empirical evidence of auditor misconduct to persuasively rebut this presumption as it applies to auditors of public companies specifically.²²³

217. According to Fritz Heider, “behavior . . . engulf[s] the total field,” meaning that when we view others their behavior is the most salient thing we perceive, while situational factors tend to be in the background. FRITZ HEIDER, *THE PSYCHOLOGY OF INTERPERSONAL RELATIONS* 54 (1958).

218. *Id.* at 35, 53–54.

219. Quintanilla, *supra* note 39, at 223 (citing Daniel T. Gilbert, *Ordinary Personology*, in 2 *THE HANDBOOK OF SOCIAL PSYCHOLOGY* 89, 112 (Daniel T. Gilbert et. al. eds., 4th ed. 1998)).

220. *See supra* notes 66–68 and accompanying text.

221. *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990).

222. *See supra* notes 157–66 and accompanying text.

223. *See supra* note 76 and accompanying text. *See also* Kahn & Lawson, *supra* note 67, at 404–05:

[T]here are many reasons to doubt the extent to which auditors will always, or even often, find it in their own best interests to challenge management. First, the financial benefits of complicity with management, in the form of audit fees, future engagements, favorable recommendations, and the like, are tangible and concrete, while the costs in terms of lost reputation are remote, speculative, and uncertain Second, the incentives of the individual auditors reinforce the perverse incentives faced by their audit firms as a whole Third, auditors are subject to

It may be simple intellectual laziness that induces judges to continue this presumption in face of so much contrary evidence, but it is also quite possible that more is at work here. Whereas stereotypes of attorneys tend to paint them as slimy and immoral,²²⁴ stereotypes of accountants picture them, at worst, as boring and timid.²²⁵ Immoral and dishonest character is not a part of society's default vision of accountants. Indeed, in recent movies accountants are most commonly portrayed as heroes.²²⁶

To the extent that judges presume that accountants generally have good character, they will have a tendency to find that whatever bad acts they are associated with were not performed intentionally. Whereas the law formally holds that a defendant's character should have little to do with any legal conclusions regarding motive,

many of the same cognitive biases that plague all people, and many of those biases work in favor of complicity with management Fourth, and most importantly, it is hard to dispute the evidence of what actually happens.

224. See Lawrence S. Krieger, *Human Nature As a New Guiding Philosophy for Legal Education and the Profession*, 47 WASHBURN L.J. 247, 267 (2008) (noting the dishonest-lawyer stereotype); Maury Landsman & Steven P. McNeel, *Moral Judgment of Law Students Across Three Years: Influences of Gender, Political Ideology and Interest in Altruistic Law Practice*, 45 S. TEX. L. REV. 891, 904 (2004) (referencing the "unethical lawyer" stereotype); Ruth E. Piller, Editorial, *Professional Courtesy Does Not Refer to the Marine Kingdom*, 40 HOUS. LAW., Sept.-Oct. 2002, at 10 (noting that "lawyers are often equated with flesh eating fish and used car salesmen"); Kenneth Ward, *Alexander Bickel's Theory of Judicial Review Reconsidered*, 28 ARIZ. ST. L.J. 893, 923 n.164 (1996) (noting "sleazy lawyer" stereotype); John Leubsdorf, Comment, *Class Actions at the Cloverleaf*, 39 ARIZ. L. REV. 453, 456 (1997) (referring to the "greedy lawyer stereotype").
225. As the vocational guidance counselor said in MONTY PYTHON'S AND NOW FOR SOMETHING COMPLETELY DIFFERENT (Columbia Pictures 1971): "Our experts describe you as an appallingly dull fellow, unimaginative, timid, spineless, easily dominated, no sense of humor, tedious company, and irrepressibly drab and awful. And whereas in most professions these would be considerable drawbacks, in accountancy, they are a positive boon." See also Howard Darmstadter, *Explaining with Examples*, 10 SCRIBES J. LEGAL WRITING 137, 141 (2005-2006) (noting that accountants are stereotyped as "dull, dry, meticulous bean counters"); Ian E. Scott, Note, *Fair Value Accounting: Friend or Foe*, 1 WM. & MARY BUS. L. REV. 489, 541 (2010) (noting that an accountant "is stereotypically rigid, rule-based, bookish, and has his calculator ready").
226. Tony Dimnik & Sandra Felton, *Accountant Stereotypes in Movies Distributed in North America in the Twentieth Century*, 31 ACCT. ORG. & SOC'Y 129, 129 (2006) ("Characters with CPAs or CAs are more likely to be Heroes than any other stereotype.").

intentionality, or ultimate blameworthiness,²²⁷ blaming is a social process and it is heavily influenced by psychological factors.²²⁸

In two recent articles,²²⁹ one with Mary-Hunter McDonnell, Professor Janice Nadler has reported a series of experiments indicating that judgments regarding moral character affect people's attributions of motive and intentionality. In other words, if people believe that Joe is a bad person, they will believe that he is acting with more intentionality than if they see Joe perform the exact same acts in the exact same context but believe that he is a good person.

In a series of three experiments they performed providing evidence of a process they call *motivated inculcation*, Nadler and McDonnell reported experiments producing

evidence that when people judge a harmful action performed by a bad person or performed with a bad motive, they are more likely to perceive that person as more responsible, and the act as more causal *and intentional*, than when they judge an identical harmful action performed by a good person or performed with a good motive.²³⁰

For current purposes, it is important to note that the process works both ways. In other words, there is also *motivated exculpation*. If people see a defendant as "good," they are generally motivated to interpret the defendant's wrongdoing as less intentional and less blameworthy.²³¹

In a second set of experiments, Nadler explored the mechanism behind motivated inculcation. Again, her experiments supported the conclusion that "psychological blame is influenced by perceptions of the actor's overall virtue or lack thereof, even apart from the actor's reason for acting in the specific instance."²³² At least part of the

227. FED. R. EVID. 404(a)(1) ("Evidence of a person's character or character trait is not admissible to prove that on a particular occasion the person acted in accordance with the character or trait.").

228. See CHARLES TILLY, CREDIT AND BLAME 4 (2008) ("[C]rediting and blaming are fundamentally social acts.").

229. Janice Nadler, *Blaming as a Social Process: The Influence of Character and Moral Emotion on Blame*, 75 LAW & CONTEMP. PROBS. 1 (2012); Janice Nadler & Mary-Hunter McDonnell, *Moral Character, Motive, and the Psychology of Blame*, 97 CORNELL L. REV. 255, 273 (2012).

230. Nadler & McDonnell, *supra* note 229, at 258 (emphasis added).

231. Nadler and McDonnell's three experiments demonstrated that people interpret certain transgressions as less legally blameworthy when they find the person responsible and likeable. Thus, in a hypothetical where a trailer fire killed two firefighters, a defendant who used the trailer to store fertilizer for his exotic orchids was found less blameworthy than one who used it to manufacture methamphetamines. *Id.* at 276, 283, 291.

232. Nadler, *supra* note 229, at 2.

mechanism at work stems from moral emotions that people feel.²³³ Nadler proposed that “compared to an otherwise virtuous person who causes harm, an otherwise bad person who causes harm makes us feel angrier and more disgusted, which in turn leads to more punitive attributions of blame.”²³⁴ Her experiments generally confirmed the supposition that when an actor’s character is thought to be good, people will judge him as having acted less intentionally in doing a bad act than when his character is perceived to be bad (and vice versa, of course).²³⁵ Overall, “[w]e give the benefit of the doubt to a person with a virtuous character who causes harm: we perceive his actions as *less intentional* and perhaps even less causal, and the harm less foreseeable than if his character is flawed.”²³⁶

To the extent that courts irrationally credit auditors with being economically rational and buy into the common stereotype of accountants as boring but generally honest, they may have a tendency to underestimate the intentionality behind auditors’ acts that contribute to flawed audits.

C. *Exacerbating Judicial Bias*

The conflicting heuristics and biases mentioned above are most likely to favor defendants in the current context, given the strength of the self-serving bias, the vigor with which courts apply the FBH doctrine, the impact of moral exculpation, the current conservatism of the federal judiciary, and the foundational (and erroneous) operative

233. *See generally*, JONATHAN HAIDT, THE HAPPINESS HYPOTHESIS: FINDING MODERN TRUTH IN ANCIENT WISDOM 20–22, 50–51, 54–55 (2006) (emotions play a significant role in guiding people to moral conclusions). Among the most important morality-tinged emotions are guilt, shame, anger, and disgust. *Id.*

234. Nadler, *supra* note 229, at 4. Nadler cites work by Mark D. Alicke also supporting the view that people’s initial emotional reactions to a harm situation directly affect perceptions of harm and *intent*. *See generally*, Mark D. Alicke, *Culpable Control and the Psychology of Blame*, 126 PSYCHOL. BULL. 556, 557–558 (2000) (“[T]he culpable control model . . . emphasize[s] that personal control judgments and blame attributions are influenced by relatively unconscious, spontaneous evaluations of the mental, behavioral, and consequence elements”).

235. Nadler’s experiment had participants read vignettes to assess the blameworthiness of “Nathan,” who accidentally kills another man in a skiing accident. Certain participants read about “good Nathan,” who was a responsible worker and volunteer, and others “bad Nathan,” who was an irresponsible worker. When Nathan’s moral character was “bad,” he was seen as having acted more intentionally and was thus more blameworthy than “good Nathan.” *See* Nadler, *supra* note 229, at 16–27 (describing the design of the experiment and its results). The effect disappeared if study participants were asked to make judgments about *both* “good Nathan” and “bad Nathan” side by side. *Id.* at 25.

236. *Id.* at 29 (emphasis added).

assumption that auditors would not sacrifice their reputations just to please a client and therefore deserve a special level of protection in 10b-5 scienter pleading. Professor Bone has argued that given judges' bounded rationality, it is not necessarily a good idea to give courts significant discretion.²³⁷ The key point to stress is not so much which side is favored by judges' unconscious biases, but the fact that whatever prejudices are in play are exacerbated by both the structure of the decision making process and the vagueness of the law that we document.

First, Rachlinski recently pointed out that the Supreme Court's recent decisions in *Twombly* and *Iqbal* require judges to decide cases based largely upon their first impression of the lawsuit without knowing which facts discovery will uncover.²³⁸ This "encourages judges to rely too heavily on their intuition, elevates the importance of potentially misleading pleading practices, and encourages overconfidence among judges."²³⁹ The PSLRA preceded *Ashcroft* and *Twombly* in encouraging judges to resolve rule 10b-5 cases before discovery, intensifying the impact of judges' psychological biases and cognitive distortions.

Second, the current muddled state of the law exacerbates whatever prejudices happen to apply whereas an ideal legal regime would instead minimize them. As Droske has pointed out, confusion or ambiguity in a doctrine increases the likelihood that the self-serving bias and other behavioral and cognitive effects will lead to judges following their own preferences:

The lack of clarity with respect to whether statutory language is ambiguous provides judges an opportunity to exercise discretion so as to maximize their own personal political preferences. Professors Frank B. Cross and Emerson H. Tiller documented this phenomenon in an essay that empirically showed that judges selectively employed the *Chevron* doctrine—only triggered in cases of statutory ambiguity—so that cases would come out in accord with their political preferences.²⁴⁰

237. See Bone, *supra* note 153, at 2023 ("The naïve assumption that trial judges have the institutional expertise and experience to exercise discretion well ignores serious and unavoidable bounded rationality, information access, and strategic interaction obstacles that impair the quality of case-specific decision-making.").

238. See Rachlinski, *supra* note 174, at 413 ("The new pleading standard that the Court has articulated forces judges to rely on their first impressions of a lawsuit. Judges must imagine the course of the lawsuit without knowing what facts discovery will uncover.").

239. *Id.* at 414.

240. Timothy J. Droske, *Congressional Polarization Due to Maximizing Political Satisfaction: Why Elhauge's Current Enactable Preferences*

Legal indeterminacy fosters unfettered judicial discretion which, in turn, creates more likelihood for judgment error.²⁴¹ Discretion has advantages, but should never be unconstrained.²⁴² Decisionmakers are more likely to be influenced by factors that they themselves view as unjustifiable, when a situation is elastic and there is more wiggle room to choose an outcome.²⁴³ Judicial discretion, while absolutely necessary in some measure, also embodies the “right to be wrong.”²⁴⁴

CONCLUSION

Pleading rules are of central concern to securities antifraud litigation. “Determining who is allowed to invoke the machinery of the civil justice system, and under what circumstances they may do

Default Rule Fails to Avoid the Congressional Deadlock and Polarization That Stems From Expansionist Statutory Interpretation, 102 NW. U. L. REV. COLLOQUY 176, 185 (2008) (citing Cross & Tiller, *supra* note 184, at 2169).

241. See Guthrie et al., *supra* note 165, at 24 (referencing the hindsight bias specifically); Chunlin Leonhard, *A Legal Chameleon: An Examination of the Doctrine of Good Faith in Chinese and American Contract Law*, 25 CONN. J. INT’L L. 305, 311 (2010) (noting that legal vagueness invites broad judicial discretion); Mary Liston, *Witnessing Arbitrariness: Roncarelli v. Duplessis Fifty Years On*, 55 MCGILL L.J. 689, 713 (2010) (“Legal indeterminacy, uncertainty, gaps, and vagueness exacerbate the risks of judicial discretion . . .”); Francis Barry McCarthy, *The Confused Constitutional Status and Meaning of Parental Rights*, 22 GA. L. REV. 975, 1022 (1988) (noting that vague laws create the problem of extensive judicial discretion); Paul L. Smith, *The Primary Caretaker Presumption: Have We Been Presuming Too Much?*, 75 IND. L.J. 731, 742 (2000) (vague legal doctrine leads to “unfettered judicial discretion” (quoting Laura Sack, *Women and Children First: A Feminist Analysis of the Primary Caretaker Standard in Child Custody Cases*, 4 YALE J.L. & FEMINISM 291, 293 (1992))).
242. See generally RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY* 31–39 (1978) (noting that, while judicial discretion is useful when laws are vague or have not been established, there must be standards that determine when judicial discretion may overrule, alter, or establish rules of law).
243. See Nadler & McDonnell, *supra* note 229, at 270 (“We are also influenced by factors that we ourselves regard as unjustifiable, though we may not be aware of such influence. This is especially true when the legitimate evidence is ‘elastic’—that is, when there is more wiggle room to come out either way in their conclusion.” (footnote omitted)).
244. Maurice Rosenberg, *Judicial Discretion of the Trial Court, Viewed from Above*, 22 SYRACUSE L. REV. 635, 637 (1971). And substantive discretion, which is what is at stake here, is more worrisome than procedural discretion. See Marcus, *supra* note 153, at 1605.

so, lies at the core of how a system of law defines itself.”²⁴⁵ Extraordinarily high stakes are involved when rule 10b-5 class action litigation is filed, so it is important to get it right, and it appears that we are not getting it right. Part I of this Article contains a doctrinal analysis that indicates that both general rules of pleading scienter in auditor fraud cases and the practical application of those rules are hopelessly muddled. Part II confirmed this conclusion through empirical study, demonstrating with some rigor that neither plaintiffs nor defendants can predict with any certainty how courts will react to specific factual allegations of auditor scienter in any given case. This is unlikely to be a satisfactory state of affairs, and Part III used the insights of behavioral psychology and related fields to explain why significant doctrinal ambiguity tends to create excessive judicial discretion which, in turn, is a recipe for bias that can disadvantage both plaintiffs and defendants. In the current state of affairs, it seems more likely that plaintiffs will be disadvantaged, but whatever the direction of bias, unfettered discretion is likely to lead to more judicial errors of judgment than would occur under a regime of clearer and more settled law.²⁴⁶

245. Jeffrey J. Rachlinski, *Why Heightened Pleading—Why Now?*, 114 PENN ST. L. REV. 1247, 1247 (2010).

246. Spelling out such a clearer state of the law is a task beyond the scope of this Article, but others have tried, and their efforts deserve some consideration. *See, e.g.*, Olazábal & Abril, *supra* note 3, at 440.



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