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Michael B. Metzger

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I. INTRODUCTION

Misrepresentations or omissions employed in connection with the purchase or sale of a security are made unlawful by section 10(b) of the Securities Exchange Act of 1934,[1] and Securities and Exchange Commission Rule 10b-5,[2] promulgated under the Act. Neither of these provisions, however, explicitly indicates the degree of intent necessary to establish a violation. Rule 10b-5 itself contains language that can be read as prohibiting completely innocent misrepresentations,[3] as well as language that seems to require some level of culpability.[4] As could be expected, this ambiguity has divided both com-

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* Assistant Professor of Business Law, Indiana University.
** Associate Professor of Accounting, Indiana University.

1. The statute, in part, reads as follows:

> 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, 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 (1970).

2. The rule reads as follows:

> It shall be unlawful for any person, directly or indirectly by the use of any means of instrumentality of interstate commerce, or of the mails or 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.

Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1977).

3. *See id.* at § 240.10b-5(b)-(c).

4. *See id.* at § 240.10b-5(a).

mentators[5] and courts.[6] As could also be expected, the ultimate resolution of this issue has been a matter of great concern to professionals regularly involved in securities transactions, such as broker-dealers, investment advisors, attorneys, and accountants. These professionals feared a nonrestrictive and recovery-oriented interpretation that would expose them to potential liability greatly disproportionate to the fees charged for securities transaction services.

In late 1975 and early 1976 securities professionals turned their attention to the case of *Ernst & Ernst v. Hochfelder.*[7] Ernst & Ernst, the auditor of a Chicago brokerage firm, was sued under Rule 10b-5 for negligently failing to discover that the president of the brokerage firm had perpetrated a massive fraud on the brokerage firm's customers.[8] The district court, while rejecting the auditor's contention that the plaintiff-customers could not bring a 10b-5 action grounded solely in negligence, granted the auditor's motion for summary judgment on finding no genuine issue of material fact as to whether Ernst & Ernst

5. *See, e.g.*, Bromberg, *Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 167 (1974); Bucklo, Scienter *and Rule 10b-5*, 67 NW. U.L. REV. 562 (1972); Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. REV. 482 (1970); Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. REV. 1206 (1970); Miller & Subak, *Lessons for Future Counselling of Insurers Involving Ethics, Liabilities, and Securities Regulation*, 30 BUS. LAW. 387 (1975); Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972); Sommer, *Professional Responsibility: How Did We Get Here?*, 30 BUS. LAW. 95, 101-02 (1975); Sonde, *The Responsibility of Professionals Under the Federal Securities Laws—Some Observations*, 68 NW. U.L. REV. 1 (1973); Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057 (1969); Comment, *Scienter and Rule 10b-5: Development of a New Standard*, 23 CLEV. ST. L. REV. 493 (1974); Comment, *Scienter in Private Damage Actions Under Rule 10b-5*, 57 GEO. L.J. 1108 (1969); Comment, *The Development of a Flexible Duty Standard of Liability Under SEC Rule 10b-5*, 32 WASH. & LEE L. REV. 99 (1975).

6. *See* text accompanying notes 25-40 *infra.*

7. 425 U.S. 185 (1976).

8. The plaintiff charged Ernst & Ernst with negligently aiding and abetting violations of Rule 10b-5 by Leston B. Nay, the former president and owner of 92% of the stock of Ernst & Ernst's client, First Securities Company of Chicago. Nay had induced the plaintiffs to invest in bogus "escrow" accounts that Nay had never, in fact, maintained. Nay had instead converted the plaintiff's funds to his own use immediately upon receipt. Nay directed the plaintiffs to make their investments by checks payable to himself or his bank account and established a "mail rule" forbidding other First Securities employees to open any mail addressed to him or for his attention, regardless of the duration of any absence by Nay from the business. No mention of these fraudulent accounts appeared anywhere in First Securities' books or accounts, and the scheme was not uncovered until Nay committed suicide in 1968 and left a note describing First Securities as bankrupt and the escrow accounts as "spurious." The plaintiffs argued that a proper audit by Ernst & Ernst would have led to the discovery of Nay's "mail rule" and ultimately would have disclosed the fraudulent scheme. *Id.* at 189-90.

had conducted its audits in accordance with generally accepted auditing standards.[9] The Seventh Circuit Court of Appeals reversed and remanded,[10] holding that Ernst & Ernst had a statutory duty of inquiry into its client's practices, and that one who breaches such a duty could be held liable for participating in a Rule 10b-5 violation if the fraud would have been discovered but for the defendant's breach of duty.[11] The circuit court remanded the case, concluding that genuine issues of material fact existed as to whether Ernst & Ernst had breached a duty of inquiry and disclosure by failing to discover the fraud.[12]

Many securities professionals hoped that the Supreme Court would take the opportunity presented by a review of *Hochfelder* to do two things. First, the Court could have explicitly held that an accountant complying with generally accepted auditing standards could not be found liable under Rule 10b-5. Second, the Court could have rejected the theory that mere negligence was sufficient basis for 10b-5 liability, and could have required proof of actual intent to defraud as a *sine qua non* for such liability.

On March 30, 1976, when the Supreme Court finally decided *Hochfelder,* it was immediately apparent that the Court had not addressed itself to the issue of whether compliance with generally accepted auditing standards relieved a securities professional of 10b-5 liability. What the Court did hold on the question of the requisite level of intent necessary for 10b-5 liability has, moreover, become a matter of dispute.[13] While contemporaneous commentators believed

9. *Id.* at 191 (district court opinion not reported).

10. Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974).

11. *Id.* at 1119.

12. *Id.* at 1111-12.

13. *See, e.g.,* Adams, *Lessening the Legal Liability of Auditors,* 32 BUS. LAW. 1037 (1977); Cox, *Ernst & Ernst v. Hochfelder: A Critique and an Evaluation of Its Impact upon the Scheme of the Federal Securities Laws,* 28 HAST. L.J. 569 (1977); Floor, *The Scienter Requirement Under Rule 10b-5 and Reliance on Advice of Counsel After Hochfelder,* 12 NEW ENG. L. REV. 191 (1976); Goldwasser, *Ernst & Ernst v. Hochfelder: An Anti-Landmark Decision,* 22 N.Y.L.S. L. REV. 29 (1976); Haimoff, *Holmes Looks at Hochfelder and 10b-5,* 32 BUS. LAW. 147 (1976); Hampson, *Accountants' Liability—The Significance of Hochfelder,* J. ACCOUNTANCY, December 1976, at 69; Schnepper, *The Accountant's Liability Under Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934: The Hole in Hochfelder,* 22 ACCOUNTING REV. 653 (1977); Note, *Securities Law—Intent to Deceive, Manipulate, or Defraud Must be Alleged in a Private Action for Damages Under Section 10(b) of The Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5,* 26 CATH. U.L. REV. 180 (1976) [hereinafter cited as *Allegations in Private Action*]; Note, *Securities Law—Private Cause of Action For Damages Under Rule 10b-5 Requires Scienter*—Ernst & Ernst v. Hochfelder, 25 EMORY L.J. 465 (1976) [hereinafter cited as *Action for Damages*]; Note, *Securities Regulations—Rule 10b-5—Civil Liability Will Not Be Imposed In A Private Cause of Action Under § 10(b) of the Act and Rule*

that securities professionals had been granted diminished responsibility in securities transactions by *Hochfelder*,[14] later authors have suggested that *Hochfelder's* express rejection of a negligence standard, and the Court's requirement of "some element of scienter"[15] for 10b-5 liability, might represent no major change in the liability of accountants.[16] It is with this latter group that we cast our lot.

This Article explores the meaning of the *Hochfelder* Court's use of the term "scienter," by examining the historical context in which the case was decided, the specific language of the opinion, and the treatment *Hochfelder* has received in the lower federal courts that have sought to apply it to subsequent controversies. This Article also examines the relationship between scienter, as defined by such an analysis, and conformance by auditors with generally accepted accounting principles and auditing standards. Finally, an attempt is made to formulate some guidelines for auditors to significantly reduce the risk of legal liability in securities practice. While the principal concern of this Article is with the impact of recent legal developments upon accountants, most of the observations advanced are generally applicable to other securities professionals as well.

II. "SCIENTER" AND *HOCHFELDER'S* HISTORICAL CONTEXT

When one considers the semantic fog that has traditionally surrounded the concept of scienter, the confusion generated by *Hochfelder's* discussion of the term should come as no surprise. As one observer noted, scienter "has been variously defined to mean everything from knowing falsity with an implication of *mens rea*, through the various gradations of recklessness, down to such nonac-

10b-5 Absent An Allegation of "Scienter"; Proof of Negligent Conduct Will Not Suffice—Ernst & Ernst v. Hochfelder, 10 GA. L. REV. 856 (1976); Note, *Securities Regulation*—Ernst & Ernst v. Hochfelder—*Rule 10b-5: Reckless or Knowing Violations?*, 2 J. CORPORATION L. 389 (1977) [hereinafter cited as *Reckless or Knowing Violations*]; Note, *Scienter's Scope and Application in Rule 10b-5 Actions: An Analysis in Light of* Hochfelder, 52 NOTRE DAME LAW. 925 (1977); Note, *Evolving Standards of Personal Liability and Scienter Under Rule 10b-5*, 16 WASHBURN L.J. 344 (1977); 25 DEPAUL L. REV. 962 (1976); Liggio, *The "Ernst" Ruling—Expansion of a Trend*, N.Y.L.J., Apr. 14, 1976, at 1, col. 2-4, Apr. 15, 1976, at 1, col. 2-4.

14. *See, e.g.*, Adams, *supra* note 13; Hampson, *supra* note 13; Liggio, *supra* note 13.

Not all observers were pleased to find that the Supreme Court had significantly limited the potential liability of securities professionals. *See, e.g., Allegations in Private Action*, *supra* note 13, at 192; Note, *Securities Regulation—Rule 10b-5—Scienter Required for Private Action*, 42 Mo. L. REV. 337, 345 (1977).

15. 425 U.S. at 201.

16. *See, e.g.*, Haimoff, *supra* note 13; *Reckless or Knowing Violations*, *supra* note 13, at 403.

tion as is virtually equivalent to negligence or even liability without fault . . . ."[17] One commentator has gone so far as to suggest that "the most important step toward clarifying the law of scienter would be to ban the word."[18]

In attempting to discern the meaning of scienter as used in Rule 10b-5, it is instructive to look first at the possible levels of culpability that can accompany any misstatement or omission. These have been defined by one authority as:

1. *intentional misconduct* designed to deceive the investor;
2. *knowing misconduct* whereby the defendant knows of the misstatement or omission, but lacks the actual intent to deceive;
3. *reckless conduct* whereby the defendant neither intended the harm, nor actually knew of the misstatement or omission but has acted carelessly;
4. *negligent conduct* whereby the misstatements or omissions could have been avoided by the exercise of due care; and
5. *innocent conduct* whereby the misstatements or omissions could not have been avoided even by the exercise of due care.[19]

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17. 3 L. Loss, Securities Regulation 1432 (2d ed. 1961).

18. 2 A. Bromberg, Securities Law: Fraud, § 8.4(503), at 204.103 (Supp. 1971).

19. Ruder, *Factors Determining the Degree of Culpability Necessary For Violation of the Federal Securities Laws In Information Transmission Cases*, 32 Wash. & Lee L. Rev. 571, 575 (1975).

For a similar explication of scienter in a securities context, see Bucklo, *supra* note 5, at 567-68, where the author posits the situation of two corporate officers who make misleading statements in a press release about a new fiberglass substitute that the corporation has acquired exclusive right to use. The author then observes that:

> The defendants' degrees of knowledge and state of mind at the time the shares were sold to the public could be any of the following:
>
> 1. They could have been convinced that the material was strong and durable, based solely on their attorney's statements regarding testing by a market research firm, and on successful first-year production. [This state the author equates with *innocent* conduct. *See id.* at 568.]
>
> 2. They could have believed in the superiority of the material for their uses, but may have known that these beliefs were based solely on the original patentee's statements and their own initial success in experimental production. [This state the author equates with *negligence. See id.* at 569.]
>
> 3. They might not have known whether the representations were true, since they had not begun production or testing designed to discover whether the material would be suitable or not. [This state the author equates with *recklessness. See id.*]
>
> 4. They could have known of the falsity of their statements but hoped that, with additional experimentation, the material would be suitable for their purposes. [This state the author equates with *knowing behavior. See id.* at 568.]
>
> 5. They could have known of the falsity of their statements and simply intended to create a demand for the stock which would raise its market value quickly, having no intention ever to market any of the products described in the release. [This state the author equates with intent to defraud equivalent to *malice. See id.*]

Much of the confusion that has traditionally existed about the meaning of scienter, and that continues to exist in Rule 10b-5 cases,[20] concerns the question of whether one must prove "intentional misconduct" in order to establish scienter. When the meaning of scienter is examined in the context of common law fraud, however, it becomes apparent that proof of "knowing" or "reckless" conduct has always been sufficient to demonstrate scienter.

In *Ultramares v. Touche*,[21] for example—a case familiar to most accountants as standing for the proposition that an accountant's liability for negligent misrepresentations in a financial statement would not extend to third parties—Judge Cardozo indicated that an accountant could be held liable to third parties for recklessness, which he defined as "the pretense of knowledge where knowledge there is none."[22]

This definition was elaborated on in *State Street Trust Co. v. Ernst*:[23]

> A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there is no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequences may take the place of deliberate intention.[24]

A brief look at those pre-*Hochfelder* cases that rejected the notion that mere negligence can provide a basis for Rule 10b-5 liability also demonstrates that the majority of the circuits were moving toward a definition of scienter that embraced both reckless and knowing misconduct. For example, the Second Circuit, in *Lanza v. Drexel & Co.*,[25] held that "willful or reckless disregard"[26] of the truth was sufficient for liability. This standard was later restated by a district court as "actual knowledge or reckless disregard for the truth."[27] The

20. *See, e.g.*, Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1291 (2d Cir. 1969) (common law fraud elements need not be present), *cert. denied*, 397 U.S. 913 (1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968) (en banc) (proof of a specific intent to deceive is not required), *cert. denied*, 394 U.S. 976 (1969); Stevens v. Vowel, 343 F.2d 374, 379 (10th Cir. 1965) (common law fraud need not be alleged or proved).

21. 255 N.Y. 170, 174 N.E. 441 (1931).

22. *Id.* at 179, 174 N.E. at 444.

23. 278 N.Y. 104, 15 N.E.2d 416 (1938).

24. *Id.* at 112, 15 N.E.2d at 419.

25. 479 F.2d 1277 (2d Cir. 1973).

26. *Id.* at 1306.

27. Katz v. Realty Equities Corp., 406 F. Supp. 802, 805 (S.D.N.Y. 1976).

Third Circuit imposed liability for "fraudulent and material misrepresentation,"[28] and the Fifth Circuit required "more than ordinary negligence,"[29] or "some culpability beyond mere negligence."[30] The Tenth Circuit covered the waterfront, so to speak, when, in discussing the trial court's instructions in *Clegg v. Conk*,[31] it observed that the instructions would have been in error had they indicated that liability could be predicated upon untrue statements or omissions resulting from "mere negligence" and without any manner of "scienter, conscious fault, intention, or recklessness."[32] The court reiterated that "simple negligence would not be enough"[33] for liability, and noted with satisfaction that the trial court's instructions sufficiently recognized "the requirement of 'scienter' or conscious fault."[34]

On the other hand, the terminology employed by those few courts that purported to eschew a scienter requirement strongly suggests that those courts were laboring under the mistaken belief that proof of scienter required proof of actual intent to defraud. For example, the Eighth Circuit, in *Myzel v. Fields*,[35] stated that "[p]roof of 'scienter,' i.e., knowledge of the falseness of the impression produced by the statements or omissions made is not required . . . ."[36] for 10b-5 liability. Likewise, the Seventh Circuit, in *Kohler v. Kohler Co.*,[37] observed that "knowledge of the falsity or [the] misleading character of a statement and a bad faith intent to mislead or misrepresent are not required to prove a violation of the statute . . . ."[38]

It is also interesting to note that in both of these cases the statements were dicta, there being adequate factual bases for a finding of actual intent to defraud. The Court in *Hochfelder* recognized this fact by stating that "few of the decisions announcing that some form of negligence suffices for civil liability under § 10(b) and Rule 10b-5 actually have involved only negligent conduct."[39] The courts may, therefore, actually have applied the same standard despite semantic differences in the tests that were espoused prior to *Hochfelder*.[40]

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28. Kohn v. American Metal Climax, Inc., 458 F.2d 255, 269 (3d Cir. 1972).
29. Woodward v. Metro Bank, 522 F.2d 84, 93 (5th Cir. 1975).
30. Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir. 1974), *cert. denied*, 419 U.S. 873 (1974).
31. 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975).
32. 507 F.2d at 1362.
33. *Id.*
34. *Id.* at 1363.
35. 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).
36. *Id.* at 734-35.
37. 319 F.2d 634 (7th Cir. 1963).
38. *Id.* at 637.
39. 425 U.S. at 193 n.12 (citing Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974), *cert. denied*, 419 U.S. 873 (1974)); Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir. 1972).
40. *See* Haimoff, *supra* note 13.

III. *ERNST & ERNST V. HOCHFELDER*

Much of the confusion surrounding the *Hochfelder* Court's use of the term "scienter" would be eliminated if *Hochfelder* were viewed as standing only for the proposition that 10b-5 liability cannot be predicated upon negligence alone. The imposition of liability based upon more culpable "reckless" or "knowing" behavior is therefore consistent with the Court's language and reasoning.[41] Rather than pursue an exhaustive analysis of *Hochfelder,* a task that has been performed elsewhere,[42] this examination is confined to those aspects of the Court's opinion that bear on this restrictive view.

An analysis of the Court's reasoning concerning the meaning of the language of section 10(b)[43] reveals a primary emphasis upon the insufficiency of negligence as a basis for liability.[44] The Court observed that "the use [in section 10(b)] of the words 'manipulative,' 'device,' and 'contrivance,' . . . connotes intentional or willful conduct designed to deceive or defraud investors."[45] Justice Powell framed the issue before the Court as "whether a private cause of action for damages [existed] under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud."[46] As previously noted,[47] however, "reckless" or "knowing" behavior has traditionally sufficed for proof of scienter in the area of common law fraud. The Court acknowledged this fact:

> In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act.

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41. The authors are not alone in this view of *Hochfelder. See, e.g.,* Floor, *supra* note 13, at 192 ("We conclude that constructive knowledge of the crucial facts based upon reckless disregard of those facts will supply the sufficient element of *scienter* for Rule 10b-5 private liability."); Haimoff, *supra* note 13, at 162; *Reckless or Knowing Violations, supra* note 13, at 403. *But see* Liggio, *supra* note 13, Apr. 14, 1976, at 2, col. 3; *Allegations in Private Action, supra* note 13, at 188 ("The narrow *Ernst & Ernst* test does not include the knowing use of a fraudulent device or constructive intent, i.e. reckless behavior, two elements that had previously been included in standards articulated by the circuits.").

42. *See* authorities cited in note 13 *supra.*

43. The Court found the statutory language to be "dispositive of the appropriate standard of liability" for 10b-5 actions. 425 U.S. at 214 n.33.

44. Indeed, since the plaintiffs in *Hochfelder* expressly disavowed any claim that Ernst & Ernst had been more than negligent, the case can technically be distinguished on that basis, relegating any other language in the opinion to the status of dictum. *See* Floor, *supra* note 13, at 201-02. One commentator has argued that *Hochfelder's* holding on the issue of the nonsufficiency of negligence may even be viewed as dictum, since Ernst & Ernst may not even have been guilty of negligence. *See Action for Damages, supra* note 13, at 470 n.19.

45. 425 U.S. at 199.

46. *Id.* at 193. In the footnote accompanying Justice Powell's statement of the issue, scienter was described in the same terms. *See id.* at 193 n.12.

47. *See* notes 25-40 *supra* and accompanying text.

> 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.[48]

The Court's intent to limit the scope of its holding to a rejection of the negligence standard is repeatedly demonstrated elsewhere in the opinion. For example, the Court described scienter as requiring *"knowing* or intentional misconduct,"[49] and, in describing the schism between the circuits, contrasted those cases holding that "negligence alone is sufficient for civil liability" with those requiring "some type of *scienter*—i.e., intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud . . . ."[50] At another point, the Court characterized its holding as "our conclusion that § 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone,"[51] and observed that the language of section 10(b) clearly demonstrates "congressional intent to proscribe a type of conduct quite different from negligence."[52]

The Court's comments on the legislative history of the 1934 Securities Exchange Act demonstrate a similar emphasis upon rejection of the negligence standard. The Court first cited a statement by a representative of the drafters of section 10(b) describing the section as a "catchall" provision aimed at "manipulative" and "cunning" devices.[53] The Court then observed that "[i]t is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions."[54] The Court also noted language in a congressional report commenting on the express civil liability sections of the 1934 Act which stated that a defendant "may escape liability by showing that the statement was made in *good faith,"*[55] and therefore concluded that "[t]he catchall provision of § 10(b) should be interpreted no more broadly."[56] Suits obviated by this interpretation are those predi-

48. 425 U.S. at 193 n.12. In this note the Court also acknowledged that some courts of appeal had held recklessness to be sufficient for scienter (citing Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), *cert. denied,* 422 U.S. 1007 (1975), and Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973)).

49. 425 U.S. at 197 (emphasis added).

50. *Id.* at 193 n.12.

51. *Id.* at 201.

52. *Id.* at 199.

53. *Id.* at 202-03 (citing statements found in *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce,* 73d Cong., 2d Sess 115 (1934).

54. 425 U.S. at 202-03.

55. *Id.* (emphasis in original) (quoting S. REP. No. 792, 73d Cong., 2d Sess. 13 (1934)).

56. 425 U.S. at 206.

cated upon negligence, which can coexist with "good faith." Actions not barred by this interpretation are those in which lack of "good faith" is shown by proof of "knowing" or "reckless" conduct.[57]

The Court noted further that the express liability sections of the 1933 Act, which grant civil relief for negligence,[58] are governed by procedural restrictions that significantly limit the availability of such relief, thereby deterring spurious claims lodged solely for their potential settlement value.[59] Since these restrictions are not applicable to judicially created 10b-5 suits, the Court concluded that their absence from section 10(b) indicated a congressional intent to preclude private 10b-5 actions grounded in negligence,[60] the approval of which would "nullify" the effect of the restrictions.[61] Reasoning predicated on the avoidance of spurious claims does not, however, bar 10b-5 actions grounded on "knowing" or "reckless" conduct, since proof of such behavior imposes a greater burden on plaintiffs than does proof of negligence. This additional burden discourages spurious claims and thus satisfies the underlying policy of the procedural restrictions of the 1933 Act.[62]

Furthermore, when one views the Court's phraseology against the backdrop of prior 10b-5 cases, it becomes even more evident that the Court intended to do nothing more than reject the negligence standard. The Court must have expected that those circuits that had previously embraced a recklessness standard would seize upon the opportunity presented by the Court's express reservation regarding recklessness and continue to impose liability for recklessness. It also must have seemed apparent to the Court that those tribunals that had previously recognized a negligence standard would be inclined to embrace the recklessness standard as the next best alternative. Moreover, since no prior 10b-5 case had clearly required an actual intent to deceive as a prerequisite for liability,[63] it is unlikely that the Court would have chosen such equivocal language had it intended to reject the bulk of previous 10b-5 caselaw.[64]

Although the Court expressly refrained from considering general questions of public policy underlying the securities acts,[65] an examination of such considerations supports the appropriateness of a con-

57. *See Reckless or Knowing Violations, supra* note 13, at 400.

58. These are sections 11, 12(2), and 15 (codified at 15 U.S.C. § 77h, § 77*l*(2), and § 77*o*, respectively).

59. *See* 425 U.S. at 210 n.30.

60. *See id.* at 210-11.

61. *See id.* at 208-10.

62. *See Reckless or Knowing Violations, supra* note 13, at 401.

63. *See* notes 25-40 *supra* and accompanying text.

64. *See* Floor, *supra* note 13, at 206.

65. *See* 425 U.S. at 214 n.33.

ception of scienter embracing both "knowing" and "reckless" conduct. The Court has frequently identified an underlying congressional concern for the protection of investors against false and deceptive practices in the purchase or sale of securities, and has stressed the importance of a flexible, nonrestrictive interpretation of the securities acts to effectuate that purpose.[66] Clearly, a "knowing" or "reckless" scienter standard would be consistent with this prophylactic purpose.[67]

The Court has also frequently recognized that an underlying objective of the securities acts is to facilitate full disclosure to the investing public.[68] It has been argued that a negligence standard would deter voluntary corporate disclosures, since such a standard threatens great liability for an inadvertent mistake, thus frustrating the policy of disclosure.[69] A "reckless" or "knowing" standard, on the other hand, would seem to be an acceptable balance between the need for investor protection and the need for voluntary disclosure of information.[70]

The Court's fear that adoption of a negligence standard would "significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts"[71] may also be abated by a "reckless" or "knowing" standard. The *Hochfelder* Court reiterated its previous expression of concern in *Blue Chip Stamps v. Manor Drug Stores*,[72] that "the inexorable broadening of the class of plaintiff who may sue in this area of the law will ulti-

66. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (Acts to be interpreted "not technically and restrictively, but flexibly to effectuate [their] remedial purposes") (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963)). *See also* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) ("Section 10(b) must be read flexibly, not technically and restrictively.").

67. In keeping with the broad remedial aims of the antifraud provisions of the federal securities laws such a standard of responsibility, while requiring proof of more than mere negligence, would not permit [defendants] to escape liability by pleading ignorance where it can be shown that red flags putting them on notice or providing warning signals of either undisclosed or misrepresented facts of a material nature were readily apparent to all and that a routine check would have disclosed the misrepresentation.

Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341, 398 (2d Cir.) (Mansfield, J., concurring), *cert. denied*, 414 U.S. 910 (1973). *See also Reckless or Knowing Violations, supra* note 13, at 402.

68. *See* SEC v. Howey Co., 328 U.S. 293, 299 (1945).

69. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969).

70. *See Reckless or Knowing Violations, supra* note 13, at 403.

71. 425 U.S. at 214 n.33.

72. 421 U.S. 723 (1975), *cited at* 425 U.S. 185, 214 n.33.

mately result in more harm than good,"[73] and noted once again Judge Cardozo's famous comment in *Ultramares*[74] that "[t]he hazards of a business conducted on these terms [(the threat of auditor liability to third parties for negligence)] are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes [auditors] to these consequences."[75] A "knowing" or "reckless" test does not extend liability as far as a negligence test does and is consistent with the common law fraud concepts that Cardozo found to be an adequate basis for liability.[76]

Finally, two actions by the Court since it decided *Hochfelder* serve to buttress the limited significance attributed to the case. First, the Court denied certiorari to an appeal from the criminal conviction of an accountant for violation of section 32(a) of the 1934 Act,[77] less than three weeks after the *Hochfelder* opinion was rendered. In *United States v. Natelli,*[78] an accountant made false statements in a proxy. In affirming the accountant's conviction, the court of appeals approved the district court's jury instruction that the jurors might find the accountant "knew" of the falsity of the statement if he acted " 'in reckless disregard' of the facts or if he 'deliberately closed his eyes' " to the obvious.[79] Although *Natelli* was not a 10b-5 case, it is doubtful that recklessness could suffice for criminal violation of the 1934 Securities Act and yet be insufficient as a basis for 10b-5 civil liability.[80] Second, the Supreme Court has recently described *Hochfelder* as "holding that a cause of action under Rule 10b-5 does not lie for mere negligence . . . ."[81]

IV. *HOCHFELDER'S* PROGENY

The following analysis of post-*Hochfelder* scienter cases provides considerable support for the proposition that recklessness will ultimately gain recognition as a sufficient basis for 10b-5 liability. Some of the circuits have already accepted the recklessness standard. Cases in other circuits, although suggesting that 10b-5 actions require either

73. 421 U.S. at 747-48.

74. *See* note 21 *supra.*

75. *Ultramares v. Touche,* 255 N.Y. 170, 179-80, 172 N.E. 441, 444 (1931) (*quoted in* 421 U.S. 723, 748).

76. *See* text accompanying note 22 *supra.*

77. 15 U.S.C. § 78ff(a) (1970) (amended 1975 & 1977).

78. 527 F.2d 311 (2d Cir. 1975), *cert. denied,* 425 U.S. 934 (1976).

79. 527 F.2d at 324. Natelli, after the accounting period in question, had accepted a writing from the management of his client, National Student Marketing, which purported to represent a substantial contract in replacement of a similar contract which had been previously rejected.

80. *See, e.g.,* Note, Herzfeld *Revisited After* Hochfelder: *The "Scienter" Standard Applied to the Reporting of Uncertainties,* 14 AM. BUS. L.J. 252, 258 (1976).

81. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977).

knowing or intentional misconduct, often contain language recognizing common law fraud concepts. These cases, which generally suggest the courts' misunderstanding of applicable precedent, invariably involve either a total absence of reckless conduct on the part of the defendant, or clear evidence of knowing or intentional conduct. Since in no case has a provably reckless defendant escaped liability, the language of circuits that have not yet clearly accepted the recklessness standard may be considered dicta.

A. The Second Circuit

As previously noted, prior to *Hochfelder* "willful or reckless disregard for the truth" was firmly established in the Second Circuit as the requisite level of scienter for 10b-5 liability.[82] An examination of the Second Circuit's post-*Hochfelder* decisions confirms the continued viability of recklessness as a basis for liability in that circuit.

The major case involving auditor liability under 10b-5 in the Second Circuit is *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath.*[83] The defendant Laventhol was sued for misleading statements contained in the audited financial statements of Firestone Group, Ltd. (FGL), a California real estate company. The controversy centered around Laventhol's accounting treatment of two November, 1969, real estate transactions in which FGL purportedly purchased and resold 23 nursing homes at a profit.[84] These transactions, supposedly entered into in the final days of the accounting period, greatly altered FGL's otherwise discouraging financial posture.[85] From the outset, however, there were enough suspicious circumstances surrounding the transactions to alert even the most obtuse observer. Both "agreements" were on identical forms and were obviously incomplete.[86] They called for small down payments with the great bulk of the respective purchase prices to be paid after the accounting period.[87] Laventhol learned that the purchaser's net worth was miniscule.[88] Neither transaction was recorded in FGL's books and there were no corporate minutes or resolutions referring to the trans-

82. *See* text accompanying notes 25-27 *supra.*

83. 540 F.2d 27 (2d Cir. 1976). The plaintiff had purchased over $500,000 worth of FGL stock. In addition to Laventhol, plaintiff had also sued Allen & Co., FGL's underwriter, and FGL's principals, all of whom entered into settlements with plaintiff. *See id.* at 29.

84. *See id.* at 30.

85. The purchase and sale of the nursing homes would have been the largest single transaction in the history of FGL. *See id.*

86. Each statement referred to nonexistent "exhibits" which were to disclose the actual properties subject to sale. *See id.*

87. FGL was to pay $5,000 down on the nursing homes and receive $25,000 down on the resale. *See id.*

88. The purchaser's net worth was only $100,000. *See id.* at 31.

actions,[89] a situation to which Laventhol responded by preparing adjusting entries for FGL's books.[90] As the court later observed, "[l]ittle wonder that when at the outset a Laventhol partner was discussing the situation from an accounting standpoint, he referred to it as a 'fictitious or proposed or artificial transaction.' "[91]

Based on this record, Laventhol, on December 6, 1969, sent FGL a consolidated balance sheet and income statement that reflected a figure of $1,795,500 as "unrealized gross profit" resulting from the transactions. An explanatory note to the income statement stated that "because of the circumstances and nature of the transactions, $1,795,500 of the gross profit thereon will be considered realized when the January 30, 1970 payment is received."[92] This, however, was not enough to satisfy FGL, which threatened to withdraw its account and sue Laventhol if it was unsuccessful in securing the desired private placement. Laventhol responded by marking the first report as "Withdrawn and Superseded" and providing a second report.[93]

In the second report, which was distributed to FGL's investors,[94] the designation in the income statement had been changed from "unrealized gross profit" to "deferred gross profit" and the explanatory note changed to read: "Of the total gross profit of $2,030,500, $235,000 is included in the Consolidated Income Statement and the balance of $1,795,000 will be considered realized when the January 30, 1970 payment is received. The latter amount is included in deferred income in the consolidated balance sheet."[95] Laventhol did qualify its opinion letter in the second report by declaring: "In our opinion, subject to the collectibility of the balance receivable on the contract of sale . . . the accompanying consolidated balance sheet and related consolidated statements of income and retained earnings present fairly the financial position of [FGL]."[96] The plaintiff read the Consolidated Statement of Income and Retained Earnings, but did not read Laventhol's opinion letter or explanatory note.[97] Neither of the two real estate transactions was ever consummated, and within a year FGL had filed a bankruptcy petition.[98]

89. *See id.* at 30.

90. *See id.* The letter from Laventhol's audit manager to FGL's controller containing these entries referred to them as "the journal entries which we *generated* for the financial statements at November 30." *Id.* (emphasis by the court).

91. *Id.*

92. *Id.* at 31.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.* at 32.

98. *Id.*

The trial court entered a judgment against Laventhol in the amount of $153,000, finding the defendant's report to be "materially misleading"[99] in numerous respects and that Laventhol had the necessary scienter, namely, "knowledge of the fact that the figures created a false picture."[100]

In affirming the trial court's decision, the court of appeals cited numerous accounting principles that it believed Laventhol had violated by treating the transactions in question as though they were consummated and as though current and deferred profit had been realized.[101] The "deferred profit" phraseology, the court observed, "conveyed the erroneous impression that all that profit was so much cash in hand and would be recognized periodically *in futuro* just as if it were prepaid interest or management fees."[102] The court observed that this misleading impression could "have been remedied by simply not recognizing the sales as completed transactions for the accounting period ending November 30, 1969."[103] Laventhol argued that its qualified opinion should insulate it from liability, but the court found the qualification to be inadequate, since ". . . Laventhol did not provide a *clear explanation of the reasons for the qualification.*"[104]

What test for scienter did *Herzfeld* adopt? Although *Herzfeld* has been cited as standing for the proposition that recklessness is sufficient for 10b-5 scienter,[105] it is difficult to justify such a conclusion. In distinguishing the case before it from the facts of *Hochfelder,* the *Herzfeld* court observed: "The accountants here are not being cast in damages for negligent nonfeasance or misfeasance, but because of their active participation in the preparation and issuance of false and materially misleading accounting reports upon which Herzfeld relied to his damage."[106] While there can be no doubt that Laventhol was "reckless," it also seems certain that there was sufficient evidence of "knowing" conduct present to limit the scope of the

99. Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 124 (S.D.N.Y. 1974).

100. *Id.* at 127 (quoting Republic Technology Fund, Inc. v. Lionel Corp., 483 F.2d 540, 541 (2d Cir. 1973)).

101. *See* 540 F.2d at 34-37.

102. *Id.* at 35.

103. *Id.* at 37.

104. *Id.* at 36 (emphasis in original). The court stated that "a simple note would have sufficed saying in substance: 'Agreement for the purchase of [the nursing homes] . . . and the sale thereof . . . , have been executed. When, as and if these transactions are consummated, FGL expects to realize a profit of $2,030,500.'" *Id.* It is interesting to speculate whether such a disclaimer would truly have sufficed to nullify the otherwise misrepresentative character of the financial statements, in view of the other factors known to Laventhol that indicated the transactions were of questionable validity. Clearly the trial court would not have thought so.

105. Coleco Industries, Inc. v. Berman, 567 F.2d 569, 574 (3d Cir. 1977); Aldrich v. New York Stock Exch., Inc., 446 F. Supp. 348 (S.D.N.Y. 1977).

106. 540 F.2d at 37.

court's holding to the proposition that "knowing" conduct will suffice for 10b-5 liability.[107]

Subsequent Second Circuit cases have, however, clearly endorsed the "willful or reckless disregard for the truth" standard enunciated in the circuit's pre-*Hochfelder* decision of *Lanza v. Drexel,*[108] which extended liability to those who actively participate in or give knowing assistance to a fraudulent scheme.[109] The subsequent Second Circuit cases have also retained *Lanza's* qualification that defendants charged with a passive failure to disclose material facts have no general duty to make such disclosures, absent some notice that misleading information is being conveyed.[110]

This distinction between active and passive failure to disclose was clearly enunciated in *Hirsch v. duPont.*[111] The plaintiffs in *Hirsch* were the major partners in a brokerage firm that had merged with F. I. duPont, losing all their capital in duPont's subsequent failure. They filed a 10b-5 suit against the New York Stock Exchange, which had supervised the merger, and Haskins & Sells, duPont's auditor. The suit was brought for failure to disclose that duPont had been in violation of the Exchange's net capital rule, and had made up the deficiency by liquidating "long" securities count differences.[112] The

107. Arguably Laventhol would not have been guilty of "intentional misconduct" unless it had been shown that it actually knew the agreements in question were bogus. *See* note 19 *supra.*

108. 479 F.2d 1277 (2d Cir. 1973). *See* text accompanying notes 25-27 *supra.*

109. *See, e.g.,* Jacobson v. Peat, Marwick, Mitchell & Co., 445 F. Supp. 518 (S.D.N.Y. 1977); Steinberg v. Carey, 439 F. Supp. 1233, 1238-39 (S.D.N.Y. 1977); Gross v. Diversified Mortgage Investors, 431 F. Supp. 1080 (S.D.N.Y. 1977); Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1039 (S.D.N.Y. 1977), *aff'd in part,* 570 F.2d 38 (2d Cir. 1978); Van Alan v. Dominick & Dominick, Inc., 441 F. Supp. 389, 400 (S.D.N.Y. 1976); Poloron Prods., Inc. v. Lybrand Ross Bros. & Montgomery, 72 F.R.D. 556, 559 (S.D.N.Y. 1976); Lewis v. Black, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,638, at 90,165 (E.D.N.Y. 1976).

110. We conclude that a director in his capacity as a director (a nonparticipant in the transaction) owes no duty to insure that all material, adverse information is conveyed to prospective purchasers of the stock of the corporation on whose board he sits. A director's liability to prospective purchasers under Rule 10b-5 can thus only be secondary, such as that of an aider and abettor, a conspirator, or a substantial participant in fraud perpetrated by others.

Lanza v. Drexel & Co., 479 F.2d 1277, 1289 (2d Cir. 1973). *See also* Murphy v. McDonnell & Co., 553 F.2d 292 (2d Cir. 1977); Steinberg v. Carey, 439 F. Supp. 1233 (S.D.N.Y. 1977); Halcyon Sec. v. Chase Manhattan Bank, 439 F. Supp. 650 (S.D.N.Y. 1977); Faturik v. Woodmere Sec., Inc., 431 F. Supp. 894 (S.D.N.Y. 1977).

111. 553 F.2d 750 (2d Cir. 1977).

112. "Long" differences occur when the "physical inventory of securities on hand, fails to tally with the broker's records of ownership," *id.* at 754 n.5, and the broker has securities on hand whose owner cannot be determined from the broker's records. Those securities whose owners could not be identified were assumed to be duPont's and sold. *See id.* at 754 n.5.

court of appeals affirmed the district court's decision to grant summary judgment for the defendants, holding that neither defendant owed a duty of disclosure to the plaintiffs and that the information was, in any case, available to the plaintiffs upon the exercise of due diligence.[113] In discussing the issue of aider-abettor liability of the Exchange, the circuit court observed: "We do not believe that the scienter required for rule 10b-5 aider-abettor liability . . . is present where, as here, the defendant entertains a reasonable belief that 'all the facts' have been fully disclosed."[114] The court went on to say that "knowledge of the fraud, and not merely the undisclosed material facts, is indispensable [for aider-abettor liability]."[115] With respect to Haskins & Sells's liability, the court observed: "We are not convinced, on the basis of the record before us, that Haskins & Sells's treatment of duPont's certified statement of financial condition violated generally accepted accounting practices as they stood in 1969."[116] The court noted that it was not until 1973 that the American Institute of Certified Public Accountants required disclosure of such violations of net capital rules,[117] and that the information had been available to the plaintiffs, who had failed to request it.[118]

In *Rolf v. Blyth Eastman Dillon & Co.*,[119] the court of appeals endorsed a recklessness standard for defendants who owe injured parties a fiduciary duty of disclosure.[120] In *Rolf*, a registered representative of a broker-dealer was charged with aiding and abetting the allegedly fraudulent management of an investor's portfolio by an investment adviser whom the broker-dealer supervised. In the course of nine months, the plaintiff's entire portfolio of $1,423,000 worth of stocks had been liquidated and replaced by many highly speculative issues, producing a fifty percent decline in the value of the investor's holding.[121] In affirming the district court's finding against the representative, the court of appeals noted that it had recognized the concept of aiding and abetting liability for section 10(b) and Rule 10b-5 violations,[122] and concluded:

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113. *See id.* at 753.

114. *Id.* at 759 (citations omitted).

115. *Id.*

116. *Id.* at 761.

117. *See* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AUDITS OF BROKERS AND DEALERS IN SECURITIES 104 (1973).

118. *See* 553 F.2d at 761.

119. 570 F.2d 38 (2d Cir. 1978).

120. *Id.* at 46. *See Cumis Ins. Soc'y v. E.F. Hutton & Co.*, [1978] FED. SEC. L. REP. (CCH) ¶ 96,576, at 94,431-32 (construing *Rolf*); Edwards & Hanley v. Wells Fargo Securities Clearance Corp., [1978] FED. SEC. L. REP. (CCH) ¶ 96,573, at 94,399 (S.D.N.Y. 1978).

121. These later securities were referred to by the representative as "junk," Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021 (S.D.N.Y. 1977), *aff'd in part*, 570 F.2d 38, 43 (2d Cir. 1978), with most investments in low value, over the counter securities. 570 F.2d at 42 n.4. The value of the portfolio declined to $712,000. *Id.* at 42.

122. The Court in *Hochfelder* expressly did not rule on whether aiding and abet-

> [W]here as here, the alleged aider and abettor owes a fiduciary duty to the defrauded party, recklessness satisfies the scienter requirement . . . . [B]y leaving open the possibility that recklessness might satisfy the scienter requirement, the Supreme Court recognized that in certain instances a recklessness standard might be appropriate . . . .
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> . . . [O]n a linguistic level, the term scienter is used by the Supreme Court to mean, in the disjunctive, "knowing or intentional misconduct." . . . The word "knowing" implies conduct that is somewhat less focused than "intentional" activity, which commonly is characterized by a specific mental state . . . . The common law tort of fraud has adopted a recklessness standard as one means of satisfying the requisite intent element of that cause of action. Similarly, securities law cases have recognized that recklessness may serve as a surrogate concept for willful fraud.[123]

It seems clear that an auditor who prepared a materially misleading financial statement would be treated as a primary or "active" participant in the alleged fraud, and subjected to the recklessness standard. In *Jacobson v. Peat, Marwick, Mitchell & Co.*,[124] for example, the district court dismissed a shareholder's derivative 10b-5 suit against the auditor of the defunct Walter Reade Organization, Inc.,[125] because the complaint failed to allege fraud with the particularity required by Rule 9(b) of the Federal Rules of Civil Procedure.[126] The court did, however, grant the plaintiff leave to file an amended complaint, and noted that the "plaintiff may need to plead facts showing that PMM acted with either knowledge that the Reade financials

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ting liability was appropriate under 10b-5. 425 U.S. at 191-92 n.7. The *Hochfelder* Court did, however, cite to authorities discussing the appropriateness of such liability: Brennan v. Midwestern United States Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966), *motion to dismiss denied*, 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); and Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 620-45 (1972). While most auditors will be charged as aiders and abettors, the authors are of the opinion that the Court's reservation of a holding on the issue, coming as it did in the face of the known propensity of the courts of appeal to recognize such liability, constitutes a de facto recognition of the aiding-abetting theory. Likewise, it is our opinion that the "knowing" assistance—required by cases such as *Brennan*—can be satisfied by facts that demonstrate that an auditor certified figures for which he had no substantial basis for belief and was, therefore, "reckless."

123. 570 F.2d at 44-46 (citations and footnote omitted).

124. 445 F. Supp. 518 (S.D.N.Y. 1977).

125. Plaintiffs argued that the 10-K reports prepared by Peat for Walter Reade were false and misleading due to substantially overstated accounts receivable. Consequently, the net worth and earnings picture was distorted. *See id.* at 521.

126. FED. R. CIV. P. 9(b) requires that "all averments of fraud . . . [and] the circumstances constituting fraud . . . shall be stated with particularity. Malice, intent, knowledge, and other conditions of mind . . . may be averred generally."

were false and misleading, or in reckless disregard of the truth, if he is to state the circumstances surrounding the fraud with particularity."[127]

Similarly, in *Lewis v. Black*,[128] the plaintiff purchased shares of C. I. Mortgage Group, a real estate investment trust, and sought recovery against C. I.'s auditors, Peat, Marwick, Mitchell & Co., for aiding and abetting a violation of Rule 10b-5 by preparing and certifying C. I.'s annual report and certain interim reports that allegedly contained misleading statements and omissions. Peat again moved to dismiss the plaintiff's complaint for failure to plead fraud with the particularity required by Rule 9(b) of the Federal Rules. The court dismissed the complaint with the comment that the allegations of fraud were stated in a confusing manner, and that "plaintiff must allege additional circumstances or facts which will . . . support an inference of knowing or culpably ignorant material misstatement or omission by Peat Marwick."[129]

B. The Third Circuit

The post-*Hochfelder* position of the Third Circuit on the question of 10b-5 scienter is relatively clear: recklessness will suffice. This state of clarity was not initially apparent, however, as the first post-*Hochfelder* case in the circuit, *Straub v. Vaisman & Co.*,[130] contained language that could be read to imply that proof of actual intent to defraud was required. The defendant in *Straub* was a New Jersey broker-dealer, upon whose recommendation the plaintiff purchased stock in Mark I Offset. The defendant was a financial consultant for Mark I, and as such, had knowledge of Mark I's imminent bank-

127. 445 F.2d at 524.

It is interesting to note in this context that an allegation that the defendant "should have known" of the misleading character of his representations will be held insufficient as an allegation of scienter in the second circuit, as it is viewed as alleging only negligence. *See* Weinberger v. Kendrick, 432 F. Supp. 316 (S.D.N.Y. 1977); Gross v. Diversified Mortgage Investors, 431 F. Supp. 1080 (S.D.N.Y. 1977); Rich v. Touche Ross & Co., 415 F. Supp. 95 (S.D.N.Y. 1976).

128. [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,638 (E.D.N.Y. 1976).

129. *Id.* at 90,168. *See also* Steinberg v. Carey, 439 F. Supp. 1233 (S.D.N.Y. 1977), in which the court granted a motion to dismiss filed by three trustees of an REIT because there was no evidence that any of the three participated in the preparation or verification of a prospectus alleged to contain untrue statements and material omissions. *Id.* at 1240. The court refused, however, to grant the motion as to a fourth trustee who had coordinated the offering on behalf of the underwriter's representative which participated in analyzing the trust and verifying the accuracy and completeness of the statements in the prospectus. *Id.* at 1241.

130. 540 F.2d 591 (3d Cir. 1976).

ruptcy.[131] To aggravate matters, the shares were sold to the plaintiff at a price above the prevailing market, and were acquired from another company in which the defendant had a controlling interest. The defendant was also the marketmaker in Mark I.[132] In order to recover in a 10b-5 action, the court of appeals declared, "[t]he plaintiff must prove knowledge by the defendant, intent to defraud, failure to disclose or misrepresentation, materiality of the information and, in some instances, reliance by the plaintiff."[133] The court went on to note that "[t]he district court found a specific intent to defraud which satisfies the *scienter* requirement discussed in *Ernst & Ernst v. Hochfelder*."[134]

Two months after the decision in *Straub*, however, the U.S. District Court for the District of Delaware decided *McLean v. Alexander*,[135] in which an accountant was found guilty of both "reckless" and "knowing" behavior. Plaintiff McLean was a private investor who had purchased all the outstanding stock of Technidyne, Inc., a small company that developed and marketed a laser-beam pipelaying system called "Technitool." Technidyne was experiencing serious cash flow problems due to the collapse of an exclusive dealership arrangement it had previously enjoyed, thus forcing it to attempt direct-selling of Technitools and to secure outside capital. In the course of the negotiations preceding the sale, McLean was given a "confidential" report on Technidyne that misrepresented the reason for the collapse of the exclusive dealership arrangement,[136] and purported to show the sale of sixteen Technitools in less than three months through the company's direct-sale program.[137] This picture of the Technitool as a saleable item was supported by a certified audit prepared by Cashman & Schiavi at Technidyne's behest[138] that listed

131. Mark I filed a Chapter XI bankruptcy petition within a month of the sale to plaintiff. *See id.* at 594.

132. The defendant's conduct was so opprobrious that the trial court labeled it "shocking to the conscience of this court." *Id.*

133. *Id.* at 596.

134. *Id.*

135. 420 F. Supp. 1057 (D. Del. 1976).

136. The real reason for the collapse of the exclusive dealership arrangement was the poor quality of the Technitools, which repeatedly broke down on the job, resulting in a refusal by the distributor to accept Technitools until the reliability problems were cured. *See id.* at 1073. The confidential report indicated that the relationship with the distributor was terminated by Technidyne due to the unreliable character of the distributor. *See id.* at 1063.

137. *See id.* at 1063-64.

138. Technidyne had been Schiavi's client since 1967, and Schiavi had subsequently entered into a partnership with Cashman. Technidyne retained the partnership on December 10, 1969, to conduct an audit as of November 30, 1969, informing Schiavi that the audit was needed to help Technidyne secure outside capital and that time was of the essence due to Technidyne's negative cash flow. *See id.* at 1067.

the sum of $73,733 in accounts receivable as a current asset and denoted the amount as considered "Fully Collectible."[139] This figure was primarily attributed to sixteen direct sales to three customers. In reality, however, these sixteen "sales" were, as the plaintiff discovered when he took control of the company, either consignments or guaranteed sales in which the supposed buyers were only obligated to pay for the Technitools if they were able to resell them.[140]

In the resulting 10b-5 suit against Cashman & Schiavi, the court found numerous culpable deficiencies in the firm's audit of Technidyne. Schiavi had, for example, issued four confirmation requests—three going to the alleged purchasers of the sixteen units, and the fourth to Erie Marine, a purchaser of tubes and a power supply unit. Erie was the only customer that returned a confirmation, and it disputed over one-third of the amount allegedly owed, a fact that was never mentioned in the audit.[141] Under pressure from Technidyne to complete the audit quickly, Schiavi indicated that he could not proceed further without some form of confirmatory response from the other three customers. Technidyne then instructed its salesmen to call their accounts and request that confirmatory telegrams be sent to Schiavi. Schiavi subsequently received two telegrams which purported to be from the two major purchasers of Technitools, acknowledging the existence of their orders, but not the existence of a debt to Technidyne.[142] Schiavi made no attempt to contact any of the alleged buyers, electing instead to rely on the telegrams.[143] Had he made such contact, he would have discovered that the telegram purporting to be from the largest account was a fake sent by a Technidyne salesman.[144] The court described the situation as one in which

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139. *Id.* at 1065.

140. *See id.* at 1067 & n.38.

141. *See id.* at 1069-70.

142. "Although these telegram messages did not, even remotely, confirm an *amount due and owing,* but instead referred solely to the customers' respective purchase orders, Schiavi relied fully upon them." *Id.* at 1070 (emphasis in original).

143. "Moreover, notwithstanding the fact that he knew absolutely nothing about the alleged purchasers or their credit worthiness, Schiavi made no efforts to contact the customers and verify the telegrams." *Id.* at 1070.

144. Had Schiavi contacted [the purchaser's agent] at any point in the five-day period between receipt of the phone message from Western Union and the issuance of the audit, he would have learned that the telegram had been forged. However, in total and reckless disregard of the facts that he had never had any prior contact with, or knowledge of [the purchaser], that the telegram was a non sequitur in relation to the confirmations and that he had no way of knowing who sent it, Schiavi never bothered to contact [the purchaser's agent].

Id.

The court also found other factors in Technidyne's records of the transactions that should have put Schiavi on notice that the sales were suspect. The invoices sent to the

the auditors crumbled in the face of client pressure,[145] and characterized Schiavi's conduct as more than negligence, but less than actual intent to defraud—including both knowing behavior and recklessness.[146] The court defined recklessness as "pretend[ing] to knowledge he did not have."[147]

Schiavi, the court concluded, had thus possessed sufficient scienter to warrant the imposition of 10b-5 liability. Citing *Hochfelder* as holding "that § 10(b) was intended to proscribe knowing or intentional misconduct,"[148] the court observed: "If the result were otherwise, Section 10(b) and Rule 10b-5 would be more restrictive in substantive scope than the substantive law of fraud. Reckless disregard for the truth is also a cognizable basis for liability in common-law fraud actions."[149] The court further expressly recognized that recklessness could provide a basis for 10b-5 liability, phrasing the issue before it as "whether the accountant proceeded in a deliberate, knowing or reckless manner in the preparation of his audit."[150] The court later explained the basis for its position: "There is little reason to distinguish between knowing misbehavior and reckless misbehavior under Section 10(b) and Rule 10b-5. In practice, one who recklessly makes a statement inherently possesses some knowledge of its falsity."[151]

The most recent Third Circuit Court of Appeals pronouncement on the scienter issue firmly established that recklessness alone is a sufficient predicate for 10b-5 liability. In *Coleco Industries, Inc. v.*

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three buyers were all issued on the cutoff date of the audit, and two of them contained payment terms postponing the original payment dates, which had already passed at the time Schiavi commenced work on the audit. *Id.* at 1071. In addition, the shipping dates stated in the two major accounts had already passed and yet, at the time of the audit, Technidyne still held all but one of the units to be shipped. *Id.* The total picture created by these facts led the court to observe that "Schiavi had facts at hand from which he knew that unless management supplied satisfactory explanations, there were serious potential problems about the accounts receivable and Technidyne's sales future." *Id.* at 1084.

145. "Pressed for an early release of his report, Schiavi accommodated his client by abandoning all caution." *Id.* at 1083.

146. "Schiavi's conduct constitutes far more than mere negligence, but falls short of a preconceived actual intent to defraud. His behavior embraces both actual knowledge of material facts not revealed and reckless disregard for the truth." *Id.* at 1080 (footnotes omitted).

A Fourth Circuit district court has characterized this case as "indicat[ing] that knowing conduct is to be equated with scienter." SEC v. American Realty Trust, 429 F. Supp. 1148, 1171 n.8 (E.D. Va. 1977). The Virginia court, however, "decline[d] to follow th[e] decision." *Id.*

147. 420 F. Supp. at 1084.

148. *Id.* at 1080 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. at 197).

149. *Id.*

150. *Id.* at 1074.

151. *Id.* at 1084.

Berman,[152] the plaintiff had purchased a swimming pool manufacturing company, and sought to recover for losses incurred due to misrepresentations contained in the financial statements of the company relating to the cost of manufacturing the pools. The trial court denied recovery against the principals of the acquired company on the ground that they made the statements in good faith, being misled by the mistakes of their accountant.[153] The trial court held that "to establish the element of scienter in an action brought under section 10(b) and Rule 10b-5, a party must prove injury resulting from a conscious deception or from a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception."[154] The court of appeals concurred, declaring:

> We agree with the trial judge, and the majority of the courts which have passed on the question since *Hochfelder,* that plaintiff may recover under Rule 10b-5 for misrepresentations that are recklessly made as well as those made with conscious fraudulent intent. We need not precisely define the nature of the recklessness which might give rise to 10(b)(5) [*sic*] liability, however, for the finding by the trial court that the actions of the . . . defendants were not reckless is amply supported by the record under any of the standards which other courts have suggested.[155]

C. The Fifth Circuit

The Fifth Circuit Court of Appeals, after a period of initial uncertainty among some of its district courts,[156] has clearly sanctioned recklessness as the appropriate standard for 10b-5 scienter, thereby reaffirming its pre-*Hochfelder* position.[157] In *Dupuy v. Dupuy,*[158] apparently intentional misrepresentations and omissions concerning the financial prospects of a closely held corporation caused the plaintiff to sell his interest to his brother at a grossly inadequate price. After a verdict for the plaintiff, the district court granted a judgment

152. 567 F.2d 569 (3d Cir. 1977) (U.S. appeal pending).

153. 423 F. Supp. 275, 289 (E.D. Pa. 1976). The accountant, Zelnick, was found liable to the defendants for his error. *Id.* at 308-10 & n.59, and had entered into a settlement with the plaintiffs for the sum of $350,000. 567 F.2d at 573.

154. 423 F. Supp. at 296.

155. 567 F.2d at 574 (footnote omitted).

156. *See, e.g.,* Plunkett v. Francisco, 430 F. Supp. 235, 235-40 (N.D. Ga. 1977) (acknowledgement of undefined scienter requirement); DeHart v. Moore, 424 F. Supp. 55, 57 (S.D. Fla. 1976) (same); Ford v. Cannon, 413 F. Supp. 1393, 1397 (M.D. Fla. 1976) (mere negligence not sufficient).

157. *See* Woodward v. Metro Bank of Dallas, 522 F.2d 84 (5th Cir. 1975); Vohs v. Dickson, 495 F.2d 607 (5th Cir. 1974); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir. 1974), *cert. denied,* 419 U.S. 873 (1974).

158. 551 F.2d 1005 (5th Cir. 1977), *cert. denied,* 434 U.S. 911 (1978).

notwithstanding the verdict due to the plaintiff's failure to exercise due diligence. With an interesting application of *Hochfelder*, the court of appeals reversed. The court stated that "[a]lthough the 'scienter' requirement may still be unsettled, the Supreme Court has imposed upon defendants a standard not stricter than recklessness."[159] The plaintiff's negligence should not bar recovery, the court concluded, since *Hochfelder's* relaxation of the standard of care for defendants necessitated a similar reduction in the standard applicable to plaintiffs. The court announced that the new test should be whether the plaintiff "intentionally refused to investigate 'in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow.' "[160]

Shortly after its decision in *Dupuy*, the court of appeals, in *First Virginia Bankshares v. Benson*,[161] further supported the view that reckless behavior is sufficient proof of scienter by stating that "[t]he defendant must know of the falsity of the information [he supplies], or must act in reckless disregard of its falsity, or must intend to deceive."[162]

D. The Sixth Circuit

The post-*Hochfelder* position of the Sixth Circuit awaits definitive resolution, as the most recent decision on the scienter issue, *Adams v. Standard Knitting Mills, Inc.*,[163] contains both recklessness and intent language, and facts that justified a finding of actual intent to deceive. The plaintiffs in *Adams* were former shareholders of Standard Knitting Mills who had exchanged their shares for preferred shares in Chadbourn, Inc., in a merger between Standard and Chadbourn. The plaintiffs' claim arose from allegedly misleading statements and omissions in a proxy statement prepared for Chadbourn by the defendant accounting firm, Peat, Marwick, Mitchell & Co.[164] The plaintiffs claimed that the proxy statements were deficient for three reasons: 1) failure to adequately disclose that a preexisting bank loan agreement placed restrictions on the payment of dividends and on the redemption of Chadbourn preferred stock; 2) failure to disclose that Chadbourn had continuing serious deficiencies in its

159. *Id.* at 1020.

160. *Id.* (quoting W. Prosser, Handbook of the Law of Torts § 34, at 185 (4th ed. 1971)).

161. 559 F.2d 1307 (5th Cir. 1977), *cert. denied sub nom.* Walter E. Heller & Co. v. First Virginia Bankshares, 435 U.S. 952 (1978).

162. *Id.* at 1314.

163. [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,683 (E.D. Tenn. 1976).

164. At the time of the trial, all other defendants had entered into a settlement agreement with the plaintiffs.

data processing systems that jeopardized its business future and cast substantial doubt upon internally generated business statistics; and 3) failure to disclose that the Chadbourn audit had not been conducted in accordance with generally accepted auditing standards.[165]

The Standard proxy statement did note the existence of the loan agreement restrictions, but incorrectly described the stock subject to the restrictions as "common" rather than "capital." There was ample evidence that Peat knew of the mistake prior to the mailing of the statement, but failed to inform the plaintiffs of it.[166] Peat did use the correct term in a proxy statement that was subsequently sent to the plaintiffs in connection with an unrelated transaction, but repeated the error in Chadbourn's 1970 annual report, which was mailed to the plaintiffs some four months later.[167] Peat argued that its use of the correct term in the second proxy statement vitiated the effect of its earlier error and that, in any event, there was no accounting requirement compelling disclosure of the redemption restrictions.[168] The court firmly rejected both arguments,[169] and further found that the repetition of the error in the 1970 annual report constituted an attempted "cover-up" by Peat.[170]

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165. [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,683, at 90,351-55 (E.D. Tenn. 1976).

166. Peat had earlier sent a proxy statement to the shareholders of another candidate for merger with Chadbourn which used the correct term "capital" instead of "common." *Id.* at 90,354. Additionally, Peat's audit manager, prior to mailing the standard proxy statement, had received a telephone call from Chadbourn's attorney informing him of the mistake. *Id.* at 90,355.

167. *Id.*

168. *Id.* at 90,357.

169. In response to the argument concerning the second proxy statement, the court stated:

> Peat made no effort to highlight or call this modification to the attention of the plaintiffs. . . . [I]t is unreasonable to assume plaintiffs would examine closely the financial statements and footnotes of Chadbourn contained in that proxy statement considering it had been only two months since plaintiffs had fully read Chadbourn's reported financial condition in the Standard proxy.

Id.

As to the argument that accounting principles did not require disclosure, the court responded:

> [A] review of the numerous accounting authorities and principles cited in this case indicate [*sic*] an intent to provide for full disclosure in financial statements. . . . Beyond doubt Peat knew plaintiffs would be relying on its financial statements and that the information regarding the . . . preferred stock would be of particular interest to plaintiffs in making a decision whether or not to approve the merger. In these unique circumstances defendant's failure to fully and fairly disclose is clearly a serious breach of professional responsibility.

Id.

170. The court observed that "the second error in the long term debt footnote

With respect to the alleged deficiencies in Chadbourn's data processing system, the court found that they "were of such a pervasive nature and importance that their existence did, or at a minimum, could have significantly affected the entire operation of Chadbourn and would therefore most directly relate to matters contained in the financial statements."[171] The court found that Peat knew of the deficiencies,[172] and that its failure to take them into account and disclose them violated generally accepted accounting principles.[173]

The court's phraseology on the scienter issue is unfortunately, but perhaps intentionally, imprecise. First, the court cited *SEC v. Coffey*,[174] a pre-*Hochfelder* Sixth Circuit case equating scienter with "*wilful or reckless disregard* for the truth,"[175] but then hedged by observing that, since *Coffey* involved a Securities Exchange Commission suit for injunctive relief, the standard enunciated may be a minimal one, applicable only to such cases.[176] Then the court, without discussing *Hochfelder's* reservation regarding recklessness, cited *Hochfelder* as holding that scienter is shown by proof of "intent to deceive, manipulate or defraud," but concluded that "[not]withstanding this stringent element of proof, . . . in all the facts and circumstances of this case, scienter on behalf of the defendant has been established.[177] Finally, the court touched all the bases once again by stating that Peat acted "willfully, with intent to 'deceive' and 'manipulate' and in 'reckless disregard for the truth.' "[178] It is impossible to tell whether this confusion of language was a result of the traditional judicial reluctance to decide issues not directly before the court, or whether it indicates that the court was itself uncertain as to whether recklessness, standing alone, would be a sufficient basis for liability.

The other major Sixth Circuit case on point is *Peltz v. Northern Ohio Bank*,[179] one of a series of 10b-5 suits growing out of the demise

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was wilful and designed to conceal the truth of defendant's *previous inexcusable error from plaintiffs. The court has not found and Peat has not suggested any other reasonable explanation for defendant's conduct . . . .*" *Id.* at 90,357-58 (emphasis in original).

171. *Id.* at 90,365.

172. One of Peat's employees had observed that "controls is [*sic*] out of control," and Peat had sent Chadbourn a letter identifying the deficiences. *Id.* at 90,359.

173. "[D]efendant failed to follow and apply general accounting principles which was essential for fair presentation of Chadbourn's financial position and the results of its operations, by not disclosing or compelling Chadbourn management to disclose its gross [electronic data processing] deficiencies." *Id.*

174. 493 F.2d 1304 (6th Cir. 1974).

175. *Id.* at 1314.

176. [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,683, at 90,366 (E.D. Tenn. 1976).

177. *Id.*

178. *Id.* at 90,367.

179. 430 F. Supp. 382 (N.D. Ohio 1976).

of the defendant bank.[180] Peltz had purchased stock in the bank, relying on allegedly false and misleading financial statements prepared for the bank by defendant Peat, Marwick, Mitchell & Company. Peat moved to dismiss, arguing that the allegation in the complaint that Peat "knew or should have known" that the statements "misrepresented or falsely presented the true aspect of [the bank's] financial condition" did not sufficiently allege scienter in the manner required by Rule 9(b) of the Federal Rules of Civil Procedure and *Hochfelder.*[181] The court noted *Hochfelder's* reservation regarding recklessness and the Sixth Circuit's pre-*Hochfelder* holding that recklessness would suffice[182] and said:

> Relying on *SEC v. Coffey,* this court concludes that scienter, an essential element in plaintiff's claim against PMM, requires proof of either actual knowledge of misrepresentations or "wilful or reckless disregard for the truth." The word "knew" meets the first half of this requirement, but "should have known" may not be equated in this court's view with "reckless disregard for the truth." Therefore, those words will be stricken.[183]

When one considers the strong support for the recklessness standard in the extant district court cases in the Sixth Circuit, the circuit's pre-*Hochfelder* espousal of the recklessness standard, and the general trend in the other circuits toward recklessness, ultimate recognition by the court of appeals seems likely.

E. The Seventh Circuit

One might reasonably expect that the Seventh Circuit, whose acceptance of negligence as sufficient for 10b-5 liability made it the birthplace of *Hochfelder,* would avail itself of the opportunity presented by the *Hochfelder* Court's reservation regarding recklessness, and adopt recklessness as the least restrictive available alternative. An examination of recent cases in the Seventh Circuit confirms this hypothesis. The Seventh Circuit has displayed little of the hesitancy evident elsewhere, and has consistently limited *Hochfelder's* application to the proposition that negligence is an insufficient predicate for 10b-5 liability. In the process, it has given one of the fullest explications of the recklessness concept.

In *Bailey v. Meister Brau, Inc.,*[184] the circuit's first post-*Hochfelder* scienter case, the plaintiff, who was an officer, director, and

180. *See* Braun v. Northern Ohio Bank, 430 F. Supp. 367 (N.D. Ohio 1977); Imperial Supply Co. v. Northern Ohio Bank, 430 F. Supp. 339 (N.D. Ohio 1976).

181. 430 F. Supp. at 383-84.

182. *See* text accompanying notes 174-76 *supra.*

183. 430 F. Supp. at 384 (footnotes omitted).

184. 535 F.2d 982 (7th Cir. 1976).

minority shareholder in Black Company, sought recovery from Meister Brau and Continental Illinois National Bank for their actions in an undisclosed transaction whereby the assets of Black were transferred to Meister Brau in exchange for unregistered Meister Brau stock. When the plaintiff discovered that the Meister Brau stock was worth far less than Black's assets,[185] he instituted suit against Continental, which had voted for the transfer in its capacity as executor of the estate of the deceased founder and controlling shareholder of Black.

The court of appeals, concurring with the judgment of the district court that the bank's failure to disclose the unfair nature of the transfer was a violation of Rule 10b-5, observed that there was a conflict of interest between the bank's desire to sell the estate's shares to Meister Brau and its fiduciary duty to Black Company and plaintiff Bailey.[186]

> The scienter requirement of Rule 10b-5, the [district] court held, had been satisfied by evidence that the bank was "grossly negligent in failing to recognize the unfairness of the asset transfer" and, "blinded by a conflict of interest, [the bank] wantonly ignore[d] evidence of the unfairness of [the] securities transaction to the corporation and therefore fail[ed] to disclose this evidence to those shareholders whose interests lie with the corporation."[187]

The next significant[188] statement of the Seventh Circuit's position on scienter occurred in *Sundstrand Corp. v. Sun Chemical Corp.*[189] Sundstrand had contemplated a merger with Standard Kolsman Industries, Inc. (SKI), and in furtherance of that purpose acquired from John D. Huarisa, then president and chairman of the board of SKI, an option to purchase the shares of SKI held by the family of the deceased founder of SKI. The proposed merger was in large part due to the efforts of Henry W. Meers, a Chicago underwriter and merger broker, who was also an outside director of SKI. Meers was to act as SKI's merger broker for the transaction in return for a $150,000 fee. Sundstrand subsequently decided to cancel the merger

185. "The transaction was manifestly unfair to the Black Company and its minority shareholder Bailey . . . ." *Id.* at 992.

186. *Id.* at 993.

187. *Id.* (quoting the district court opinion, 378 F. Supp. 869, 876 (N.D. Ill. 1973)).

188. In the interim between *Bailey* and *Sundstrand,* a district court, in Neill v. David A. Noyes & Co., 416 F. Supp. 78 (N.D. Ill. 1976), denied a motion to dismiss a customer suit against a broker-dealer for fraudulent violation of margin requirements in the sale of the customer's securities. The defendant argued that *Hochfelder* barred the plaintiff's claim. The court characterized *Hochfelder* as requiring an allegation of scienter and concluded that "since the Plaintiffs did allege some form of scienter beyond mere negligence, they have avoided the impact of *Ernst & Ernst.*" *Id.* at 82.

189. 553 F.2d 1033 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977).

negotiations and SKI ultimately merged into Sun Chemical. Sundstrand subsequently filed suit against Huarisa, Sun, and Meers for alleged violations of Rule 10b-5 in connection with its purchase of Huarisa's option. Sundstrand's claim against Huarisa and Sun was based upon alleged misrepresentations by Huarisa and other SKI officers,[190] and upon their failure to disclose the existence of reports on SKI compiled by a dissident SKI director and his accounting firm which were critical of certain SKI accounting practices.[191] Sundstrand's claim against Meers was primarily predicated upon his failure to disclose the existence of the adverse reports.

The trial court held Huarisa and Sun liable, finding that the misrepresentations and omissions had been made "deliberately or recklessly."[192] The court of appeals approved the application of this test, noting *Hochfelder's* reservation regarding recklessness,[193] and the court's previous holding in *Bailey v. Meister Brau,*[194] which it characterized as "akin to the alternative reckless [*sic*] standard"[195] announced by the trial court.

The court of appeals also approved the trial court's holding against Meers, and determined that since his liability was based upon reckless nondisclosure rather than reckless misrepresentation, a full discussion of the recklessness standard was warranted.[196] The court noted that recklessness was sufficient for fraud at common law, and stated: "Since there is no hint in *Hochfelder* that the Court intended a radical departure from accepted Rule 10b-5 principles, it would be highly inappropriate to construe the Rule 10b-5 remedy to be more restrictive in substantive scope than its common law analogs."[197] The court then held that 10b-5 liability could attach for reckless omissions,[198] and adopted the definition of reckless omissions adduced in *Franke v. Midwestern Oklahoma Development Authority:*[199]

> [R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence,

190. The substance of the misrepresentations concerned SKI's 1968 and 1969 earnings, the interest of other companies in acquiring SKI at a price greater than that contemplated by the Sundstrand offer, and the amount of potential write-offs of deferred preproduction costs for 1968. *Id.* at 1039.

191. These reports questioned "the propriety of SKI's continued deferral of preproduction costs and the failure to recognize losses on some . . . contracts which ultimately resulted in a net loss of 15¢ per share in SKI's report for 1968." *Id.*

192. *Id.* (trial court opinion not reported).

193. *Id.* at 1039-40 (citing 425 U.S. at 194 n.12).

194. *See* text accompanying notes 184-87 *supra.*

195. 553 F.2d at 1040.

196. *Id.* at 1044.

197. *Id.* (footnote omitted).

198. *Id.*

199. 428 F. Supp. 719 (W.D. Okla. 1976).

> but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[200]

Under this test, the court indicated, "the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing, and the omission must derive from something more egregious than even 'white heart/empty head' good faith."[201] In regard to the latter phrase the court observed that if the trial judge found that the defendant truly forgot to disclose the information, or that it never occurred to him to disclose it, no liability would attach, even though the reasonable man would never have forgotten.[202] This observation is questionable, since there is little in the *Franke* test that clearly leads to this conclusion. In any event, from a practical standpoint this good faith defense may be of little consequence, since it is unlikely that, for example, an auditor who made no attempt to verify accounts receivable before certifying them would be able to successfully convince a court or jury that he merely "forgot" to do so, and thereby avoid liability to an innocent purchaser who had been injured by relying on the figures certified.

The most recent expression of the Seventh Circuit on the scienter issue may be found in *Sanders v. John Nuveen & Co.*,[203] a class action in which the purchasers of short-term notes of a defunct consumer finance company sued the underwriter of the issue. Prior to the decision in *Hochfelder*, the court of appeals had affirmed a finding against the defendant based upon negligence, holding that, although the defendant had honestly relied upon the audited financial statements of the defunct company, it had breached a duty to make reasonable inquiries that would have led to the discovery of the issuer's fraud.[204] The Supreme Court vacated this earlier decision and remanded the case for reconsideration in the light of *Hochfelder*.[205]

On remand, the court of appeals noted that it had previously held that recklessness could constitute scienter,[206] but then observed:

> In view of the Supreme Court's analysis in *Hochfelder* of the statutory scheme of implied private remedies and express remedies, the definition of "reckless behavior" should not be a liberal one lest any discernible distinction between "scienter" and "negligence" be

200. 553 F.2d at 1045 (quoting Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719, 725 (W.D. Okla. 1976)).

201. 553 F.2d at 1045 (footnote omitted).

202. *Id.* at n.20.

203. 554 F.2d 790 (7th Cir. 1977).

204. Sanders v. John Nuveen & Co., 524 F.2d 1064, 1071 (7th Cir. 1975).

205. John Nuveen & Co. v. Sanders, 425 U.S. 929 (1976) (vacating and remanding 524 F.2d 1064 (7th Cir. 1975) in light of *Hochfelder*).

206. 554 F.2d at 792-93.

> obliterated for these purposes. We believe "reckless" in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree, but also in kind.[207]

The court again quoted the *Franke* test,[208] and found no factual basis for a finding of recklessness on the part of the underwriter.[209] Thus, the *Franke* test for recklessness seems to be fairly well established in the Seventh Circuit.

F. The Ninth Circuit

The Ninth Circuit had not, until very recently, adopted a clear post-*Hochfelder* position on scienter. In the initial case on point in the circuit, *Robinson v. Heilman,*[210] the plaintiffs were the owners of a small company that was sold to Nova-Tech, Inc., in exchange for Nova-Tech shares. Nova-Tech subsequently went bankrupt and the plaintiffs filed a 10b-5 suit against the president of Nova-Tech, alleging that statements in the merger agreements concerning the financial condition of Nova-Tech were false, and that the defendant either knew or should have known the truth at the time the agreements were executed.[211]

The trial court decided the case prior to *Hochfelder* and, following the lead of *White v. Abrams,*[212] instructed the jury that a corporate officer had a duty to advise the purchasers of corporate stock "if any material statement made to [them] is false or misleading, if such director knows or in the exercise of ordinary care should know, first, that such statement was made, and second, that it was false or misleading."[213] The court of appeals reversed the jury's verdict against the defendant, and remanded the case for reconsideration in the light of *Hochfelder.* The circuit court did not define scienter, being content to correctly characterize *Hochfelder* as barring private 10b-5 suits based on negligence.[214]

The Ninth Circuit's pre-*Hochfelder* acceptance of negligence as

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207. *Id.* at 793.

208. *See* text accompanying notes 200 *supra* & 226 *infra.*

209. *See* 554 F.2d at 793. *See also* Hoffman v. Estabrook & Co., [1978] Fed. Sec. L. Rep. (CCH) ¶ 96,587, at 94,510-11 (1st Cir. 1978) (discussing Seventh Circuit recklessness test) (dictum); Cook v. Avien, 573 F.2d 685, 692 (1st Cir. 1978) (same) (dictum).

210. 563 F.2d 1304 (9th Cir. 1977).

211. Nova-Tech had furnished the plaintiffs with an audited financial statement as of March 31, 1968, and an unaudited statement as of July 31, 1968. The agreement contained warranties to the effect that no adverse material change in the financial condition of Nova-Tech had occurred since the July 31, 1968, statement. *Id.* at 1306.

212. 495 F.2d 725 (9th Cir. 1974). The court in *White* adopted a five-factor test of liability focusing on the goals of securities fraud legislation, which accepted negligence as sufficient for 10b-5 liability. *Id.* at 734-35.

213. 563 F.2d at 1306.

214. *"Hochfelder's* rejection of a negligence standard . . . under Section 10(b)

a basis for 10b-5 liability,[215] coupled with its perception of the holding in *Hochfelder*, seemed to indicate a likelihood that recklessness would ultimately gain recognition there. This prognosis has been confirmed by the circuit's recent holding in *Nelson v. Serwold*.[216] *Nelson* involved a suit by the heir of an estate which had sold 36 shares of a small telephone company's stock for $5 per share. The stock was sold to the president of the company, who was the record holder of 56% of all outstanding shares. When the estate's attorney wrote the company inquiring about the status of the stock, he was informed that no dividends had accrued and none were expected. The defendant's reply failed to disclose that the book value of the stock was approximately $60 per share, and that a "control group" of shareholders existed who intended to modernize the company and transform it into a marketable enterprise. When the company was sold six years later, the shareholders received approximately $500 per share.

The defendants argued that reversal of the district court's decision for the plaintiff was dictated by *Hochfelder's* scienter requirement. The court of appeals disagreed, holding that "*Ernst & Ernst*, we think, only went so far as to eliminate negligence as a basis for liability. We agree with those courts which have found that Congress intended the ambit of § 10(b) to reach a broad category of behavior, including knowing or reckless conduct."[217] The court concluded "that the defendants' omissions were [made], at the very least, with knowledge,"[218] and therefore the scienter requirement was satisfied.

G. The Tenth Circuit

The Tenth Circuit has yet to adopt a clear position on the scienter issue. The extant cases in the circuit contain language that could be read to require at least "knowing" conduct, if not "intentional" misconduct. Further developments must occur in the Tenth Circuit, however, before any firm conclusions on the subject may be drawn.

In *Holdsworth v. Strong*,[219] the parties were three couples, the Holdsworths, the Strongs, and the Tanners, who had originally owned equal numbers of the outstanding shares of Sans-Copy, a closely held corporation marketing a timekeeping system for law offices. Defendant Strong was in charge of the business and had been given a controlling interest. Annual dividends were disbursed by Strong until 1970. In 1971, Strong informed the plaintiffs that the

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and Rule 10b-5 is both sweeping and unqualified." *Id.* at 1307.

215. For a discussion of the Ninth Circuit's pronouncement in White v. Abrams, 495 F.2d 725 (9th Cir. 1974), see 3 A. Bromberg, *supra* note 18, at 420.1-.7 (Supp. 1975).

216. 576 F.2d 1332 (9th Cir. 1978).

217. *Id.* at 1337.

218. *Id.*

219. 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 431 U.S. 918 (1977).

company had invaded capital to pay the 1970 dividends and would, therefore, be unable to issue dividends for 1971. Strong subsequently offered to purchase the plaintiffs' shares, stating that the corporation would not be able to pay dividends in the future. The plaintiffs sold their shares to Strong, but subsequently sought to rescind the transaction on the basis of violations of Rule 10b-5 and common law fraud, arguing that the corporation was in fact a growing business, and that Strong had committed numerous breaches of his fiduciary duty to plaintiffs in his management of the corporation.[220] The trial court found that Strong had knowingly and intentionally made false representations, and entered a judgment for the plaintiffs.[221]

The court of appeals affirmed, noting that "substantial evidence of intentional fraud and deceit is present."[222] The court cited *Hochfelder* as "holding that proof of negligence is not enough in a 10b-5 action; that such an action will not lie in the absence of an allegation and proof of scienter, the same being an 'intent to deceive, manipulate, or defraud,'"[223] and subsequently characterized *Hochfelder* as holding that "only intentional conduct . . . could give rise to a recovery under Rule 10b-5."[224] Later in the opinion, however, the court observed that "[a]nother important result of the *Ernst & Ernst* decision is that it brings the standards for 10b-5 liability closer to the analogous tort of deceit or intentional misrepresentation."[225] The court did not indicate that it understood that recklessness is a sufficient basis for deceit at common law and did not discuss *Hochfelder's* reservation regarding recklessness. Indeed, recklessness is not discussed in the opinion, and the clear evidence of actual intent to defraud limits the court's holding to the indisputable proposition that actual intent to defraud will suffice for scienter under *Hochfelder.*

Shortly after the *Holdsworth* decision, the District Court for the Western District of Oklahoma delivered a similarly confusing opinion in *Franke v. Midwestern Oklahoma Development Authority,*[226] a suit by a purchaser of industrial revenue bonds against a law firm that had served as bond counsel and had allegedly failed to disclose sev-

220. The plaintiffs charged that numerous operations expenses claimed by Strong were excessive and improper, some being paid to Strong and his relatives; that Strong had borrowed corporate funds which he had failed to repay; and that the $1500 purchase price was unfair in the light of the earnings and growth potential of the corporation. *Id.* at 690.

221. *Id.* at 691.

222. *Id.*

223. *Id.* at 693.

224. *Id.*

225. *Id.*

226. 428 F. Supp. 719 (W.D. Okla. 1976).

eral facts relating to the economic soundness of the issue. The court granted the defendants' motion for a summary judgment, finding that the defendants' limited role as bond counsel included no duty to warrant the economic merits of the issue, and that there was no evidence of any wrongdoing by the defendants.[227]

In discussing the necessity of proof of scienter for 10b-5 liability, the court stated that "[a] plaintiff in a Section 10(b) case must plead and prove that the defendant was guilty of *conscious fault,* which would require that the defendant have *actual knowledge* of the matters complained of."[228] The court cited the pre-*Hochfelder,* Tenth Circuit case of *Clegg v. Conk*[229] as authority for this statement, but, as previously seen, *Clegg* contains language that recognizes recklessness as a sufficient basis for 10b-5 liability.[230] The district court in *Franke* then stated that *Hochfelder* had acknowledged *Clegg* as the correct view, and concluded that there was no evidence in the record to show that the defendants "had any knowledge which would permit a finding of the necessary scienter at trial."[231] The plaintiff had argued that recklessness was a sufficient substitute for scienter, prompting the court to formulate a definition of recklessness in the context of omissions cases that was ultimately adopted by the Seventh Circuit.[232] The court in *Franke* did not, however, rule on the issue, stating instead that "[i]f indeed there is any validity to the proposition that obviousness of risk of harm can be a substitute for guilty knowledge, it is sufficient to note that there is no evidence here of such a state of facts."[233]

The most recent significant pronouncement of the Tenth Circuit's view of scienter was in *Utah State University v. Bear, Stearns & Co.,*[234] where the court of appeals affirmed the trial court's dismissal of the plaintiff's Rule 10b-5 claim for failure to allege scienter. The court stated that "[w]illful or intentional misconduct, or the equivalent thereof, is essential to recovery,"[235] but failed to elaborate on the nature of such "equivalent" conduct. The precise position of the Tenth Circuit Court of Appeals on the scienter issue therefore remains uncertain.

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227. *Id.* at 722, 726.

228. *Id.* at 724 (emphasis added).

229. 507 F.2d 1351 (10th Cir. 1974), *cert. denied,* 422 U.S. 1007 (1975).

230. *See* text accompanying note 32 *supra.*

231. 428 F. Supp. at 725.

232. *See* text accompanying note 200 *supra.*

233. 428 F. Supp. at 725.

234. 549 F.2d 164 (10th Cir.), *cert. denied,* 434 U.S. 890 (1977).

235. *Id.* at 169. *See also In re* Clinton Oil Co. Securities Litigation, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,015, at 91,566 (D. Kan. 1977) (quoting *Utah State Univ.*).

V. SCIENTER AND COMPLIANCE WITH GAAP & GAAS

The relationship between liability under the securities acts and conformance with generally accepted accounting principles (GAAP), and generally accepted auditing standards (GAAS), has long been a topic of concern among accountants. Accountants have traditionally argued that conformance with professionally accepted standards should exonerate them from liability. The courts, however, have been hostile to what they view as "private" lawmaking; their assumption being that a profession's natural tendency toward self-protection may not always produce standards that adequately protect the public interest.

Prior to *Hochfelder,* it was apparent that compliance with GAAP and GAAS would not necessarily insulate an accountant from liability. In *United States v. Simon,*[236] the Supreme Court refused to hear a case in which the defendant accountants had been held criminally liable for violating the 1934 Securities Act and the mail fraud statute by failing to disclose, in a client's financial statements, that the president of the company had engaged in suspect transactions indicating a misappropriation of company funds. The defendants presented testimony by eight expert witnesses that GAAP did not require such disclosure. Nonetheless, the court of appeals affirmed the trial court's charge to the jury, which made the ultimate liability of the defendants dependent upon the answers to two interrelated questions. Did the financial statements as a whole fairly present "the financial position of the audited firm"?[237] If not, did the defendants act in "good faith"?[238] Post-*Hochfelder* Rule 10b-5 cases will essentially ask the same questions, merely rephrasing the latter question to ask whether the misleading character of the financial statements is due to conduct on the part of the auditors that is sufficiently culpable to satisfy the scienter requirement.

Although it would not provide an automatic defense, it is probably fair to say that thorough adherence to, and compliance with, GAAP and GAAS will not produce a materially misleading financial statement in most instances. Liability will hinge, however, upon whether the statement "fairly presents" the financial position of the audited firm, and not upon whether there is compliance with GAAP and GAAS. Consider, for example, the trial court's comment in *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*:

236. 425 F.2d 796 (2d Cir. 1969), *cert. denied,* 397 U.S. 1006 (1970).

237. *Id.* at 805.

238. *Id.* One may infer from the opinion as a whole that the court viewed good faith in this context as compliance with the duty to disclose that arises when an auditor has reason to believe that, to a material extent, a corporation is not being managed in the best interests of its shareholders.

> Much has been said by the parties about generally accepted accounting principles and the proper way for an accountant to report real estate transactions. We think this misses the point. Our inquiry is properly focused not on whether Laventhol's report satisfies esoteric accounting norms, comprehensible only to the initiate, but whether the report fairly presents the true financial position of Firestone, as of November 30, 1969, to the untutored eye of an ordinary investor.[239]

This emphasis upon "fair presentation" is well established, and is supported both in the earliest[240] and most recent cases.[241] Its message for auditors is clear: when in doubt, provide full disclosure.

While compliance with GAAP and GAAS may not ensure the attainment of "fair presentation," the failure to comply with GAAP and GAAS may be evidence of scienter. As previously shown, an accountant who knows, or should know, facts that cast doubt on the validity of the figures in the financial statement, or knows that he lacks a sufficient basis for belief in those figures, and nonetheless certifies them, has the requisite scienter for 10b-5 liability. Hence, the failure to apply basic auditing procedures designed to test the sufficiency of the data provided by the client's management, or the failure to "follow through" on suspicious discoveries made in the course of the audit, can constitute the "reckless" or "knowing" behavior necessary for 10b-5 liability.[242]

It is instructive to note that in each of the previously discussed post-*Hochfelder* cases finding audit violations of 10b-5, the court also found that the defendants failed to comply with GAAP and GAAS. In *Herzfeld,*[243] the court held that Laventhol's treatment of the anticipated income from the unconsummated transactions as current and deferred profit was contrary to "the elemental and universal accounting principle that revenue should not be recognized until the 'earning process is complete or virtually complete, and 'an exchange has taken place.' "[244] The court likewise found that Laventhol's failure to take

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239. 378 F. Supp. 112, 121 (S.D.N.Y. 1974), *aff'd in part, rev'd in part,* 540 F.2d 27 (2d Cir. 1976).

240. *See, e.g., In re* Associated Gas & Elec. Co., 11 S.E.C. 975, 1058-59 (1942) ("[T]oo much attention to the question whether the financial statements formally complied with principles, practices and conventions accepted at the time should not be permitted to blind us to the basic question whether the financial statements performed the function of enlightenment, which is their only reason for existence.").

241. *See, e.g.,* McLean v. Alexander, 420 F. Supp. 1057, 1085 (D. Del. 1976); Sonde, *supra* note 5, at 4.

242. *See* Haimoff, *supra* note 13, at 162 ("Accountants who gullibly accept transparently fishy explanations from their clients of an obviously suspicious transaction are liable under 10b-5, no matter what their mental state.").

243. *See* text accompanying notes 83-105 *supra.*

244. 540 F.2d 27, 34 (2d Cir. 1976) (quoting AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD STATEMENT No. 4 § 150, and 2

adequate steps to investigate the *bona fides* of the transactions violated *Statements on Auditing Procedure No. 33 (SAP 33),* which provides, in part, that "[s]ufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmation to affirm a reasonable basis for an opinion regarding the financial statements under examination."[245] The court also found Laventhol's attempt to qualify its opinion to be deficient under another chapter of *SAP 33.*[246] Similarly, in *McLean,*[247] the court observed that Schiavi's failure to adequately verify Technidyne's accounts receivable by following up on unreturned confirmation letters and seeking adequate management explanations of inconsistencies in company records, was contrary to basic auditing standards. Likewise, in *Adams,*[248] the court found that Peat had violated several accounting standards.[249]

Although it is possible to fully conform to GAAP and GAAS and still be "reckless," the only situation in which this is likely to occur is where the auditor has notice of facts that materially affect the financial position of the audited firm but that are not specifically covered by official pronouncements of GAAP. A good example of this phenomenon can be found in *Escott v. BarChris Construction Corp.,*[250] which involved, *inter alia,* treatment of profits on sale and leaseback transactions. The official accounting pronouncement in this area—*Accounting Principles Board Opinion No. 5*[251]—had not yet been issued at the time the financial statements in question were issued. The auditors chose to recognize the profits currently, a treat-

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES (CCH) 9036 (1978)).

245. *Id.* at 35 (quoting STATEMENTS ON ACCOUNTING PROCEDURE No. 33, Ch. 2, at 16 (1963)).

246. *Id.* at 35-36 (quoting STATEMENTS ON ACCOUNTING PROCEDURE No. 33, Ch. 10, at 58 (1963)):

> When a qualified opinion is intended by the independent auditor, the opening paragraph of the standard short-form report should be modified in a way that makes clear the nature of the qualification. It should refer specifically to the subject of the qualification and . . . the effect on financial position and results of operations, if reasonably determinable.

247. *See* text accompanying notes 135-51 *supra.*

248. *See* text accompanying notes 163-78 *supra.*

249. [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,683 at 90,360 (E.D. Tenn. 1976). The auditing standards noted by the court deal with the auditor's responsibility to study and evaluate internal control (second field work standard), to maintain an independence in mental attitude (second general standard), to exercise due professional care (third general standard), and to obtain sufficient competent evidential matter to afford a basis for an opinion (third field work standard).

250. 283 F. Supp. 643 (S.D.N.Y. 1968).

251. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD OPINION No. 5 (1964).

ment eventually disallowed by the Accounting Principles Board. The court ruled that "fair presentation" dictated that the profits should not have been recognized currently, and that the auditors should have realized this.

In the current reporting environment, accounting for oil exploration costs might present a similar problem. Until the issuance of *Statement of Financial Accounting Standards No. 19,* GAAP did not specify whether full cost,[252] or successful efforts[253] accounting was appropriate. An auditor who approved the use of the full cost method in 1977 financial statements might subsequently be taken to task for not having provided a "fair presentation" of his client's true current exploration costs and thus distorting the financial position.

Where GAAP have not been explicitly articulated, the operative guidelines of the courts clearly appear to be "fair presentation" and "full disclosure." Because practicing auditors might find these guidelines too nebulous to be of practical value, this Article offers operating guidelines for auditors to help reduce the risk of 10b-5 liability.

VI. GUIDELINES FOR AUDITORS

The foregoing case analyses provide the basis for a number of suggestions to accountants seeking to minimize their risk of liability. The guidelines presented below are by no means all inclusive, nor would adherence to them guarantee ultimate triumph in a Rule 10b-5 suit. But by following these guidelines, the probability of a Rule 10b-5 violation would be substantially reduced. On the other hand, failure to adhere to the guidelines would likely increase the probability of a violation.

A. Always Scrupulously Comply with GAAP

Whenever GAAP have been formally defined, the auditor should follow those principles. For an accountant involved in securities matters, GAAP obviously include the various accounting guidelines promulgated by the Securities and Exchange Commission. Indeed, in two of the three post-*Hochfelder* cases assessing liability against accountants, there was a failure to follow SEC guidelines.[254] If GAAP

252. The full cost accounting method is that in which exploration costs are capitalized, and amortized over the life of the production fields.

253. The successful efforts accounting method is that in which exploration costs are currently treated in expense accounts, except for those wells that are productive. This method is not required by *Statement of Financial Accounting Standards No. 19.*

254. *See* Herzfeld v. Laventhol, Krekstein, Horvath & Horvath, 540 F.2d 27 (2d Cir. 1976); Adams v. Standard Knitting Mills, Inc., [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,683 (E.D. Tenn. 1976).

have not been formally defined, the auditor should consider not whether the financial statements follow the letter of the accounting laws, but whether a fair presentation of a company's affairs is being made. Consider seeking the opinion of counsel or of a colleague not otherwise involved with the client, and document your efforts. The latter could be relevant to showing "good faith" in a subsequent defense of your audit work. Finally, provide full disclosure of the accounting method selected and, at least in your work papers, the rationale for selecting it.

B. Always Fully Comply with GAAS

There are two dimensions to this guideline. First, be sure to accumulate sufficient evidentiary matter in all material areas of client activity, and document your efforts in the audit work papers. Second, if in conducting the audit you encounter any items or areas requiring further analysis or audit judgment, follow up on such matters fully, and form and record your conclusions. If the auditor in *McLean*[255] would have followed this guideline and pursued the accounts receivable confirmation, he probably would have been spared liability.

C. Err on the Side of Full Disclosure

If one idea could be characterized as central to all the foregoing cases, it would be that any and all information relevant to the financial position of the audited concern should be fully disclosed. This principle is consistent with the fundamental policy of the securities acts in favor of full disclosure, and should be followed as to any information the accountant feels might be relevant. It is difficult to imagine a situation in which erring on the side of full disclosure could serve as a basis for 10b-5 liability, but it is easy to see how a fact that seemed of doubtful relevance at the time of the audit might later, in the blinding glare of hindsight, appear to have been material.

D. If You Make a Mistake, Take Immediate Steps to Directly Inform Anyone who Might be Injured by the Mistake

This is important for two reasons. First, an honest, negligent, or even reckless misrepresentation or omission is elevated to intentional, or at least knowing, status once the mistaken party has notice of his mistake and elects to remain silent. On the other hand, prompt notification of potentially injured parties is a demonstration of the accountant's good faith and, arguably, evidence of the inadvertent na-

255. *See* text accompanying notes 135-49 *supra.*

ture of the mistake. Second, from a practical standpoint, if a culpable mistake is recognized quickly enough and proper notification promptly follows, injury to some parties may be avoided and ultimate liability thereby lessened. If the defendant accounting firm in the *Adams* case[256] would have promptly advised all the standard shareholders of the error in the proxy statement rather than attempting to cover up the error, a different result might have ensued.

E. Don't Cave in to Client Pressure

Two of the three post-*Hochfelder* cases assessing liability against accountants involved obvious elements of auditors crumbling in the face of client pressure. In *Herzfeld,* FGL threatened to withdraw its account and sue Laventhol unless Laventhol rendered a favorable audit.[257] In *McLean,* the court characterized the situation as one in which an auditor had disregarded his professional responsibilities to accommodate his client's desire for a speedy audit.[258] It should be obvious that loss of a client or even a suit by a client is, in the vast majority of cases, to be preferred to a 10b-5 suit by injured investors. Further, the very fact of extraordinary client pressure should put the auditor on notice that a disclosure problem may exist, furnishing a factual basis for an allegation of recklessness. An auditor faced with such client pressure thus would be well advised to remain ever mindful of his duties to the public.

VII. CONCLUSION

The foregoing guidelines are formulated in accordance with the conclusion that the recklessness test will ultimately gain ascendancy as the minimally acceptable standard of behavior by which liability under Section 10(b) and Rule 10b-5 will be assessed. Should subsequent events prove otherwise, however, the utility of adherence to the guidelines would still be substantial. Obviously, behavior that would be held harmless under a recklessness test would not serve to impose liability under a more stringent standard. In any event, given the current trend toward recognition of the recklessness standard, prudence dictates that the auditor should assume its viability in the interim, and govern his behavior accordingly.

256. *See* text accompanying notes 163-78 *supra.*

257. Herzfeld v. Laventhol, Krekstein, Horvath & Horvath, 540 F.2d 27 (2d Cir. 1976), *discussed at* text accompanying notes 83-107 *supra.*

258. McLean v. Alexander, 420 F. Supp. 1057 (D. Del. 1976), *discussed at* text accompanying notes 135-51 *supra.*