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LIABILITY OF ACCOUNTANTS FOR PROXY VIOLATIONS—THE APPROPRIATE STANDARD OF CULPABILITY—*Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980).

In *Adams v. Standard Knitting Mills, Inc.*,[1] the Court of Appeals for the Sixth Circuit found an accounting firm not liable to shareholders for an error made in the preparation of financial reports accompanying a proxy statement. The court held that scienter[2] was necessary to find liability for an accounting firm's error; a mere showing of negligence was insufficient. Because the court based its finding on the grounds that the proper degree of culpability had not been proven, it must have assumed that, under some circumstances, accountants can be held liable for proxy violations.

This note will first examine whether in fact accountants can be held primarily liable for proxy violations. Concluding that they can, the note will scrutinize the court's opinion to determine whether it requires scienter for all primary violators or only for accountants. The court's rationale suggests that the court intended to apply a uniform standard of culpability. This note will then compare the court's reasoning with the reasoning that led courts in two other circuits to choose, at least in some cases, negligence as the standard for primary violators. The comparison will show negligence to be the more appropriate minimum standard under the policies of section 14(a) of the Securities Exchange Act of 1934[3] and SEC rule 14a–9.[4]

Finally, this note concludes that a uniform standard of culpability cannot equitably be applied to the wide range of potential defendants and that perhaps the *Adams* court reached its holding by implicitly applying a flexible-duty standard. This would justify requiring scienter for accountants, but negligence for other, more central participants in proxy violations. Alternatively, the court's result could be justified on an aiding and abetting theory without finding an accountant primarily liable under the statute.

I. BACKGROUND OF PROXY REGULATION

The Securities and Exchange Commission (SEC) regulates the solicitation of proxies under section 14(a) of the Securities Exchange Act of

1. 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980).

2. The court in *Adams* defined scienter as "a desire to deceive, defraud or manipulate." *Id.* at 427. This follows the Supreme Court's definition in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

3. 15 U.S.C. § 78n(a) (1976). For the text of this section, see note 5 *infra*.

4. 17 C.F.R. § 240.14a–9 (1981). For the pertinent text of this section, see note 6 *infra*.

1934.[5] This section forbids any person to solicit, or permit the use of his or her name to solicit, a proxy in violation of the rules and regulations promulgated by the SEC for the protection of investors. Rule 14a–9,[6] adopted by the SEC under section 14(a), prohibits making false or misleading statements with respect to a material fact in any proxy solicitation. It also prohibits the omission of a material fact necessary to make a statement true or not misleading.

Although section 14(a) does not expressly provide civil or criminal penalties, in 1964 the United States Supreme Court found in section 14(a) an implied private cause of action.[7] The Court stated that although the language of the statute "makes no specific reference to a private right of action, among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result."[8]

In the 1970 case of *Mills v. Electric Auto-Lite Co.*,[9] the Court held that to state a cause of action a shareholder need only show that the defect in the proxy statement was material.[10] The Court rejected the common law fraud test, which requires that the injured party *rely* on the misrepresentation, because of the impracticality of testing reliance by thousands of

5. 15 U.S.C. § 78n(a) (1976). This section provides:

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, 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, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

6. 17 C.F.R. § 240.14a–9 (1981). This rule, entitled "False or misleading statements," provides in pertinent part:

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

7. J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

8. *Id.* at 432. The Court stated that the remedy could be money damages, because "the possibility of civil damages . . . serves as a most effective weapon in the enforcement of the proxy requirements." *Id.*

9. 396 U.S. 375 (1970).

10. The Court stated:

Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction.

Id. at 385.

stockholders.[11] "Materiality" was defined generally as a requirement that the defect have a significant propensity to affect the share voting process.[12] The 1976 case of *TSC Industries, Inc. v. Northway, Inc.*[13] provided the Court with the opportunity to further define materiality: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[14]

In *TSC Industries*, the Supreme Court expressly reserved judgment on the issue of the proper standard of culpability under section 14(a).[15] The Court has not addressed this issue since.[16] Although the language of neither the statute nor of rule 14a–9 sets forth a standard, all courts that have considered the question have required some showing of culpability.[17] In

11. *Id.* at 382 n.5. The Court rejected the Seventh Circuit's reliance test, which proposed examining the underlying fairness of the transaction approved by the shareholders because "[u]se of a solicitation that is materially misleading is itself a violation of law . . . ." *Id.* at 383. The Court claimed that the objective materiality test "will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions." *Id.* at 385.

12. *Id.* at 384.

13. 426 U.S. 438 (1976).

14. *Id.* at 449.

15. The Court stated:

> Our cases have not considered, and we have no occasion in this case to consider, what showing of culpability is required to establish the liability under § 14(a) of a corporation issuing a materially misleading proxy statement, or of a person involved in the preparation of a materially misleading proxy statement.

Id. at 444 n.7.

16. The Court did mention the use by courts of a negligence standard under § 14(a) in a footnote when it decided to impose a scienter requirement under § 10(b) in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 209 n.28 (1976), stating:

> Emphasizing the important difference between the operative language and purpose of § 14(a) of the 1934 Act, 15 U.S.C. § 78n(a), as contrasted with § 10(b), however, some courts have concluded that proof of scienter is unnecessary in an action for damages by the shareholder recipients of a materially misleading proxy statement against the issuer corporation. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1299 (CA2 1973).

One commentator suggested that *Hochfelder* makes the use of a negligence standard of culpability questionable. Calhoun, *Divining the Implications of* Ernst & Ernst v. Hochfelder, 1 CORP. L. REV. 99, 115–17 (1978). *But see* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 778 (3d Cir. 1976), where the court cited *Hochfelder* as support for their use of a negligence standard stating:

> We are confirmed in this view by the very recent case of *Ernst & Ernst v. Hochfelder*, in which the Supreme Court pointed out that the "operative language and purpose" of each particular section of the Acts of 1933 and 1934 are important considerations in determining the standard of liability for violations of the section in question.

(citation omitted).

17. Most courts have accepted negligence as the proper standard of culpability. *See* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761 (3d Cir. 1976); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973); Del Noce v. Delyar Corp., [1976–1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,670 (S.D.N.Y. 1976); Berman v. Thomson, 403 F. Supp. 695 (N.D. Ill. 1975); Chris-Craft Indus., Inc. v. Independent Stockholders Comm., 354 F. Supp. 895 (D. Del. 1973); Norte & Co. v. R.L. Huffines, 304 F. Supp. 1096 (S.D.N.Y. 1968), *aff'd in pertinent part*, 416 F.2d

Gerstle v. Gamble-Skogmo, Inc.,[18] the Second Circuit held that, for the corporation soliciting the proxies, negligence was the appropriate standard of culpability.[19] In *Gould v. American-Hawaiian Steamship Co.*,[20] the Third Circuit extended the negligence standard beyond the soliciting corporation to an outside, non-management director. Then, in *Adams v. Standard Knitting Mills, Inc.*,[21] the Sixth Circuit held that scienter was the appropriate standard for an accountant.

The results reached in these cases are not necessarily inconsistent since each may be limited to its facts. A comparison of the reasoning used by the respective circuits, however, indicates a conflict between the Sixth Circuit and the Second and Third Circuits on the minimum standard of culpability applicable to proxy violators.

II. THE COURT'S REASONING IN *ADAMS v. STANDARD KNITTING MILLS, INC.*

In *Adams v. Standard Knitting Mills, Inc.*,[22] the defendant accounting firm prepared financial statements on Chadbourn, Inc. These financial statements accompanied a solicitation of proxies by Standard Knitting Mills, Inc.'s management from its shareholders, in which it favored a merger with Chadbourn. Under the terms of the proposed merger, Standard Knitting Mills' shareholders would exchange their common stock for Chadbourn preferred stock.[23] A footnote in the financial statement claimed that Chadbourn's debt agreement restricted the payment of common stock dividends, but would not restrict dividends on the preferred

1189 (2d Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (dicta); Richland v. Crandall, 262 F. Supp. 538 (S.D.N.Y. 1967) (dicta). *But see* Adams v. Standard Knitting Mills Inc., 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980).

For a discussion of why strict liability is not applied under § 14(a), see Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 859 (D. Del. 1972), *aff'd*, 535 F.2d 761 (3d Cir. 1976). *See also* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1300 (2d Cir. 1973).

18. 478 F.2d 1281, 1298–99 (2d Cir. 1973).

19. The court stated, however, that scienter may be an appropriate standard of culpability on different facts. *Id.* at 1300.

20. 535 F.2d 761, 777–78 (3d Cir. 1976).

21. 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980).

22. *Id.*

23. The merger offer proposed that:

> In return for their common, plaintiffs were to receive cumulative preferred dividends larger than dividends declared historically on Standard common, each share of preferred was convertible into Chadbourn common, the preferred was readily marketable on the New York Stock Exchange for cash, a small amount of Chadbourn common would be distributed pro rata among holders of the preferred if Standard achieved certain earnings goals, and Chadbourn promised to redeem the preferred at $11 per share in installments from 1975 to 1979 to shareholders desiring redemption.

Id. at 438–39 (Weick, J., dissenting).

stock the Standard Knitting Mills' shareholders were to receive.[24] One year after the merger, Chadbourn suffered financial setbacks. Contrary to the footnote in the financial statement, the debt agreement in fact kept it from paying the preferred stock dividends. The plaintiff shareholders brought suit against Standard Knitting Mills, Chadbourn, their respective lawyers, and their accountants for violation of sections 10(b)[25] and 14(a) of the 1934 Act and SEC rules 10b–5[26] and 14a–9.[27]

Both the district court and the court of appeals agreed that the footnote was false and misleading as to a material fact; they disagreed on the accountants' culpability. The district court found that the defendant accounting firm, Peat, Marwick, Mitchell & Co. (Peat), had acted with scienter with respect to the erroneous footnote and therefore was liable under both rule 10b–5 and rule 14a–9.[28] The district court's finding of scienter was based on the fact that Peat had been informed of its error in the foot-

24. The footnote read in pertinent part:

> (c) As to the note payable to three banks, the Company has agreed to various restrictive provisions including those relating to maintenance of minimum stockholders' equity and working capital, the purchase, sale or encumbering of fixed assets, incurrance [sic] of indebtedness, the leasing of additional assets and the payment of dividends *on common stock* in excess of $2,000,-000 plus earnings subsequent to August 2, 1969.

Id. at 426.

25. The Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j (1976), provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, 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.

(emphasis added).

26. 17 C.F.R. § 240.10b–5 (1981), entitled "Employment of manipulative and deceptive devices," provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of 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.

27. The plaintiff shareholders settled out of court with the defendants other than Peat, Marwick, Mitchell & Co. (Peat), the accountant for Chadbourn, Inc. The former Standard Knitting Mills shareholders were given control of Chadbourn under the settlement agreement. 623 F.2d at 425.

28. [1976–1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,683 (E.D. Tenn. 1976).

note by Chadbourn's outside counsel, but did not amend the footnote or attempt to alert the stockholders to the error.[29]

The court of appeals overturned the district court's finding of scienter, stating that Peat's failure to foresee "that the bottom would drop out of Chadbourn's earnings and that what appeared to be a minor error at the time would become a major bone of contention"[30] was mere negligence, not a "desire to deceive, defraud or manipulate."[31] The court thus reversed the portion of Peat's liability based on rule 10b–5, since liability under rule 10b–5 requires a finding of scienter.[32]

The appellate court then considered whether scienter should also be required to hold Peat liable under rule 14a–9. The answer, the court stated, depended not only on the language of the statute but also on legislative history and public policy.[33] The court concluded from committee reports and congressional debates that section 14(a) was intended to prevent only knowing or reckless wrongdoing of outsiders.[34] It found no indication that Congress intended investors to be protected against the negligence of accountants in preparing proxy materials. The court also compared provisions of the tender offer statute[35] to the proxy provisions because congressional statements indicated that tender offers would be treated similarly to proxy solicitations. Because the tender offer statute

29. *Id.* at 90,355. Peat was informed of the footnote error between March 23, 1970 and April 1, 1970. It did not contact the shareholders even though the proxy material was mailed to the shareholders on March 27, 1970.

The district court judge also found fault with Peat's valuation of the closing inventory (which would falsely increase the retained earnings), its valuation of Chadbourn's accounts receivable, and its failure to disclose defects in Chadbourn's computerized accounting system. The appeals court held these alleged defects to be at most negligent and therefore unimportant in light of its holding on the appropriate culpability standard. 623 F.2d at 431–36.

30. *Id.* at 428.

31. *Id.* at 427.

32. The Supreme Court held in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), that there must be a showing of scienter before an accountant can be held liable under § 10(b).

33. 623 F.2d at 428. *See* notes 65–80 and accompanying text *infra* for more discussion of the courts of appeals' views on the appropriate standard of liability.

34. *Id.* at 430.

35. The Securities Exchange Act of 1934, § 14(e), 15 U.S.C. § 78n(e) (1976), states:

> It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any *fraudulent, deceptive,* or *manipulative* acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

(emphasis added). This section was added in 1968 as part of the Williams Act, Pub. L. No. 90–439, § 3, 82 Stat. 457 (1968).

required scienter, the court held that section 14(a) implicitly required scienter as well.[36]

Furthermore, because the private right of action under section 14(a) was judicially created, the court claimed it had a "special responsibility to consider the consequences of [its ruling] and to mold liability fairly to reflect the circumstances of the parties."[37] The circumstances of the parties in *Adams* influenced the court against using a negligence standard. Peat was not in privity with the plaintiff shareholders and did not directly benefit from the proxy vote. The court claimed that a negligence standard would expose accounting firms to potentially enormous liability for minor mistakes in their daily work of preparing financial statements.[38] This potential liability would not be limited by procedural safeguards, such as privity or reliance, present in other securities provisions where negligence is the standard of culpability.[39] The court therefore concluded that a higher standard, scienter, was necessary to establish liability.

Judge Weick, dissenting, disagreed with the majority's reversal of the finding of scienter. He argued that the majority had engaged in a de novo review of the trial court's finding rather than applying the proper "clearly erroneous" standard under which the district court's finding of scienter would have been upheld.[40] Judge Weick noted that the accountant charged "a fee that was 125% of its usual fee because 'SEC work does

36. 623 F.2d at 430–31.

37. *Id.* at 428.

38. *Id.*

39. *Id.* at 428–29. The court cites as examples of procedural safeguards § 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1976), which imposes liability for negligent misrepresentation in registration statements only if there is proof of investor reliance, and § 12(2) of the 1933 Act, 15 U.S.C. § 77*l* (1976), which imposes liability for negligent misrepresentation in a prospectus provided there is privity. In fact, the court overstates its case here, as § 11 only requires reliance after an earning statement has been issued for a 12-month period following the effective date of the registration statement. 15 U.S.C. § 77k(a) (1976).

The majority noted that no shareholders had testified that they were deceived. The dissent pointed out that requiring a showing of reliance under either rule 10b-5 or rule 14a-9 violates Supreme Court holdings on this point. 623 F.2d at 443–44 (Weick, J., dissenting). *See also* note 11 and accompanying text *supra*.

40. *Id.* at 436–37 (Weick, J., dissenting). The dissent cited both Zenith Corp. v. Hazeltine, 395 U.S. 100 (1969), and FED. R. CIV. P. 52(a) as support for its claim that the majority had not properly applied the clearly erroneous standard. In *Zenith*, the Supreme Court said that "[i]n applying the clearly erroneous standard to the findings of a district court sitting without a jury, appellate courts must constantly have in mind that their function is not to decide factual issues *de novo*." 623 F.2d at 436 (Weick, J., dissenting) (quoting Zenith, 395 U.S. at 123). FED. R. CIV. P. 52(a) provides in pertinent part: "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses."

See Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 (6th Cir. 1979) (recklessness a factual determination). *But see* Edward & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 485 (2d Cir. 1979) ("negligence is a mixed question of fact and law, and we are not necessarily bound by the limitation of Rule 52(a)").

require a higher degree of risk.' "[41] The judge argued further that even if the original error was a mere "slip of the pen," the failure to correct it after it was called to the firm's attention was deliberate.[42] Thus, Judge Weick concluded that there was substantial evidence supporting the district court's finding that Peat had "intent to 'deceive' and 'manipulate' and [acted] in 'reckless disregard of the truth.' "[43]

Judge Weick also claimed that even if the accounting firm did not have an intent to deceive, its conduct was at least reckless. He claimed that the majority, by failing to find recklessness, had implicitly overruled *Mansbach v. Prescott, Ball & Turben*,[44] in which the Sixth Circuit found recklessness sufficient to satisfy a scienter requirement.[45]

Finally, Judge Weick argued that considerable weight should be given to the views of the SEC as the agency charged with administering the statute.[46] As amicus curiae on a rehearing petition, the SEC asserted that scienter should not be required to impose liability under rule 14a–9.[47] The SEC further argued that, if scienter was required, recklessness should satisfy the requirement. In addition, the SEC claimed that although the majority had in effect treated the accounting firm as a secondary participant it had failed to apply traditional concepts of secondary liability.[48]

III. ANALYSIS

In *Adams,* the Court of Appeals for the Sixth Circuit assumed that accountants can be liable under the proxy provisions when it based its reversal on the need to find scienter before imposing liability. It did not, however, discuss the issue. To date, no other court has held an accountant liable under the proxy provisions, while one court has suggested that ac-

41. 623 F.2d at 439 (Weick, J., dissenting).

42. *Id.* at 442 (Weick, J., dissenting).

43. *Id.* at 443 (Weick, J., dissenting).

44. 598 F.2d 1017 (6th Cir. 1979). The court held that recklessness satisfied the scienter requirement of § 10(b). The court defined recklessness as "highly unreasonable conduct which is an extreme departure from the standards of ordinary care. While the danger need not be known, it must at least be so obvious that any reasonable man would have known of it." *Id.* at 1025 (citing Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)).

45. 623 F.2d at 443 n.1 (Weick, J., dissenting).

46. *Id.* at 447 (Weick, J., dissenting). The dissent's view accords with Supreme Court comments on the subject. In Udall v. Tallman, 380 U.S. 1, 16 (1965), the Court, when construing the weight to give a proclamation of the Secretary of the Interior, stated: "When faced with a problem of statutory construction, this Court shows great deference to the interpretation given the statute by the officers or agency charged with its administration. . . . When the construction of an administrative regulation rather than a statute is in issue, deference is even more clearly in order."

47. 623 F.2d at 446–47 (Weick, J., dissenting).

48. *Id.*

countants could not be held liable under section 14(a) for preparing the proxies.[49]

A. Can Accountants Be Held Liable for Proxy Violations?

Section 14(a) states: "It shall be unlawful for any person . . . to *solicit* or to *permit the use of his name* to solicit any proxy" in contravention of the SEC rules and regulations.[50] Given this language, it can be argued that liability is limited to those who solicit or allow the use of their names for solicitation.

A number of SEC interpretations suggest that the preparation of proxy statements by accountants is not within the definition of "solicit." For example, rule 14a–1 defines the terms "solicit" and "solicitation" to include any request for a proxy, any request to execute a proxy, and furnishing a proxy form under circumstances implying a request for a proxy.[51] Thus, to "solicit," a person must take affirmative action to procure a proxy; it is questionable whether merely preparing the proxy statement accompanying the procuring is sufficient.

49. In Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 865 (D. Del. 1972), *aff'd*, 535 F.2d 761 (3d Cir. 1976), the district court stated:

> Section 14(a) imposes liability on individuals soliciting proxies, and not on the attorneys or accountants preparing them. Thus, unless the responsibility for examining proxy statements is borne by the directors and others who are potentially liable for misstatements, § 14(a) will be rendered largely ineffectual whenever proxy materials are prepared by experts or others not involved in the solicitation.

50. Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n(a) (1976) (emphasis added).

51. 17 C.F.R. § 240.14a–1 (1981), entitled "Definitions," provides in pertinent part:

> Unless the context otherwise requires, all terms used in §§ 240.14a–1 to 240.14a–10 and in Schedule 14A have the same meanings as in the act or elsewhere in the general rules and regulations thereunder. In addition, the following definitions apply unless the context otherwise requires:
>
> . . . .
>
> (d) *Proxy*. The term "proxy" includes every proxy, consent or authorization within the meaning of section 14(a) of the act. The consent or authorization may take the form of failure to object or to dissent.
>
> . . . .
>
> (f) *Solicitation*. (1) The terms "solicit" and "solicitation" include:
>
> (i) Any request for a proxy whether or not accompanied by or included in a form of proxy;
>
> (ii) Any request to execute or not to execute, or to revoke, a proxy; or
>
> (iii) The furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.
>
> (2) The terms do not apply, however, to the furnishing of a form of proxy to a security holder upon the unsolicited request of such security holder, the performance by the issuer of acts required by § 240.14a–7, or the performance by any person of ministerial acts on behalf of a person soliciting a proxy.

Rule 14a–11,[52] which applies when dissident shareholders challenge present management in a proxy contest, provides further support for the exclusion of accountants from the class of solicitors. The rule requires both sides to completely disclose all "participants" in the contest.[53] In defining "participants," however, the rule explicitly excludes "any person employed by a participant in the capacity of . . . accountant . . . whose activities are limited to the performance of his duties in the course of such employment."[54] These rules suggest that when accountants are engaged only to prepare financial reports for proxy statements, the SEC does not consider them to be persons who "solicit" under the statute.

The proxy statute also applies to those who permit the use of their names for solicitation of proxies;[55] rule 14a–101[56] requires that the accountant's name be listed in any proxy solicitation by management involving a merger proposal. Therefore, an accountant could conceivably be liable under the second phase of the statute. The Ninth Circuit, inter-

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52. 17 C.F.R. § 240.14a–11 (1981), entitled "Special provisions applicable to election contests," provides in pertinent part:

(a) *Solicitations to which this section applies.* This section applies to any solicitation . . . by any person or group of persons for the purpose of opposing a solicitation . . . by any other person or group of persons with respect to the election or removal of directors at any annual or special meeting of security holders.

(b) *Participant or participant in a solicitation.* For purposes of this rule the terms "participant" and "participant in a solicitation" include the following:

. . . .

(6) Any other person who solicits proxies. The foregoing terms do not, however, include . . . (iii) any person employed by a participant in the capacity of attorney, accountant, or advertising, public relations or financial adviser, and whose activities are limited to the performance of his duties in the course of such employment . . . .

53. *Id.* at § 240.14a–11(c) & (d).

54. *Id.* at § 240.14a–11(b)(6).

55. 15 U.S.C. § 78n(a) (1976). The pertinent part of this section states: "It shall be unlawful for any person . . . in contravention of such rules and regulations as the Commission may prescribe . . . to permit the use of his name to solicit any proxy . . . ." *See generally* note 5 *supra* (complete text of section).

56. 17 C.F.R. § 240.14a–101 (1981), entitled "Schedule 14A. Information required in proxy statement," states in pertinent part:

Item 8. Relationship with independent public accountants. If the solicitation is made on behalf of the issuer and relates to an annual meeting of security holders at which directors are to be elected, or financial statements are included pursuant to Item 15, furnish the following information describing the issuer's relationship with its independent public accountants:

(a) The name of the principal accountant selected or being recommended to shareholders for election, approval or ratification for the current year. If no accountant has been selected or recommended, so state and briefly describe the reasons therefor.

. . . .

Item 15. Financial statements and supplementary data.

If action is to be taken with respect to any matter specified in [Item 14, *Mergers, consolidations, acquisitions and similar matters*] furnish the [required] financial statement . . . .

preting that phrase in *Yamamoto v. Omiya*,[57] required a substantial connection between the person's name and the solicitation effort. Thus, it can be argued that this provision was not intended to apply to accountants unless they were actively seeking the proxy solicitation or stood to gain from its success. If an accounting firm's role does not fit within either "soliciting" or "using its name to solicit," accountants should not be held liable as primary violators of the proxy rules.

Arguments do exist, however, for holding accountants primarily liable. Courts have imposed special responsibilities on accountants despite language in security provisions that arguably excludes them.[58] For example, in *SEC v. Coffey*,[59] the Sixth Circuit claimed: "An accountant . . . who prepares a dishonest statement is a primary participant in a violation [of section 10(b)] even though someone else may conduct the personal negotiations with a securities purchaser."[60] If an accountant can be held liable in connection with a "purchase or sale of any security"[61] under rule 10b-5,[62] it seems possible, by analogy, to find an accountant liable as a primary violator of section 14(a) for preparing a faulty proxy statement.

In addition, accountants play a special role in the securities field because of the public's dependence on their accuracy.[63] The importance of this role could give the accountants' activities a "substantial connection with the solicitation effort" that would justify primary liability for misstatements. Therefore, there is support for the court's assumption in *Adams* that accountants can be held liable as primary violators of proxy provisions. This author thinks that accountants should be held liable in light of their special position in the securities field.[64]

57. 564 F.2d 1319 (9th Cir. 1977) (holding that including the name of the proposed purchaser of the corporation's building in the proxy statement did not render him liable for any deception in it).

58. *See generally* note 91 and accompanying text *infra*.

59. 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

60. *Id.* at 1315 n.24.

61. Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j (1976) (reproduced in pertinent part in note 25 *supra*).

62. 17 C.F.R. § 240.10b-5 (1981) (reproduced in pertinent part in note 26 *supra*).

63. The district court in *Adams* held that Peat owed a duty to the shareholders stating:

> Additionally, an accountant owes a duty to the public to be independent of his client and to report fairly the facts before him.
>
> "The policy underlying the securities laws of providing investors with all the facts needed to make intelligent investment decisions can only be accomplished if financial statements fully and fairly portray the *actual financial* condition of the company."

[1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,683, at 90,364-65 (quoting Herzfeld v. Laventhol, Kreskstein, Horwath & Horwath, 378 F. Supp. 112, 122 (S.D.N.Y. 1974)) (emphasis added) (footnotes omitted).

64. "A really successful fraud can scarcely be accomplished in our complex financial worlds without the help of accountants and lawyers. This may be active and intentional connivance or it may be more passive and subtle, but it is frequently essential." Speech of former SEC Chairman Ray Garret, Jr. before ABA National Institute of Professional Liability, in Montreal (May 30-31, 1974),

B. *What is the Appropriate Standard of Culpability for Primary Violators?*

1. *Is the Court Proposing a Uniform Standard of Scienter for All Primary Violators?*

The court of appeals in *Adams,* in requiring scienter, did not rely on the language of section 14(a). Instead, it focused on the failure of rule 14a–9 to require privity or reliance, two procedural safeguards present in other security provisions where Congress imposes liability for negligence.[65] The court apparently concluded that the "less exacting standard of materiality,"[66] used as a surrogate for those safeguards in private rights of

quoted in Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 96 n.234 (1975).

65. 623 F.2d at 428–29. *See* note 39 *supra*. The Third Circuit in *Gould* focused on the similarities between § 11 of the 1933 Act, 15 U.S.C. § 77k (1976), and § 14(a) of the 1934 Act and not on the differences between reliance and materiality. The court said that both provisions enumerate "specific classes of individuals who bear liability for failure to meet the required standard of disclosure. Moreover, each involves single specific documents which are of primary importance in . . . fundamental areas of securities regulation . . . . " Gould v. American-Hawaiian S.S. Co., 535 F.2d at 777. Because of these similarities the court claimed both should have a negligence standard.

66. 623 F.2d at 429. The Sixth Circuit's attitude toward the materiality standard apparently follows from Supreme Court comments in *Ernst & Ernst v. Hochfelder*. The Court compared § 10(b) with provisions of the 1933 Act which specifically allowed recovery for negligent conduct stating:

> We think these procedural limitations indicate that the judicially created private damages remedy under § 10(b)—which has no comparable restrictions—cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrong-doing. Such extension would allow causes of action covered by §§ 11 [and] 12(2) . . . to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.

425 U.S. at 210 (footnotes omitted). The Court later claimed that the comparison with other security provisions was not the determinative factor in deciding on a scienter standard for § 10(b). Aaron v. SEC, 446 U.S. 680, 691 n.9 (1980).

There is no suggestion by the Sixth Circuit that a negligence standard under § 14(a) would intrude on the subject matter of § 11 or § 12 of the 1933 Act. In addition, the procedural restrictions the Supreme Court referred to in *Hochfelder* were the posting of bond for costs (including attorney fees) and the length of the statute of limitations. The Court said nothing about materiality being a "less exacting standard" than reliance.

The Court rejected the use of reliance under the proxy provisions in Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1975), because it was impractical to apply a reliance test to thousands of shareholders. *See* notes 9–11 and accompanying text *supra*. In TSC Indus., Inc., v. Northway, Inc., 426 U.S. 438 (1976), the Court explicitly recognized the potentially great liability for a rule 14a–9 violation if the standard of materiality was unnecessarily low. It was for this reason the Court rejected a standard holding a fact material if it *might* affect the voting process in favor of a standard requiring a *substantial likelihood* the omitted fact would have significance to a reasonable shareholder. *Id.* at 448–49. *See* notes 13 & 14 and accompanying text *supra*.

The Sixth Circuit unnecessarily denigrates the materiality standard which is the cornerstone of the disclosure policy of the federal securities laws. The Supreme Court claimed that the materiality standard was the best balance between protecting the investor and subjecting the potential violator to unreasonable liability. The Sixth Circuit should have deferred to the Supreme Court's opinion on this subject and used other means to justify its finding. For a discussion of materiality, see Hewitt, *Developing Concepts of Materiality and Disclosure*, 32 BUS. LAW. 887 (1977).

action under section 14(a), was insufficient protection against liability if coupled with a negligence standard. Thus, the court required scienter.

The court also relied on legislative history because neither the statute nor the rule designate a standard of culpability.[67] The court cited a Senate report to the 1934 Act which stated that SEC rules and regulations would "protect investors from *promiscuous* solicitation of their proxies . . . by irresponsible outsiders seeking to wrest control . . . and . . . by *unscrupulous* corporate officials seeking to retain control . . . by *concealing* and *distorting* facts."[68] The court used this broad statement to support its position that Congress intended to require intentional conduct for accountant liability.[69]

These reasons for requiring scienter have broad implications. The rationale is equally applicable to all primary violators. If the court intended scienter as a uniform standard, its decision is contrary to the conclusions of courts in two other circuits which have considered the issue of the appropriate standard of culpability. The Second Circuit in *Gerstle v. Gamble-Skogmo, Inc.*,[70] held that when the soliciting corporation was the defendant in a suit for damages under rule 14a–9, negligence was the proper standard; it reserved the right to require a higher standard of culpability if circumstances, such as the absence of privity, called for it.[71] Negligence was also held to be the standard by the Third Circuit in *Gould v. American-Hawaiian Steamship Co.*,[72] in which the defendant was an outside, non-management director of the soliciting corporation. Both courts emphasized that neither section 14(a) nor rule 14a–9 contained words such as "manipulative," "deceptive," or "contrivance," which were used by the Supreme Court in *Ernst & Ernst v. Hochfelder*[73] as a basis for requiring scienter under section 10(b).[74]

In addition, the language of rule 14a–9 is virtually identical to that of

67. 623 F.2d at 429.

68. S. REP. No. 1455, 73d Cong., 2d Sess. 77 (1934), *quoted in Adams*, 623 F.2d at 429 (emphasis provided by court). The court found significant the report's use of the words "unscrupulous," "concealing," and "distorting," which the court claimed implied knowledge or scienter. The court interpreted "promiscuous" as meaning reckless. 623 F.2d at 430.

69. *Id.*

70. 478 F.2d 1281 (2d Cir. 1973).

71. *Id.* at 1300–01. The court identified privity, although not required under the security provision, as bearing heavily on the appropriate standard of culpability. The court also said that whether or not the transaction benefited the defendant was important. *Id.* at 1300. *Gerstle* is not necessarily contrary to *Adams* because of the lack of privity in the latter. The *Adams* court, however, did not apply the same rationale as the *Gerstle* court but instead drew opposite conclusions from the legislative history.

72. 535 F.2d 761 (3d Cir. 1976).

73. 425 U.S. 185, 199 (1976).

74. *Gould*, 535 F.2d at 777; *Gerstle*, 478 F.2d at 1281.

section 17(a)(2) of the Securities Act of 1933[75] which was interpreted by the Supreme Court in *Aaron v. SEC*[76] not to require scienter.[77] This is further evidence that the language of section 14(a) does not require scienter.

The congressional statements the court of appeals cites in *Adams* are not as persuasive as the court suggests. There is no doubt that Congress enacted section 14(a) to stop severe abuses such as those listed in the Senate report. On the other hand, there is no evidence that Congress intended to limit the SEC's regulatory authority to "manipulative or deceptive" acts. If Congress intended to limit the SEC's authority, it could have included in section 14(a) the restrictions found in section 10(b). A House report suggests that Congress intended the SEC's regulatory authority under the 1934 Act to include situations unknown to and undescribed by Congress.[78] Thus, the SEC was given broad grants of power to define violations of the proxy statute. The absence of language in the statute setting forth the appropriate standard of culpability also implies that this definition was to be left to the SEC's discretion. The congressional statements relied upon by the *Adams* court describe the extremes to which the statute was to apply, and were made to aid its passage. It is questionable whether these statements should be conclusive as to the statute's scope.

The Second and Third Circuits agree that if the defendant is the soliciting corporation, negligence is the appropriate standard.[79] To the extent

75. The Securities Act of 1933, § 17(a), 15 U.S.C. § 77q (1976), provides in pertinent part:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any *device*, *scheme*, or *artifice* to *defraud*, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission 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 . . . .

(emphasis added).

76. 446 U.S. 680 (1980).

77. The Court stated that "[i]n the absence of a conflict between reasonably plain meaning and legislative history, the words of the statute must prevail." *Id.* at 700 (footnotes omitted). Scienter was required under § 17(a)(1) because it contains language similar to that found in § 10(b).

78. H.R. REP. No. 1383, 73d Cong., 2d Sess. 6 (1934) states:

[T]he complicated nature of the problems justif[y] leaving much greater latitude of discretion with the administrative agencies than would otherwise be the case. It is for that reason that the bill in dealing with a number of difficult problems singles out these problems as matters appropriate to be subject to restrictive rules and regulations, but leaves to the administrative agencies the determination of the most appropriate form of rule or regulation to be enforced.

79. *See* notes 70–72 and accompanying text *supra*.

the Sixth Circuit suggests scienter as a uniform standard for all defendants, it adopts a minority position.[80]

2. *Is the Same Standard of Culpability Appropriate for All Primary Violators?*

Because of the many different potential defendants in a section 14(a) action, application of a uniform standard of culpability is questionable. The court in *Adams* itself suggested a need to consider the special circumstances of the parties.[81] If, for example, negligence were chosen as the appropriate standard, in harmony with *Gerstle* and *Gould,* it would have to be applied to accountants held to be primary participants. Many courts have been reluctant to impose liability on accountants for mere negligence because of their unique position, focusing especially on their limited contact with the public. For example, in *Ultramares Corp. v. Touche,*[82] Justice Cardozo said that in the absence of any privity requirement, "[i]f liability for negligence exists, a thoughtless slip or blunder . . . may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."

This same concern was voiced by the court of appeals in *Adams*: "Unlike the corporate issuer, the preparation of financial statements to be appended to proxies and other reports is the daily fare of accountants, and the accountant's potential liability for relatively minor mistakes would be enormous under a negligence standard."[83] The court found the potential for liability especially high because rule 14a–9 does not require privity or reliance but only a showing of materiality.[84]

Courts have also hesitated to apply the same culpability standard to lawyers and other experts giving advice to corporations as they apply to the corporation itself.[85] Some commentators on rule 10b–5 litigation claim that one standard of culpability is not feasible considering all the

80. *See* note 17 *supra*. *But see* Note, *The Proper Standard of Fault for Imposing Personal Liability on Corporate Directors for False or Misleading Statements in Proxy Solicitations under Section 14(a) of the Securities Exchange Act of 1934 and SEC Rule 14a–9*, 34 OHIO STATE L.J. 670 (1973), where the author claims that a modified scienter standard is the proper standard of fault for corporate directors under the proxy provisions.

81. *See* text accompanying notes 37 & 38 *supra*.

82. 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931).

83. 623 F.2d at 428.

84. *Id.* at 428–29. *See* notes 39 & 66 *supra*.

85. *See* 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).

possible relationships between plaintiffs and defendants.[86] The Ninth Circuit's solution was to focus on the duty the particular defendant owed to the plaintiff and vary the culpability required according to the strength of that duty.[87] The Ninth Circuit's flexible-duty standard answers the critics' complaints about the uniform standard of culpability and allows courts to require a greater showing of culpability for more remote defendants without lessening the protection of investors against more central violators.

3. *Did the Court in* Adams *Implicitly Apply a Flexible-Duty Standard?*

The flexible-duty approach varies the standard of culpability according to the nature of the interaction between the various plaintiffs and defendants. This approach allows courts to consider all factors they deem important in assessing liability, but frees them from the need to fit a particular defendant into a previously defined class with a set standard of culpability.[88]

The Ninth Circuit suggested, that when assessing liability, courts should consider the relationship of the defendant to the plaintiff, the relative access each has to the information, the benefit the defendant derives from the relationship, the degree to which the defendant was aware of the plaintiff's reliance on the defendant's activity, and the defendant's role in initiating the security transaction.[89] Courts may add to this list as the particular case demands. A standard of culpability is applied according to the particular facts of the case.[90] Negligence would be the minimum standard

86. *See, e.g.*, 3 A. Bromberg & L. Lowenfels, Securities Fraud & Commodities Fraud § 8.4 (513), at 204.115 (1981), where the author states:

A comprehensive *scienter* standard would have to fit the enormous variability of 10b–5 private suits, including

(1) Whether the violation is misrepresentation, nondisclosure or some more complex scheme or manipulation;

(2) Whether there is privity, a lesser relationship (such as aiding-abetting or conspiracy) or no privity at all (as in insider trading cases); in the parlance of this text, whether the transactions are direct or indirect, personal or impersonal;

(3) Whether there is one plaintiff or thousands;

(4) Whether there is some special relationship between the parties, such as fiduciary-beneficiary or broker-customer;

(5) Whether the relief sought is damages, recission, injunction or something else.

There is a real question whether a single standard can do the job adequately.

See also Mann, note 85 *supra*.

87. White v. Abrams, 495 F.2d 724 (9th Cir. 1974).

88. *Id.* at 734. The Ninth Circuit stated: "By adopting such a duty analysis, we avoid the confusion that arises from classifying the defendants as primary and secondary, or from classifying the transactions as direct and indirect."

89. *Id.* at 735–36.

90. There was some question as to whether the flexible-duty standard survived *Ernst & Ernst v. Hochfelder* because the standard allowed liability for negligence under rule 10b–5, whereas *Hoch-*

under section 14(a) applied to central actors. Courts may apply a recklessness standard or higher for persons with less contact.

The court of appeals' opinion in *Adams* should be viewed as implicitly applying a flexible-duty standard. This makes its requirement of scienter for the accounting firm more justifiable, given the facts of this case. The facts, however, do not lead to a clear result on the appropriate standard of culpability.

Facts that could have influenced the court to use a lower standard of culpability are as follows. First, as an accountant, Peat had a special relationship with the public under federal securities law and owed a duty of care to the shareholders from whom the proxies were solicited.[91] Peat also had greater access to the information than the shareholders. In addition, it could protect itself from loss caused by liability, either through insurance or by the exercise of greater care. The shareholders had no reason to suspect the footnote was erroneous, and thus were unable to protect themselves. Furthermore, since the financial statements were material, Peat was aware that the shareholders would consider them in making their decision.[92] Peat's duty to give accurate information to the shareholders under these factors points toward a lower standard of culpability.

Balanced against these factors, however, are others that indicate a higher standard of culpability is appropriate. Peat did not initiate the security transaction and did not benefit from the approval of the merger. Peat also was not in privity with the shareholders; the court in *Gerstle* claimed that privity was an important factor in determining the degree of culpability required.[93] By balancing these circumstances in favor of a higher standard of culpability with the above factors, the *Adams* court could conclude that a scienter standard was appropriate on these facts.[94]

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felder required recklessness. Since *Hochfelder*, however, the standard has been applied with a recklessness minimum in both the Fifth and Ninth Circuits. *See* Steinberg & Gruenbaum, *Variations of "Recklessness" After* Hochfelder *and* Aaron, 8 SEC. REG. L.J. 179, 203–08 (1980). There should be no problem in using the flexible-duty standard under rule 14a-9 since it does not require a scienter minimum.

91. *See, e.g.*, Isbell, *An Overview of Accountants' Duties and Liabilities under the Federal Securities Laws and a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261 (1974); Kosek, *Professional Responsibility of Accountants and Lawyers before the Securities and Exchange Commission*, 72 LAW LIB. J. 453 (1979), *reprinted in* SECURITIES LAW REVIEW—1980, at 523 (H. Blumenthal ed. 1980). Peat recognized the need for greater care when it charged 125% of its normal fee because of the securities nature of the job. *Adams*, 623 F.2d at 439 (Weick, J., dissenting).

92. *See* text accompanying note 14 *supra*.

93. 478 F.2d at 1300.

94. *But see* Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967), where the court held a showing of negligence was sufficient to impose liability on an accountant for not correcting prior audited statements when the accountant later discovered the statements were materially misleading when made. The decision was based on both the common law and § 10(b). A different result would be reached under the § 10(b) claim after Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

C. If Accountants Are Not Primary Violators, Are They Liable for Aiding and Abetting?

The scienter requirement could also be justified by applying an aiding and abetting theory.[95] Statutory language does not preclude accountant liability for aiding and abetting a primary participant's violation of section 14(a).[96] Although the Supreme Court has not directly addressed this issue,[97] most of the circuits that have considered the question with respect to other security provisions have found such secondary liability possible.[98] The Sixth Circuit, in *SEC v. Coffey*,[99] also held that aiding and

95. The district court in *Adams* used an aiding and abetting theory to hold Peat liable under § 14(a), saying: "In short, defendant's financial statements were not neutral but were knowingly and deliberately biased. This constituted advocacy and in practical effect a solicitation of approval for the Chadbourn merger; and therefore aiding and abetting a proxy solicitation by Peat." [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,683, at 90,370.

96. A commentator defined secondary liability saying "persons owing direct duties to the public will be classified as primary wrong-doers. Those whose liabilities arise only because another has violated the law will be called secondary wrongdoers." Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* in Pari Delicto, *Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 600 (1972). Therefore the statutory language would need to cover only the primary violator.

But see Fischel, *Secondary Liability under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80 (1981), in which the author claims that in light of recent Supreme Court decisions, aiding and abetting liability applies only to those security provisions that explicitly provide for it. Under this proposal, if the accused violator does not qualify as a primary violator under the provision in question, the only recourse open to a plaintiff would be to find liability against the alleged violator under § 10(b) for a "manipulative or deceptive act." This, the author claims, often includes accountants who knowingly prepare and *certify* false and misleading financial statements in connection with a sale or purchase of a security. *Id.* at 107–08.

97. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), came to the Supreme Court after the Seventh Circuit held the defendant accounting firm liable as an aider and abettor for failing to discover the fraud of the primary wrongdoer. 503 F.2d 1100 (7th Cir. 1974), *rev'd*, 425 U.S. 185 (1976). In a footnote the Supreme Court stated: "In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10(b) and Rule 10b–5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the Rule . . . ." 425 U.S. at 191 n.7.

98. *See* Edward J. Mawod & Co. v. SEC, 591 F.2d 588 (10th Cir. 1979); Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

These courts based their finding of aiding and abetting liability on tort principles. Section 876 of the *Restatement of Torts* provides:

> For harm resulting to a third person from the tortious conduct of another, a person is liable if he
>
> . . . .
>
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

4 RESTATEMENT OF TORTS § 876 (1939).

99. 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

abetting a rule 10b–5 violation gave rise to an actionable claim. In *Gould,* the Third Circuit discussed approvingly the possible application of aiding and abetting principles to the accused proxy violators.[100]

The standards for imposing liability on one who aids and abets another in committing a securities violation are stricter than those necessary to hold a primary violator liable. The court in *Coffey* set forth three elements that must be met to hold a person liable as an aider-abettor.[101] First, there must be a securities law violation by some other party. Second, it must be shown that there was general awareness or knowledge by the aider-abettor that his or her role was part of the improper activity. Some courts have viewed this general awareness requirement as insufficient and substituted as a requirement actual or constructive notice[102] of the intended impropriety. The higher standard avoids unreasonable imposition of liability on defendants who may have been unaware of the results of their actions.

Finally, the potential aider and abettor must have knowingly and substantially assisted the violation. This requirement is generally met if the court finds that the aider-abettor recklessly assisted a wrongful act. In addition, when money damages are sought, at least one circuit requires a breach of fiduciary duty.[103] Usually more than mere inaction is required because of courts' reluctance to impose a duty to investigate.[104] Failure to state facts necessary to make statements not false or misleading, though, is not viewed as mere inaction, particularly when the omission is known.[105]

It is highly probable that both Chadbourn, Inc. and Standard Knitting Mills were primary violators of rule 14a–9 when they failed to correct the

100. 535 F.2d 761, 778–81 (3d Cir. 1976).

101. 493 F.2d at 1304.

102. The Third Circuit stated in *Gould* that the knowledge requirement "may be less strict where the alleged aider and abettor derives benefits from the wrongdoing but even in this situation the proof offered must establish conscious involvement in impropriety or constructive notice of intended impropriety." 535 F.2d at 780. *See* Ruder, *supra* note 96, at 638 ("[a]dherence to the knowledge requirement still allows imposition of liability in appropriate cases, since knowledge can be shown by reckless conduct or through inference").

103. Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 484 (2d Cir. 1979). In this rule 10b–5 case, the court stated: "We have not used the 'recklessness' standard when money damages are claimed in an aiding and abetting context, except on the basis of a breach of fiduciary duty."

104. *See* Ruder, *supra* note 96, at 641–44.

105. The Second Circuit in United States v. Natelli, 527 F.2d 311 (2d Cir. 1975), *cert. denied,* 425 U.S. 934 (1976), held that an accountant has a duty to correct earlier audited financial statements if it becomes known that figures in the report in question are materially false and misleading and there is a chance to correct them. This was a criminal prosecution under §§ 14 & 32 of the 1934 Act, 15 U.S.C. §§ 78ff & 78n.

erroneous footnote in the financial statements.[106] Furthermore, Peat had both a general awareness and actual knowledge of its role in the violation.[107] Most courts, however, require at least reckless assistance of the violation for aiding and abetting liability because of the more remote position of the defendant.[108] If the *Adams* court was correct in finding Peat's conduct negligent, but not reckless,[109] then its decision is supportable under an aiding and abetting theory.

IV. CONCLUSION

The Court of Appeals for the Sixth Circuit should be commended for finding that accountants can be liable for proxy violations under section 14(a). Unfortunately, the court failed to explain how it reached that result. The court should have also been more explicit as to whether it intended scienter to be the standard of culpability for all primary proxy violators or just accountants. The court's reasoning is sufficiently broad to infer an intention to require scienter as the appropriate standard of culpability for all defendants. This endangers future investors' attempts to protect their interests against proxy violators who are not accountants. Explicit use of a flexible-duty standard or an aiding and abetting theory would have given the court's decision more support without eliminating the proper use of a negligence standard against more central actors, such as a soliciting corporation. Although the court made a positive contribution in holding accountants potentially liable under section 14(a), its contribution would have been more positive if it had used a rationale that made clear the standard of culpability to be used in various private rights of action for proxy violations.

Bruce E. Dick

106. It is questionable whether the corporations needed to be informed of the error to be found negligent.

107. *See* note 29 and accompanying text *supra*.

108. *See* Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 484 (2d Cir. 1979), *quoted in* note 103 *supra* (recklessness not sufficient).

109. The court could have avoided the entire issue of the appropriate standard of culpability by applying the clearly erroneous standard to the district court's finding that Peat acted with scienter and upholding that finding. Peat's conduct was close enough to constituting recklessness to at least warrant discussion of it.