1980

Securities Law - Rule 10b-5 - Recklessness Formulation of Scienter Requirement under Rule 10b-5

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SECURITIES LAW—RULE 10b-5—RECKLESSNESS FORMULATION OF SCIEN TER REQUIREMENT UNDER RULE 10b-5.

McLean v. Alexander (1979)

Plaintiff Malcolm McLean,\(^1\) having read an opinion audit containing material misrepresentations\(^2\) in connection with his purchase of all of the outstanding stock of Technidyne, Inc. (Technidyne),\(^3\) sued Cashman & Schiavi (C & S), the certified public accountants responsible for the audit, as well as the selling shareholders and an investment advisory firm,\(^4\) alleging violations of section 10(b) of the Securities Exchange Act of 1934 (1934 Act),\(^5\) Securities and Exchange Commission (SEC) rule 10b-5,\(^6\) and the Delaware common law of fraud.\(^7\) The trial court concluded that the plaintiff had re-

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\(^1\) McLean v. Alexander, 420 F. Supp. 1057, 1062-63 (D. Del. 1976), rev’d, 599 F.2d 1190 (3d Cir. 1979). McLean was a man of considerable wealth, estimating his personal net worth at the time of the Technidyne, Inc. purchase in the area of $50 million. 420 F. Supp. at 1062. McLean first built a trucking empire, McLean Trucking, and later a shipping empire, Sea-Land Services, for which he is credited with pioneering the concept of containerized shipping. Id. During the late 1960’s and early 1970’s, McLean, a sophisticated investor, acquired a series of highly speculative business enterprises which manufactured technologically sophisticated products ranging from atomic reactor detectors to electron microscopes. Id. at 1063.

\(^2\) 599 F.2d at 1194. The opinion audit misrepresented accounts receivable for the 11 month period ending November 30, 1969. Id.

\(^3\) Id. at 1193. Technidyne was a small company that developed, manufactured, and marketed as its principal product a laser beam pipe-laying system called “Technitool.” Id.

\(^4\) Id. at 1194. A New York investment advisory firm employed by Technidyne circulated a report to prospective private investors stressing the saleability of Technitools and disclosing, falsely, that the termination of an exclusive distributorship arrangement was due to the distributor’s poor performance. Id. at 1193. The report, for which the managing shareholders of Technidyne supplied the information, further purported to show that 16 Technitools had been sold in less than three months as a result of the company’s direct selling efforts. Id. In fact, these “sales” turned out to be mere orders, sales conditioned on resale, or consignments. Id. at 1194. Moreover, the exclusive distributorship arrangement had collapsed, not because of the distributor’s unreliability, but because the poor quality of the Technitool units had resulted in frequent product breakdowns. Id.

\(^5\) 15 U.S.C. § 78j(b) (1976). Section 10(b) makes it unlawful for any person . . . (t)о use or employ, in connection with the purchase or sale of any security . . . (a)ny manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. Id.

\(^6\) 17 C.F.R. § 240.10b-5 (1980). Promulgated in 1942 pursuant to the SEC’s rulemaking authority, rule 10b-5 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 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.

Id.

\(^7\) See 599 F.2d at 1194.
lied upon the auditor's balance sheet attached to the C & S Report of Examination which materially misrepresented mere consignments and guaranteed sales as amounts due and owing from bona fide sales transactions. The United States District Court for the District of Delaware, sitting without a jury, found for the plaintiff, determining that the evidence established, and that liability for scienter purposes under section 10(b) and rule

8. Id. at 1195-96. The C & S report, which contained an audited balance sheet dated November 30, 1969, limited certification to the balance sheet, declining to attest to the statements of operations and retained earnings. Id. at 1198. An opinion letter attached to the report also noted the C & S's "examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as [C & S] considered necessary in the circumstances." Id.

9. 420 F. Supp. at 1067. The shipment of merchandise to a consignee should not be considered as a sale for accounting purposes because title does not pass to the consignee. ATTORNEY’S HANDBOOK OF ACCOUNTING § 17.02[4] (H. Sellin ed. 1979) [hereinafter cited as ATTORNEY’S HANDBOOK]. For accounting purposes, consignment sales should be specially noted on the balance sheet in a memorandum account. Id.

10. 599 F.2d at 1196. A guaranteed sale reserves the right in the retailer to return the merchandise to the seller if the product cannot be resold. ATTORNEY’S HANDBOOK, supra note 9, § 17.02[9]. Guaranteed sales should not be recognized on the seller’s corporate balance sheet unless “certain conditions are met, including: fixed prices, insurable interest, and ability to reasonably predict future returns.” Id.

11. 599 F.2d at 1196. C & S, in its opinion audit, listed the sum of $73,333 in accounts receivable as a current asset and designated the amount as “Considered Fully Collectible.” Id. at 1195 & n.3. This figure was primarily attributed to 16 direct “sales” of Technitools to three customers. Id. at 1198-201. The audit revealed several inconsistencies between purchase orders and invoices regarding billing dates and deliveries of the corporation’s principal product, the Model V Technitool. Id. at 1199-201. One invoice was dated on the closing date of the audit and a second, not issued until a week after the purchase order, called for payment nearly nine weeks after the date on which the purchase order required payment. Id. at 1199, 1200.

In addition, sales confirmation letters sent to each of the four accounts failed to produce fully responsive statements from the purchasers as to amounts owed Technidyne. Id. at 1199-201. Although not inconsistent with Technidyne’s documentation of sales, all of the telegrams received by C & S confirmed the existence of purchase orders but not amounts due and owing. Id. C & S did not contact any of the accounts in person or by telephone either to obtain fully responsive replies or to determine why one confirmation letter was never returned. Id. Further, one confirmation telegram, purporting to account for about $40,000 of the receivables and accepted as genuine by C & S, was later found to have been fraudulently sent to C & S by a Technidyne salesman. Id. at 1200. Finally, C & S failed to inquire of management concerning the retention of Technitool units in its warehouse in apparent contradiction of delivery date documentation. Id. at 1199, 1200.

For an extensive examination of Technidyne’s documentation of transactions and correspondence with each of the four accounts in question, see 420 F. Supp. at 1061-74.

12. 420 F. Supp. at 1086. The district court held C & S liable under both rule 10b-5 and common law fraud under Delaware law. Id. During the course of a lengthy trial, McLean settled his claims against the investment advisory firm and the selling shareholders. 599 F.2d at 1194. McLean’s case against C & S proceeded to judgment, resulting in a determination that McLean had suffered $2,514,751 in damages for which C & S was liable as a joint tortfeasor. Id. at 1194. Applying relative fault principles, however, the court determined that C & S was responsible for only 10% of McLean's damages and therefore should receive a 90% contribution from the other defendants. Id. at 1194-95. C & S appealed the final judgment and McLean, having agreed in a settlement with the investment advisory firm and the selling shareholders to indemnify all but one of the settling defendants against contribution claims from C & S, cross-appealed the contribution allowance and the denial of prejudgment interest. Id. See generally McLean v. Alexander, 449 F. Supp. 1251 (D. Del. 1978) (subsequent opinion on the issue of damages).

13. 420 F. Supp. at 1082-86. The trial judge noted that C & S had provided professional accounting services to Technidyne since 1967, that it was aware of Technidyne’s serious cash
10b-5 can be predicated upon, a showing of reckless disregard for the
truth.14 The United States Court of Appeals for the Third Circuit15 re-
versed, holding that the accountant’s misrepresentations and omissions in
the opinion audit would support a finding of negligence but did not constitute
the reckless conduct necessary to satisfy the scienter requirement in private
damage actions under the federal securities antifraud provisions.16 McLean
v. Alexander, 599 F.2d 1190 (3d Cir. 1979).

shortage, and that the certified audit was necessary to Technidyne’s plan to raise additional
capital through a private placement of securities. Id. at 1082. Further, the court determined
that “obvious conflicts” between purchase orders and invoices, as well as one overdue account,
were signals to the auditors to confer with management. Id. at 1083. As to the adequacy of C &
S’s attempt to independently verify sales with Technidyne customers, the district court con-
cluded that C & S “abandon[ed] all caution” when it certified the $73,733 accounts receivable
figure as a fully collectible debt on the basis of one disputed debt, one company’s failure to
respond on a $5,000 account, and two nonresponsive telegrams not actually received until after
the report was issued. Id. The district court observed that the accountant’s possession of, but
failure to disclose to the investing public information concerning the potential unreliability of
the accounts receivable figure and of Technidyne’s sales future placed the plaintiff in a position
where he could not exercise the informed judgment sought to be promoted by the securities
laws. Id. at 1084. According to the trial court, the fact that the accounts receivable figure
was based merely upon the accountant’s assumptions, without any request for proper documenta-
tion or verification from management, amounted to “no more than a reckless disregard for the
truth.” Id. at 1084-85. The court defined the accountant’s recklessness as “pretend[ing] to
knowledge he did not have.” Id. at 1084. Finally, the court concluded that the accountant’s
designation of the receivables account as “considered fully collectible” on the basis of two as-
sumptions (i.e., that Technidyne used a bill and hold procedure—which would explain the
company’s inventory of merchandise supposedly already sold—and that the customers were
credit-worthy), considered together with the fact that C & S failed to request proper documenta-
tion or verification of such items from management, constituted a reckless disregard for the
truth. Id. The district court noted that generally accepted accounting principles (GAAP) require
the issuance of a disclaimer when the accountant “has substantial doubts as to material asser-
tions [or] when the scope of his examination is restricted by his client.” Id. The district court
further stated that, if compliance with GAAP fails to present fairly the financial posture of the
client company, an accountant may not rely on GAAP to insulate itself from antifraud liability.
Id., citing Sonde, Responsibility of Professionals Under the Federal Securities Laws—Some Ob-
servations, 68 Nw. U.L. REV. 1 (1973). In the present case, for instance, the lower court
asserted that, whatever the designation “considered fully collectible” means to the accounting
profession, “the investing public, however sophisticated, may reasonably infer that the use of
this language presumes some hard knowledge that accounts receivable both exist and will be
paid.” 420 F. Supp. at 1084. The court further reasoned that the existence of accounts receiv-
able was of great importance to McLean, in spite of their relatively small size in relation to the
purchase price, because they demonstrated to a prospective buyer of a fledgling company whose
product embodies technological innovation “probably the most important indicia . . . [of]
whether the product being offered has a reasonable chance of sufficient marketability acceptance
so as to ultimately be commercially profitable.” Id. at 1075.

14. 420 F. Supp. at 1084. Alternatively, the district court found the scienter requirement
satisfied by the defendant’s “knowing misconduct” in failing to disclose material facts in its
opinion audit. Id. at 1082. The court stated, however, that “[t]here 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
falsehood.” Id. at 1084.

15. The case was heard by Circuit Judges Gibbons and Hunter, and District Judge Meanor
of the District of New Jersey, sitting by designation. Judge Gibbons wrote the opinion.

16. 599 F.2d at 1199-202. The Third Circuit also found that knowing nondisclosures of
material facts to a prospective purchase is sufficient to establish scienter for § 10(b) purposes,
but concluded, contrary to the district court holding, that the evidence taken as a whole pre-
cluded a finding that the accountant “knowingly” withheld material information from the pur-
chaser. Id. at 1202. See notes 69-70 & 73-74 and accompanying text infra.
The central purpose of the 1934 Act was to promote a high standard of ethics in the securities industry by substituting a philosophy of full disclosure to investors for the then prevailing philosophy of caveat emptor.\(^\text{17}\) Despite this oft-stated commitment, the federal courts, largely due to the Supreme Court's notable silence on issues of professional liability under the federal securities laws,\(^\text{18}\) have struggled for more than three decades\(^\text{19}\) to define the mental state, or culpability, necessary to impose liability under section 10(b) of the 1934 Act and rule 10b-5 promulgated thereunder.\(^\text{20}\) The provisions of rule 10b-5 do not explicitly state the degree of intent required to impose liability and, in fact, contain language that can reasonably be read to forbid even wholly innocent misstatements\(^\text{21}\) as well as language that appears to require at least some level of unlawful intent.\(^\text{22}\) Although there has been general agreement that some form of scienter must be alleged and proven,\(^\text{23}\) the establishment of this requirement has done little to settle the

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18. For a partial listing of civil damage actions presenting the question of professional liability under § 10(b) for which a hearing was denied by the Supreme Court, see Parker, Attorney Liability Under the Securities Laws After Ernst & Ernst v. Hochfelder, 10 LOY. L.A.L. REV. 521, 525 n.30 (1977).


20. Scienter for rule 10b-5 purposes has been variously defined to mean everything from knowing falsity with an implication of criminal mens rea, "through the various gradations of recklessness, down to such non-action as is virtually equivalent to negligence." 3 L. LOSS, supra note 19, at 1432 (2d ed. 1961). It has been suggested that a major contributor to the confusion surrounding scienter in rule 10b-5 private damage suits is the "extraordinary variety" of transactions covered by the rule. 3 A. BROMBERG, SECURITIES FRAUD & COMMODITIES FRAUD § 8.4(507), at 204.111 (1979).


22. See 17 C.F.R. § 240.10b-5(a) (1980). See also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976); cases cited note 21 supra. Even though rule 10b-5 contains three clauses, see note 6 supra, commentators have suggested that the same state of mind requirement should apply to all three since they are aimed at the same types of activities. See 3 A. BROMBERG, supra note 20, § 8.4(505), at 204.107; Epstein, The Scienter Requirement in Actions Under Rule 10b-5, 48 N.C.L. REV. 482, 492 (1970); Meisenholder, Scienter and Reliance as Elements in Buyer's Suit Against Seller Under Rule 10b-5, 4 CORP. PRAC. COMMENTATOR 27, 41 (Feb. 1963). But see 6 L. LOSS, supra note 19, at 3884-87 (2d ed. Supp. 1969).

23. See, e.g., Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), cert. denied, 422 U.S. 1007 (1975); Barnes v. Oslosky, 373 F.2d 269, 272 (2d Cir. 1967). See generally 3 A. BROMBERG, supra note 20, § 8.4, at 503; 6 L. LOSS, supra note 19, at 3883-85; 3 L. LOSS, supra note 19, at 1766. Epstein, supra note 22, at 503-04 (possibly negligence, depending upon effect on flow of information to public; but scienter clearly met if defendant is convinced of falsity of information
much-debated issue of what state of mind is necessary for rule 10b-5 liability. In an effort to resolve this problem, the Supreme Court, in Ernst & Ernst v. Hochfelder, held that a private cause of action for damages will not lie under section 10(b) and rule 10b-5 unless scienter is alleged——

or realizes it is probably false, or has no genuine belief in its truth); 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, 1207 (1970) (scienter just one element of a "sliding scale" of conduct); Ruder, Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases, 63 N.W. U. L. Rev. 423, 436 (1968) (deliberate, knowing, and reckless conduct); Comment, Scientist and Rule 10b-5, 69 Colum. L. Rev. 1057, 1067-69 (1969) (negligence standard as to trading insiders but not with respect to nontrading issuers).

24. See Mann, supra note 23, at 1206-07. One commentator has summed up the varying approaches of the courts, observing that "through the use of catch phrases and categories [the courts] have feigned consistent standards while broadly deciding each case on its individual facts depending on the result they believe is dictated by their own particular construction of Section 10(b)." Id. Professor Bromberg suggests that the term "scienter" should simply be abandoned. 3 A. Bromberg, supra note 20, § 8.4(503), at 204.103. Accord, White v. Abrams, 495 F.2d 724, 728 n.3 (9th Cir. 1974).

25. Scienter in rule 10b-5 cases has been held to encompass a wide spectrum of states of mind ranging from an intention to deceive, to knowledge of undisclosed facts, to a reckless failure to acquire knowledge of true facts. See, e.g., Lanza v. Drexel & Co., 479 F.2d 1277, 1301 (2d Cir. 1973) (en banc), quoting Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971) ("cases in this circuit clearly indicate that 'facts amounting to scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud' are essential to the imposition of liability.")


27. See note 19 supra. The United States Supreme Court recently held, with three justices dissenting on the issue, that the SEC is also required to establish scienter as an element of a civil enforcement action to enjoin violations of § 10(b) and rule 10b-5. Aaron v. SEC, 100 S. Ct. 1945 (1980). The Aaron court vacated and remanded a decision of the Second Circuit in which the appeals court had held that, when the SEC is seeking injunctive relief, proof of negligence alone will suffice because government initiated actions are brought to provide "maximum protection for the investing public, as contrasted with the purpose of private damage actions which are brought to obtain monetary relief for individual investors." SEC v. Aaron, 605 F.2d 612, 621 (2d Cir. 1979) (citations omitted), vacated and remanded, 100 S. Ct. 1945 (1980). In reaching its decision, the Supreme Court resolved a split among the circuits. Compare SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976) with SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978). For the statutory, historical, and policy considerations concerning the scienter requirement in injunctive actions, see generally Berner & Franklin, Scientist and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder, 51 N.Y.U. L. Rev. 799 (1976); Haimoff, Holmes Looks at Hochfelder and Rule 10b-5, 32 Bus. Law. 147 (1976); Harkleroad, Requirements for Injunctive Actions Under the Federal Securities Laws, 2 J. Corporat. L. 481 (1977); Comment, Scientist and SEC Injunctive Suits, 90 Harv. L. Rev. 1018 (1977); Note, The Scientist Requirement in SEC Injunctive Enforcement of Section 10(b) After Ernst & Ernst v. Hochfielder, 77 Colum. L. Rev. 419 (1977). For an early criticism of the Supreme Court's disposition of the injunctive relief issue, see Feller, Aaron Case: A Technical Analysis Out of Touch with Today's Markets, National L.J., June 30, 1980, at 28-29.

28. 425 U.S. at 193. In Hochfelder, the plaintiffs were induced by the president of a brokerage firm to make investments in accounts which did not actually exist since the president had converted the funds to his own use. Id. at 189. The investors charged Ernst & Ernst, the
brokerage firm’s independent auditor, with aiding and abetting the fraud in violation of § 10(b) and rule 10b-5 by failing to adequately investigate the brokerage firm’s internal accounting control procedures. Id. at 150. The plaintiffs contended that a proper investigation would have revealed irregular internal procedures and led to discovery of the underlying fraudulent scheme. Id. The Court concluded that the plaintiffs’ allegations encompassed only negligent conduct which could not support civil liability under § 10(b) and rule 10b-5. Id. at 215.

29. 425 U.S. at 193-94 n.12. While the court observed that a showing of intent to deceive will clearly sustain a private action under rule 10b-5, it did not explicitly hold that knowing misrepresentation—generally considered to be a more stringent standard of culpability than recklessness but a less stringent test than intent—satisfies the scienter requirement in the absence of proof of an intent to deceive. Id. at 214. For a discussion of the relative levels of culpability, see generally Bucklo, The Supreme Court Attempts to Define Caeiener Under Rule 10b-5: Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213, 214 n.12 (1976). The words “intent to deceive, manipulate, or defraud,” considered alone, would appear to preclude liability for both actual knowledge of misstatements and for reckless conduct. See RESTATEMENT OF TORTS § 531 (1938) (“the maker of a fraudulent misrepresentation is subject to liability . . . only to those persons to whom it is made with the intent to cause them to act in reliance upon it”). Derry v. Peek, 14 App. Cas. 337 (1889), is credited with establishing the strict intent requirement for deceit actions at common law. See McLean v. Alexander, 420 F. Supp. at 1089 n.118, citing W. PROSSER, LAW OF TORTS § 107, at 699 (4th ed. 1971).

30. 425 U.S. at 199. The Court concluded that the use of such operative terms as “manipulative,” “device,” and “contrivance” evinced an “unmistakable . . . congressional intent to proscribe a type of conduct quite different from negligence.” Id. at 198. For the text of § 10(b), see note 5 supra. For the text of rule 10b-5, see note 6 supra.

31. 425 U.S. at 210-06. Although having acknowledged in a previous case that Congress intended that the antifraud legislation be construed flexibly in light of its remedial purposes, the Court found no legislative history concerning § 10(b) to contradict its conclusion that the statutory language requires scienter. See id. at 210-11. Further, in light of its conclusion that Congress intended to limit § 10(b) liability to activities involving scienter, the Court determined that a more liberal construction of rule 10b-5 would involve an overextension of the SEC’s delegated authority under § 10(b). Id. at 213-14.

32. Id. at 206 (emphasis supplied by the Court), quoting S. REP. NO. 792, 73d Cong., 2d Sess. 13 (1934), Accord., Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973) (en banc); Kohn v. American Metal Climax, Inc., 458 F.2d 255, 280 (3d Cir.), cert. denied, 409 U.S. 874 (1972). The Court distinguished the express liability provisions of the 1933 Act which grant civil relief for negligence on two grounds. See 425 U.S. at 205-11. First, those sections that recognize a cause of action for negligence do so explicitly. Id. at 208. Second, since § 10(b) contains none of the significant procedural restrictions limiting the availability of relief in suits under the negligence provisions of the Securities Act of 1933, liability under § 10(b) for negligent conduct would “nullify the effectiveness of the carefully drawn procedural restrictions” and unnecessarily broaden liability under rule 10b-5’s “judicially created private damage remedy.” Id. at 210.

33. See notes 26-29 and accompanying text supra. The Supreme Court recognized, however, that, prior to Hochfelder, three courts of appeals, evidencing a rapidly developing trend, had held in substance that negligence alone was sufficient for civil liability under the federal securities antifraud provisions. 425 U.S. at 193 n.12, citing White v. Abrams, 495 F.2d 724, 730.
discussion and disparity,\(^3\) in large measure because the Court carefully declined to decide whether reckless behavior is sufficient to establish civil liability under section 10(b) and rule 10b-5.\(^4\) Moreover, as to the potential

\(^3\) (9th Cir. 1974) ("flexible duty" standard); Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968) (negligence sufficient); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963) (dicta) (knowledge not required). The negligence standard was put forward on the ground that Congress' intent in promulgating antifraud legislation was that the provisions not be construed "technically and restrictively, but flexibly to effectuate their remedial purposes." 425 U.S. at 217 (Blackmun, J., dissenting), quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963). See also Ruder, supra note 23, at 441 (negligence criteria justified on the ground that it encourages care).

34. Several courts have concluded that, after Hochfelder, requires a showing of "knowing" conduct. See, e.g., Whitney v. SEC, 604 F.2d 676 (D.C. Cir. 1979); SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978). Other courts have taken the position that scienter requires something more than "mere negligence." Lewis v. Anderson, 615 F.2d 776, 784 (9th Cir. 1979); Mansbach v. Prescott, Ball & Turben, 506 F.2d 1017, 1025 (6th Cir. 1979). See also Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977). The commentators have been similarly divided. Compare Floor, The Scientist Requirement Under Rule 10b-5 and Reliance on Advice of Counsel After Hochfelder, 12 NEW ENG. L. REV. 191, 192 (1976) ("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") with Ligeto, The "Ernst" Ruling—Expansion of a Trend, N.Y.L.J., Apr. 14, 1976, at 2, col. 3 [hereinafter cited as Ligeto I] (scienter following Hochfelder does not encompass "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"). For current post-Hochfelder discussions of the issue, see also Adams, Lessening the Liability of Auditors, 32 BUS. L. 1037 (1977); Bucklo, supra note 29, Cox, Ernst & Ernst v. Hochfelder: A Critique and an Evaluation of Its Impact upon the Scheme of Federal Securities Laws, 28 HASTINGS L.J. 569 (1977); Goldwasser, Ernst & Ernst v. Hochfelder: An Anti-Landmark Decision, 22 N.Y.L.S. L. REV. 29 (1976); Haimoff, supra note 27, Hampson, Accountants' Liability—The Significance of Hochfelder, J. ACCOUNTANCY, Dec. 1976, at 69; Metzger & Heintz, Hochfelder's Progeny: Implications for the Auditor, 63 MINN. L. REV. 79 (1978); Parker, supra note 18; Schmoker, The Accountants' 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 Intent Note]; 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); 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 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); Note, Scientist's Scope and Application in Rule 10b-5 Actions: An Analysis in Light of Hochfelder, 52 NOTRE DAME L. REV. 925 (1977); Note, Existing Standards of Personal Liability and Scientist Under Rule 10b-5, 16 WASHBURN L.J. 344 (1977); Ligeto, The "Ernst" Ruling—Expansion of a Trend, N.Y.L.J., Apr. 15, 1976, at 1, col. 2-4 [hereinafter cited as Ligeto II]; Ligeto I, supra, at 1, col. 2-4.

The American Law Institute's proposed Securities Code includes recklessness in its definition of scienter. ALI FED. SECURITIES CODE § 269AA (Final Draft, 1980).

35. 425 U.S. at 193-94 n.12. The Court observed that reckless or knowing behavior has traditionally sufficed to prove scienter in the area of common law fraud: "In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and rule 10b-5." Id. The Court also acknowledged that some courts of appeals had found scienter for § 10(b) and rule 10b-5 purposes to be met by proof of reckless conduct. Id., citing Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), cert. denied, 422 U.S. 1007 (1975); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc).
liability of accountants in particular, the Court’s failure to address the long-standing question of whether compliance with generally accepted accounting principles (GAAP) should relieve accountants of 10b-5 liability has left many securities professionals without reliable legal guidelines to follow in everyday transactions.36

The general thrust of both commentary and decisions of the courts of appeals after Hochfelder has been to reject a strict intent to deceive standard and to recognize that some form of recklessness is actionable under rule 10b-5.37 One line of cases recalls pre-Hochfelder decisions, which held that section 10(b) and rule 10b-5 are to be liberally construed to effectuate the remedial policies underlying the federal securities laws,38 and concludes that

36. See 425 U.S. at 191. The Supreme Court made only passing reference to the district court’s granting of the auditor’s motion for summary judgment on finding no genuine issue of material fact as to whether Ernst & Ernst had conducted its audits in accordance with generally accepted auditing standards. Id. (district court opinion not reported). Prior to Hochfelder, compliance with GAAP or with generally accepted auditing standards (GAAS) would not necessarily insulate an accountant from rule 10b-5 liability. Hochfelder v. Laventhol, Horwath & Horwath 540 F.2d 27, 35-37 (2d Cir. 1976); United States v. Simon, 425 F.2d 796, 806 (2d Cir. 1969), cert. denied, 397 U.S. 1006 (1970) (proof of compliance with generally accepted standards “may be highly persuasive, but it is not conclusive”). The courts have evidenced some hostility towards what they consider to be a kind of private lawmaking; their assumption being that a profession’s desire to insulate itself from liability may conflict with the more compelling need to protect the public interest. See also Metzger & Heintz, supra note 34, at 114 (failure to comply with GAAP and with GAAS may be evidence of scienter).

37. See, e.g., Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980); Spectrum Financial Cos. v. Marconsult, Inc., 608 F.2d 377 (9th Cir. 1979); Heizer Corp. v. Rose, 601 F.2d 330 (7th Cir. 1979); Edward J. Mawod & Co. v. SEC, 591 F.2d 588 (10th Cir. 1979); Goodman v. Epstein, 582 F.2d 398 (7th Cir. 1978); Nelson v. Serwold, 576 F.2d 1332 (9th Cir.), cert. denied, 439 U.S. 970 (1978); First Va. Bankshares v. Benson, 559 F.2d 1307 (5th Cir. 1977), cert. denied, 435 U.S. 952 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir.), cert. denied, 434 U.S. 875 (1977); Sanders v. John Nuveen & Co., 554 F.2d 790 (7th Cir. 1977). See also Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 484-85 (2d Cir. 1979) (recklessness enough for aider and abettor liability only when there also exists a fiduciary duty to disclose); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44-48 (2d Cir.), cert. denied, 439 U.S. 1039 (1978). Cf. Mauldin v. Shaffer, [1977-1978 Transfer Binder] FED SEC. L. REP. (CCH) 96,211, at 92,456 (M.D. N.C. 1977) (it is “entirely unclear that reckless conduct can support the imposition of liability under Rule 10b-5”). Significantly, reckless conduct is sufficient to sustain criminal liability under the securities laws. See United States v. Natelli, 527 F.2d 311 (2d Cir. 1976), cert. denied, 425 U.S. 934 (1975); United States v. Benjamin, 329 F.2d 845 (2d Cir. 1964). See also Metzger & Heintz, supra, note 34, at 90 (“it is doubtful that recklessness could suffice for a criminal violation of the 1934 Securities Act and yet be insufficient as a basis for 10b-5 liability”); Note, Hochfelder Revisited After Hochfelder: The ‘Scienter’ Standard Applied to the Reporting of Uncertainties, 14 AM. BUS. L.J. 252, 258 (1976). The Supreme Court has recently described Hochfelder as “holding that a cause of action under Rule 10b-5 does not lie for mere negligence...” Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 468 (1977). See also Metzger & Heintz, supra, at 86 (“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”). But see Liggio II, supra note 34, at 2, col. 3; Intent Note, supra note 34, at 188.

38. For Supreme Court cases espousing a liberal construction, see, e.g., Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972), quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963) (securities acts to be interpreted "not technically and restrictively, but flexibly to effectuate (their) remedial purposes"); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) ("Section 10(b) must be read flexibly, not technically and

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the antifraud provisions should be interpreted no more narrowly than required by Hochfelder. A second line of cases analyzes section 10(b) and rule 10b-5 to common law fraud, for which recklessness satisfies the scienter requirement.

restrictively”). See also Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 (6th Cir. 1979).

It has also been observed that a “knowing” or “reckless” scienter standard would be consistent with the oft-stated purpose of protecting investors against false and deceptive practices:

In keeping with the broad remedial aims of the anti-fraud 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.


40. See, e.g., Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979); Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38, 46 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1044 (7th Cir.), cert. denied, 434 U.S. 875 (1977). The Seventh Circuit, drawing on common law fraud concepts, has put forward one of the fullest explications of the recklessness concept, defining such conduct as

highly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, 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.

Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d at 1045, quoting Franke v. Midwestern Okla. Dev. Auth., 429 F. Supp. 719, 725 (W.D. Okla. 1976). According to the Sundstrand court, under this test, "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." 553 F.2d at 1045 (footnote omitted). One commentator has observed that the good faith defense noted by the Seventh Circuit "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 unsuspecting purchaser who had relied on the certified figures to his detriment. Metzger & Heinz, supra note 34, at 108.

41. W. PROSSER, LAW OF TORTS § 107, at 700-01 (4th ed. 1971); RESTATEMENT OF TORTS § 526 (b) (1938). Examining an auditor’s potential liability for common law fraud, the New York Court of Appeals has stated:

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.

State Street Trust Co. v. Ernst 275, N.Y. 104, 112, 15 N.E.2d 416, 419 (1938). See also Ultramares v. Touche, 255 N.Y. 170, 190, 174 N.E. 441, 449 (1931) (Cardozo, C.J.). Several commentators have concluded that common law fraud culpability standards should apply in 10b-5 actions. See, e.g., Bucklo, supra note 29, at 228 n.106 (framers of the securities acts drew on contemporary common law); Note, 82 HARV. L. REV. 938, 947 (1969) (if Congress meant to codify common law as it existed in 1934, it did not forbid federal courts from applying current common law fraud and participating in the evolution and growth of common law fraud and deceit principles).
Operating under the premise that both knowing conduct and recklessness will suffice for section 10(b) and rule 10b-5, the majority of post-
Hochfelder courts have focused on the scope of these alternative scienter standards. While the post-Hochfelder formulation of scienter in the Third Circuit was initially uncertain due to that court's choice of language in a case where there was clearly a specific intent to defraud, its more recent pronouncement on the issue, Coleco Industries, Inc. v. Berman, clearly established that an accountant's reckless preparation of financial statements may give rise to section 10(b) and rule 10b-5 liability. Although failing to "precisely define the nature" of actionable conduct, the Third Circuit concurred

42. See notes 29 & 33-35 and accompanying text supra.

44. The use of the scienter concept is "particularly prone to word manipulation for the justification of results reached on other, often unexpressed, grounds." 3 A. Bromberg, supra note 20, § 8.4(503), at 204.103. Modifiers and variations, such as "guilty knowledge" and "conscious fraud," are common. Id., quoting E. Gadsby, BUSINESS ORGANIZATIONS, FEDERAL SECURITIES ACT OF 1934 § 5.03[1][d], at 5-28 (1970).

So, too, courts have consciously failed to specify their standards of liability. See, e.g., Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 n.36 (6th Cir. 1979) ("it suffices to say that the [scienter] standard falls somewhere between intent and negligence. There is little analytical value in deciding precisely where along this spectrum recklessness falls"); Berdahl v. SEC, 572 F.2d 643, 647 n.6 (8th Cir. 1978) (court declined "to become embroiled in a semantic controversy over the varying shades of meaning of such terms as 'intentional,' 'willful,' 'deliberate,' or 'knowing' [because defendant's] conduct was sufficiently purposive"] to satisfy Hochfelder's scienter test). See also Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977) (reckless conduct "comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence").

45. See Straub v. Vaisman & Co., 540 F.2d 591, 596 (3d Cir. 1976). The Third Circuit declared that, in order to recover in a rule 10b-5 action, "[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." Id.

Before the Supreme Court negated negligence as a standard of culpability, the Third Circuit had held that the scienter requirement was satisfied when the defendant merely had knowledge of the undisclosed information. Rochez Bros. v. Rhoades, 491 F.2d 402, 407 (3d Cir. 1974), cert. denied, 425 U.S. 993 (1976). In Rochez, the Third Circuit cited with approval an influential Second Circuit opinion which not only embraced actual knowledge of misrepresentations and omissions, but also predicated liability on a reckless disregard for the truth. 491 F.2d at 407 n.6, citing Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc).

47. See 567 F.2d at 574. The district court had denied recovery against the principals of the company acquired by the plaintiff because their misstatements concerning gross profits had been made in good faith, induced by the accountant's errors in overestimating total inventory. Coleco Indus., Inc. v. Berman, 423 F. Supp. 275, 289 (E.D. Pa. 1976), aff'd in part and rev'd and remanded in part, 567 F.2d 569 (3d Cir. 1977), cert. denied, 439 U.S. 830 (1978).


49. 567 F.2d at 574. The Coleco court concluded that further elaboration on a recklessness standard was unnecessary because the plaintiffs had failed to make out a case under any of the recklessness standards forwarded by other courts. Id. The Third Circuit further asserted that the scienter for rule 10b-5 purposes is identical to that required for common law fraud. Id. at 574-75.
in the district court's holding that plaintiffs must prove that their injury resulted from either a "conscious deception" or a misrepresentation made so recklessly that it approximated conscious deception.\(^{50}\)

In *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*,\(^{51}\) the Second Circuit examined accountant liability, focusing specifically on the accounting treatment of unconsummated sales transactions.\(^{52}\) The "sales"—purported real estate transactions in which the audited company had purchased and resold twenty-three nursing homes for profit\(^{53}\)—were reflected on the consolidated balance sheet and income statement distributed to investors as "deferred gross profit"\(^{54}\) and accompanied by an explanatory note stating that nearly ninety percent of the gross profit "will be considered realized when [a subsequent] payment is received."\(^{55}\) The defendant did qualify its opinion letter\(^{56}\) and argued, following a trial court finding that it acted with the necessary scienter in the form of knowledge of the "materially misleading" nature of the figures,\(^{57}\) that the qualification should insulate it from liability.\(^{58}\) Nevertheless, the court of appeals found the qualification inadequate because the accountant failed to "provide a clear explanation of the reasons for the qualification."\(^{59}\) The Second Circuit affirmed the trial court's decision,\(^{60}\) concluding that the accountant's treatment of the as yet unrealized income from the unconsummated real estate transactions as current and "deferred" gross profit was inimical "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.'"\(^{61}\)

\(^{50}\) Id. at 574. Cf. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968) (en banc) (Friendly, J., concurring), cert. denied, 394 U.S. 976 (1969) (liability should only attach to the "kind of recklessness equivalent to willful fraud"). The *Circo* court also observed that the requirement of scienter for a rule 10b-5 violation "in dealing with an experienced buyer who is expected to examine the seller's business thoroughly may well be a more culpable state of mind than that necessary to a violation in public offerings." 567 F.2d at 574-75 n.10.

\(^{51}\) 540 F.2d 27 (2d Cir. 1976).

\(^{52}\) Id. at 34-37. For a criticism of the *McLean* court's analysis of the accounting treatment of unconsummated sales transactions, see notes 89-97 and accompanying text infra.

\(^{53}\) See 540 F.2d at 30. The sale, in actuality, was arguably nothing more than an option exercisable at the buyer's discretion. See id. at 29-30.

\(^{54}\) Id. at 30. If ever completed, the disputed purchase and sale would have greatly altered the audited company's financial posture, producing a conversion of $772,108 in estimated losses into a $1,257,892 gain by the addition of $2,030,500 "profit" from the nursing home transactions. *Id.*

\(^{55}\) Id.

\(^{56}\) Id. The report stated: "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 [the audited company] . . ." *Id.* (emphasis added). For a discussion of the concept of "fair presentation," see text accompanying note 91 infra.


\(^{58}\) 540 F.2d at 36.

\(^{59}\) Id. (emphasis in original). The court further stated that a disclaimer noting that the transactions forming the bulk of total gross profits were, as yet, unconsummated, would have sufficed to negate the finding that scienter was present. *Id.*

\(^{60}\) Id. at 37.

\(^{61}\) Id. at 34, quoting *American Institute of Certified Public Accountants, Accounting Principles Board Statement No. 4*, § 150; *American Institute of Cer-
In *McLean*, the Third Circuit first rejected the district court's suggestion that the burden of proof shifts to the defendants once their statements are shown to be inaccurate. Although a shift in the burden of proof would not have changed the outcome of the litigation, Judge Gibbons, writing for the court, stated that the plaintiff has the burden of persuasion as to each element of a private cause of action under section 10(b)—including scienter.

In attempting to "precisely define" the legal standard for recklessness and to establish the "minimum threshold" for liability for securities fraud, the *McLean* court approved the Seventh Circuit's "known or objectively obvious danger" test whereby recklessness is established as a matter of law upon a showing of defendant's "extreme departure from the standards of ordinary care" coupled with a known or objectively obvious danger of misleading buyers or sellers. This standard, the court observed, encompasses accountants' conduct undertaken without "a genuine belief that the information disclosed was accurate and complete in all material respects," such as

TIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES (CCH) 9086 (1978). The court similarly found that the defendant's failure to adequately investigate the *bona fides* of the sales transactions violated standard auditing procedures which provide, in part, that "[s]ufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination." 540 F.2d at 35, quoting STATEMENTS ON ACCOUNTING PROCEDURE No. 33, ch. 2, at 16 (1963).

62. 599 F.2d at 1196-97.
63. *Id.* The *McLean* court further observed that requiring the plaintiff to carry the burden of going forward on each element "must have been a central if unarticulated premise of Hochfelder, since if the burden was not upon the plaintiff to prove scienter, then he need not have alleged it in his complaint." *Id.* at 1197 n.10.
64. *Id.* at 1197. Because the court found that the defendants lacked the requisite scienter, it stated that consideration of the other issues bearing upon liability—such as materiality, reliance, and the plaintiff's exercise of due diligence commensurate with his sophistication as an investor—was unnecessary. *Id.* at 1196 & n.7, 1202 n.20.

The widely adopted Seventh Circuit definition has been labelled in a recent article the "highly" reckless standard. Steinberg & Gruenbaum, supra note 39, at 195. The authors further observe that the *McLean* court's refinement of that standard is the added requirement of proof of bad faith on the defendant's part. *Id.* & n.83, citing 599 F.2d at 1198. The authors favor the rejection by the "highly" reckless culpability standard where the relationship between the parties is "remote," but would impose a slightly less rigorous burden on the plaintiff where, for example, there exists a fiduciary relationship that significantly benefits the defendant or results in the plaintiff's heavy and foreseeable reliance on the defendant . . . . *Id.* at 209.

66. 599 F.2d at 1198, citing Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 n.20 (7th Cir.), cert. denied, 434 U.S. 875 (1977). The Third Circuit, in an opinion by Chief Judge Seitz, recently reaffirmed its commitment to the *Sundstrand* jury charge in Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641, 649 (3d Cir. 1980). In *Healey*, the appeals court held that recklessness for rule 10b-5 scienter purposes following *McLean* is not satisfied by a jury finding that defendant acted "with indifference to the consequences." *Id.*
was actionable at common law. Judge Gibbons further concluded that, although developed in the context of material omissions, the recklessness test should be equally applicable to misstatements.

Applying this standard, the McLean court determined that the evidence would support the inference that, when C & S prepared its certified opinion audit, it harbored a "genuine belief that it had the information on which it could predicate that opinion." According to the court, the record failed to show that the C & S partner in charge of the audit knew or was even "aware of the risk," that a number of purported purchase orders were in fact simply consignments of which the "buyers" were obligated to pay for equipment only if they were able to resell it. The Third Circuit accepted the testimony of this partner that the accountants believed Technidyne's bill and hold practice with its distributor explained discrepancies between payment due dates on purchase orders and invoices as well as between delivery orders and warehouse inventory.

The court of appeals thus rejected the district court's conclusion that C & S had "actual knowledge" of material facts not disclosed in the audit. In addition, the Third Circuit rejected the district court's finding that the defendant had "knowingly" withheld material information, construing prior case law as requiring knowledge "not only of the facts withheld, but also of

67. 599 F.2d at 1198, citing O'Connor v. Ludlam, 92 F.2d 50, 54 (2d Cir. 1937) (lack of "honest belief"); Ultramares v. Touche, 255 N.Y. 170, 174 N.E. 441, 447-48 (1931) (without a "genuine belief in truth of misrepresentation, or with "pretense of knowledge when knowledge there is none"). For a discussion of common law recklessness standards, see notes 40-41 and accompanying text supra.

68. 599 F.2d at 1197, citing Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir.), cert. denied, 439 U.S. 1039 (1978). Moreover, Judge Gibbons asserted that circumstantial evidence may be used to prove bad faith or lack of honest belief. 599 F.2d at 1198. For a discussion of the origin and effect of the good faith defense, see note 32 and accompanying text supra; note 40 supra.

69. 599 F.2d at 1198. Considering the accounting firm's recital describing the formulation and limits of its "opinion," the Third Circuit accepted the audit as an expression of opinion based upon generally accepted auditing standards. Id. For the text of the accountant's recital, see note 8 supra. In contrast, however, when the trial court was presented with the accountant's position that the certified report was an expression of opinion and not fact, it responded by remarking that such an argument "hardly warrants a response. The weight of a CPA's opinion audit is presumed to have a basis in fact and not in speculation." 420 F. Supp. at 1085.

For a discussion of the interrelationship between conformance with generally accepted auditing principles and potential rule 10b-5 liability, see Metzger & Heintz, supra note 34, at 113-18 (failure to apply basic auditing procedures designed to test the adequacy of data provided by management, or failure to "follow through" on suspicious discoveries, may constitute reckless or knowing behavior sufficient for rule 10b-5 liability). See also Haimoff, supra note 27, at 162 ("Accountants who gullibly accept a transparently fishy explanation from their clients of an obviously suspicious transaction are liable under rule 10b-5, no matter what their mental state."). For a general discussion regarding the historical development of GAAP and GAAS standards, see Struthers, The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards, 28 Vand. L. Rev. 201 (1975).

70. 599 F.2d at 1199. See notes 8-11 and accompanying text supra.

71. 599 F.2d at 1199. 1200.


73. See Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), cert. denied, 425 U.S. 993 (1976); note 45 supra.
the risk that the buyer or seller will be thereby misled.” 74 Although conceding that C & S “may have been negligent” 75 in failing to pursue confirmation requests concerning accounts receivable 76 and in describing those accounts as “fully collectible,” 77 the court concluded that the accounting firm’s conduct, taken individually or collectively, was not reckless. 78 The court further stated that, with respect to one customer’s account, even if the defendant had been reckless in failing to question management regarding a nine-week discrepancy between payment dates recited on a particular purchase order and the corresponding invoice, and in subsequently failing to make inquiry when the confirmation request was not returned, liability would have been denied on the ground that the information in question was immaterial to McLean’s investment decision. 79 Finally, although noting that Delaware had not yet fixed the standard of liability for an accountant who renders an insufficiently informed opinion, 80 the McLean court refused to predicate liability upon common law fraud on the ground that scienter was lacking. 81

The district court’s opinion in McLean received considerable scholarly acclaim as the “most careful and extended discussion of the scienter question since [Hochfelder].” 82 It is submitted, however, that the Third Circuit’s

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74. 599 F.2d at 1202. The court stated that since the “defendant professed to believe that his statement of opinion did not present . . . a risk” of misleading the buyer, and since circumstantial evidence indicated that the belief was genuinely held, the partner in charge of the audit could not be considered to have knowingly withheld material information from the purchaser. Id.
75. Id.
76. See id. at 1190-201. See note 11 supra.
77. See 599 F.2d at 1201-02. See note 11 supra.
78. 599 F.2d at 1202. Summarizing its view of the accountant’s conduct, the court stated: “The accountant examined purchase orders which appeared to be genuine, received representations from management, took steps to obtain confirmation from the account debtors, and received partial confirmation of 15 of the 16 centrally in issue.” Id. The court noted in this regard that C & S’s knowledge that Technidyne needed the certified report quickly in order to obtain an infusion of capital to remedy its poor financial health, although relevant to the accountant’s mental state, did not lend support to the trial court’s conclusion that C & S knew it did not have the information on which to base its opinion concerning Technidyne’s accounts receivable. Id. at 1201.
79. Id. at 1200. Applying a similar analysis to another account in which $2,000 was in dispute, the court stated that C & S’s failure to note the dispute in its report was immaterial for purposes of McLean’s investment decision, since the disputed sum was relatively small when compared with a nearly $40,000 initial purchase price and since it had no bearing on the genuineness of purported Technitool sales to the other three customers. See note 11 supra.
80. 599 F.2d at 1202, citing Eastern States Petroleum Co. v. Universal Prods. Co., 24 Del. Ch. 11, 3 A.2d 768, 775 (1939) (suggesting that Delaware would apply common law scienter principles). For a discussion of the types of conduct sufficient to satisfy common law scienter requirements, see note 41 supra.
81. 599 F.2d at 1202.
82. See Bucklo, supra note 29, at 240 n.205 (citing the McLean district court opinion for the proposition “that unless otherwise specified, the Securities Acts merely federalize the existing law of deceit”). Another commentator also praised the trial court opinion, suggesting that “[McLean] addresses most extensively the issue of recklessness’ inclusion within the purview of the 10b-5 scienter requirement . . . . This holding is less susceptible to an attack alleging an insufficient mental state, because it incorporated the principles of common law fraud into the area of securities regulations.” Comment, 52 NOTRE DAME LAW. 925, 937 (1977).
approach, made with the benefit of three years of case interpretation and commentary on Hochfelder, while of questionable value in providing guidance to securities professionals, more carefully complies with the restricted scope of section 10(b) and rule 10b-5 liability enunciated by the Supreme Court. 83

It is clear following McLean that, in the absence of good faith,84 the Hochfelder scienter mandate will be met in the Third Circuit by proof of intentional misstatements, by knowing nondisclosures of material facts coupled with knowledge on the part of the defendant that the buyer or seller will thereby be misled,85 or by reckless nondisclosures and misstatements representing "an extreme departure from the standards of ordinary care" and "a danger of misleading buyers or sellers that is either known to the defendant or [objectively obvious]."86 Further, as to the liability of accountants in particular, scienter for section 10(b) and rule 10b-5 purposes may be inferred from conduct sufficient to establish common law fraud under Delaware law87—that is, when the accountant lacks a "genuine belief" that the information reflected in the audited corporate financial reports is "accurate and complete in all material respects."88

While "a showing of shoddy accounting practices" may constitute evidence of scienter,89 still uncertain after McLean is the effect of the accountant's failure to comply with generally accepted accounting principles.90

83. See notes 84-97 and accompanying text infra. For a discussion of Hochfelder, see notes 26-36 and accompanying text supra.

Predicating liability on reckless behavior should serve at least two of the Supreme Court's articulated goals in the area of securities fraud. First, requiring plaintiffs to at least show recklessness is a step toward alleviating the Supreme Court's concern that the class of rule 10b-5 plaintiffs "who may seek to impose liability upon accountants" is too expansive. Ernst & Ernst v. Hochfelder, 425 U.S. at 214 n.33, citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 747-48 (1975) ("the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good"). Cf. Bucklo, supra note 29, at 240 ("the inclusion of recklessness within the definition of scienter would not greatly expand the group of defendants whose conduct fall within the ambit of rule 10b-5 culpability"). Second, the securities acts' policies of full disclosure and investor protection should be furthered by a scienter standard which does not encourage the coverup of inadvertent mistakes for fear of potential liability. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968) (en banc) (Friendly, J., concurring), cert. denied, 394 U.S. 976 (1969); Note, Securities Regulation—Ernst & Ernst v. Hochfelder—Rule 10b-5: Reckless or Knowing Violations?, 2 J. CORPORATION L. 389, 403 (1977).

The SEC "continues to believe that a scienter requirement is fundamentally inconsistent with the remedial purposes of the federal securities laws, lessens investor protection, and constitutes a significant obstacle not only to just compensation of investors injured by violations—intentional or careless—but also to effective Commission action with a view towards prevention of future unlawful conduct." SEC Report on the Accounting Profession, No. 876, Fed. Sec. L. Rep., (CCH) 92-93 (Part II, Sept. 10, 1980).

84. See 599 F.2d at 1198. For a discussion of the good faith defense, see note 32 and accompanying text supra; see note 40 & 65 supra.

85. See 599 F.2d at 1202; notes 73-74 and accompanying text supra.

86. See 599 F.2d at 1197; notes 64-65 & 68 and accompanying text supra.

87. See 599 F.2d at 1202; note 80 supra.

88. See 599 F.2d at 1198; notes 66-67 and accompanying text supra.

89. See 599 F.2d at 1198.

90. For a discussion of generally accepted accounting principles, see note 36 and accompanying text supra; notes 13 & 69 supra.
Likewise, the importance of the duty of "fair presentation," an issue addressed at the district court level, is also uncertain because the appeals court failed to mention the issue. It is submitted that the determination of whether a departure from ordinary standards of care occurred, and whether that departure was "extreme," should be made with reference to GAAP—as the courts did in *Herzfeld* and at trial in *McLean*—except in those cases where GAAP either do not speak to the specific problem or might produce materially misleading results. It is suggested that such an approach would provide helpful guidance to accountants in avoiding potential liability under the antifraud provisions, as well as ensuring disclosure of material facts in a manner not likely to mislead.

As to the guidance afforded accountants in everyday auditing decisions, the *McLean* case confirms little except that a failure to investigate the circumstances underlying unreturned confirmation requests, together with a failure to question management regarding discrepancies in account payment due dates as well as in delivery documentation and warehouse inventories, constitutes negligence. Consequently, *McLean* may be seen as standing for the proposition that even in the face of suspicious circumstances, cumulative instances of negligent conduct violative of basic auditing standards will not necessarily amount to a finding of recklessness under the adopted Seventh Circuit test.

The Third Circuit also failed to address the question, first raised by the *Coleco* court, of whether its newly enunciated standard of culpability may increase with the plaintiff's sophistication. It is suggested that underlying the *McLean* court's critical interpretation of the plaintiff's theory of recovery was an antagonism to addressing questions of reliance and materiality when faced with a single, sophisticated investor-plaintiff.

The Third Circuit's adoption of an accepted definition of recklessness for section 10(b) and rule 10b-5 purposes, and its inclusion within that standard of the elements of common law fraud, evidences an intention to inject a settling element into a notoriously unsettled area of securities law. It is submitted, however, that continued case interpretation is necessary before it can be said that the "semantic fog" pervading the scienter issue has been

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91. See 420 F. Supp. at 1079, 1085.
92. See 540 F.2d at 34-37; notes 60-61 and accompanying text supra.
93. See 420 F. Supp. at 1085; note 13 supra.
94. See Metzger & Heintz, supra note 34, at 115 (auditor may still be found reckless if he has notice of facts which materially affect the financial position of the client but which are not specifically covered by official GAAP announcements).
95. See 599 F.2d at 1199-202; notes 8-11 & 75-79 and accompanying text supra; note 13 supra.
96. See 599 F.2d at 1200-02. The Third Circuit's failure to find actionable misconduct may stem in part from its unwillingness to independently inquire, as the district court did, into the standard of care in the accounting profession in the absence of testimony offered by plaintiff. Id. at 1200 n.19.
97. See 599 F.2d at 1202; note 40 supra; notes 64-65 and accompanying text supra.
98. See note 50 supra.
99. See notes 1, 50 & 79 and accompanying text supra.
successfully lifted.\textsuperscript{100} On a more positive note, \textit{McLean} presents the Third Circuit's first full-fledged attempt to formulate the bounds of the state of mind requirements to be applied in the ever-increasing volume of section 10(b) and rule 10b-5 claims against accountants. Its definitions, borrowed from other circuits as well as from the common law developments in state courts, will thus have the benefit of refinement through application to myriad fact situations in both spheres.\textsuperscript{101}

\textit{Thomas G. Wilkinson, Jr.}

\textsuperscript{100} See notes 21-29 & 43-44 and accompanying text \textit{supra}.
\textsuperscript{101} See notes 41 & 65 \textit{supra}. 