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ACCOUNTANTS' LIABILITY — THE SCIENTER STANDARD UNDER SECTION 10b AND RULE 10b-5 OF THE SECURITIES EXCHANGE ACT OF 1934

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The recent decision of the United States Court of Appeals for the Third Circuit in McLean v. Alexander¹ has sparked renewed debate on the scienter requirement for the liability of accountants and auditors under section 10(b) of the Securities Exchange Act of 1934² and rule 10b-5 promulgated thereunder.³ The purpose of this article is to review the elements of a section 10(b) and rule 10b-5 violation,⁴ and to examine the

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1. 599 F.2d 1190 (3d Cir. 1979). This case was first tried and decided in 1978. 449 F. Supp. 1251 (D. Del. 1978).
2. 15 U.S.C. § 78j(b) (1976). Section 10(b) of the Securities Exchange Act of 1934 [hereinafter cited as the 1934 Act] provides in pertinent part as follows:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
   
   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
3. 17 C.F.R. § 240.10b-5 (1979). Rule 10b-5, promulgated under section 10(b) of the 1934 Act, provides as follows:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
   (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.
4. Traditionally, complaints also include claims made under other provisions of
current status of the scienter element. A brief comparison will then be made between these elements and the principles for accountants’ liability under the American Law Institute’s Proposed Federal Securities Code, presently being studied by the

the federal securities laws, under common law, and under state Blue Sky laws.

The principles under sections 14(a) and 14(e) of the 1934 Act, 15 U.S.C. §§ 78n(a) and 78n(e), are similar to the standards under section 10(b) and rule 10b-5. Sections 11 and 12 of the 1933 Act, 15 U.S.C. §§ 77k and 77l, specify bases for accountant’s liability as well as defenses. The Supreme Court has recently ruled that no private cause of action for damages is implied under section 17(a) of the 1933 Act, 15 U.S.C. § 77q. Redington v. Touche Ross & Co., 99 S. Ct. 2479 (1979), rehearing denied, 99 S. Ct. 3095 (1979).

Additionally, it has been stated that secondary liability for aiding and abetting a violation of federal securities law may arise upon a showing: “(1) that there has been a commission of a wrongful act — an underlying securities violation; (2) that the alleged aider and abettor had knowledge of that act; and, (3) that the aider-abettor knowingly and substantially participated in the wrongdoing.” Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 799 (3d Cir.), cert. denied sub nom. First Pa. Bank v. Monsen, 439 U.S. 930 (1978) (indicating that where aider and abettor derived benefit from wrongdoing, knowledge requirement could be satisfied by “constructive notice of intended impropriety”); but cf. Murphy v. McDonnell & Co., 553 F.2d 292, 295-96 (2d Cir. 1977) (holding that while scienter would satisfy the knowing participation requirement, stock exchange had no duty to disclose results of investigation of firm to sophisticated lenders who had not sought exchange’s advice); Hirsch v. du Pont, 553 F.2d 750, 759 (2d Cir. 1977) (holding stock exchange not liable as aider and abettor to fraudulent merger where exchange knew of undisclosed material facts but not of fraud); Hochfelder v. Midwest Stock Exch., 503 F.2d 364, 374 (7th Cir.), cert. denied, 419 U.S. 875 (1974) (there, the court said to invoke liability for aiding and abetting solely by inaction, “investors must show that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure.”); Kerbs v. Fall River Indus., Inc., 502 F.2d 731 (10th Cir. 1974) (holding that mere presence at a meeting satisfied substantial participation requirement).


Additionally, the Blue Sky laws of the separate states should not be overlooked. See, e.g., CAL. CORP. CODE § 25401 (West 1977); N.Y. GEN. BUS. LAW § 339-a (McKinney 1968); WIS. STAT. ch. 551 (1977).

 Securities and Exchange Commission, which attempts to establish a unified scheme of liability.

I. SECTION 10(b) AND RULE 10b-5 OF THE 1934 ACT

To recover for violations of section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 promulgated thereunder, plaintiff need only prove by a fair preponderance of the evidence that the defendants, in connection with the purchase and sale of securities, (1) through the use of interstate instrumentalities, (2) made false or misleading misrepresentations or omissions which were (3) material and as to which (4) defendants had the requisite "scienter," (5) that plaintiff relied on the representations in making its purchases of the securities and (6) that plaintiff suffered damages as a result.

A. Use of Interstate Instrumentalities

This jurisdictional requirement is satisfied by a showing that, in connection with plaintiff's purchase of securities, defendants, directly or indirectly, individually or through any agent, used the United States mails or engaged in interstate travel or transportation, or participated in telephone conversations. At least five circuits have ruled that in the case of telephone usage, even intrastate calls suffice because the instrumentality used is an interstate instrumentality.

B. Misrepresentations and Omissions

Misrepresentations and omissions chargeable to defen-

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6. Fey v. Walston & Co., 493 F.2d 1036, 1049 (7th Cir. 1974); Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 168, 171 n.2 (10th Cir. 1974); Myzel v. Fields, 386 F.2d 718 (9th Cir. 1967), cert. denied, 390 U.S. 951 (1968). See also SEC v. Joiner, 320 U.S. 344, 355 (1943), arising under Sections 5 and 17 of the Securities Act of 1934: "Where this proof is offered in a civil action, as here, a preponderance of the evidence will establish the case."


8. See Spilker v. Shayne Laboratories, 520 F.2d 523, 526 (9th Cir. 1975): "Therefore, we join the Fifth, Sixth, Eighth and Tenth Circuits holding expressly that the intrastate use of telephone confers federal jurisdiction under §10 of the Securities Exchange Act of 1934, and S.E.C. Rule 10b-5 where the telephone calls in question are connected to the transaction of which there is a complaint."
dant-accountants can arise in diverse factual settings, from false financial statements to misleading opinion letters.\textsuperscript{9} Where the accountant prepares audited financial statements, liability can be grounded upon (1) substantially understated allowances for doubtful accounts on balance sheets and statements of operations, (2) grossly overstated reported revenues, (3) understated deficits and (4) concomitant misstatements of assets and stockholder's equity.

For example, in the case of a fledgling company the financial statements may present a picture of a company which had successfully come through its start-up phase, overcoming deficits and emerging with a profit. Yet the facts at trial may show the audited company had never made a profit and its deficits had been consistently large, while these truths were masked by the gross understatements of the company's provisions and allowances for doubtful accounts on its financial statements. Additionally, the further facts may show that the company's revenues had been falsely inflated through the practice of accruing certain revenues which the company had no reasonable expectation of receiving.

Similarly, the accountants will state in their opinion and report that their examination was made in accordance with generally accepted auditing standards. The facts at trial, however, may show departures from and violations of generally accepted auditing standards, such as the acceptance of data (e.g., credit criteria, write-offs, provisions for doubtful accounts, internal control procedures of the company) without audit tests or procedures to verify the accuracy of such data (in the face of knowledge that the data was subject to the distortions), or the acceptance of data when limited tests evidence discrepancies (e.g., reporting accrued revenues and receivables when the competent evidential matter in the hands of the accountants demonstrates that the bases for such accruals were non-existent). Other departures from generally accepted auditing standards include employing inadequate qualifications in the opinion (e.g., sanctioning the presentation of

\textsuperscript{9} For a dated general discussion of principles of liability, including misrepresentation, see Symposium on Accounting and the Federal Securities Laws, 28 VAND. L. REV. 1 (1975); cf. ALI PROPOSED CODE, supra note 5, at §§ 256, 297 (defining "misrepresentation" and "fact").
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financial statements on a going concern, rather than a liquidation, basis when from the cash and income forecasts reviewed by the accountants, it was known that the assumptions on which the company's viability was projected were false), affirmatively including false statements (e.g., "subsequently the company has improved its operations to a profitable level"), and expressing an opinion as to the financial statements when the accountants lacked the basis on which to do so.

Accountants, however, will often defend against these charges with the claim that they were themselves deceived by the management of the audited company. For the opposing view, plaintiffs maintain that accountants are not to be excused from detection of fraud if observance of generally accepted auditing standards would uncover the fraud. This latter point was well made by the SEC, in In re Touche Ross & Co.,\textsuperscript{10} where the accounting firm consented to the entry of an SEC disciplinary order resulting from its audit of U.S. Financial, Inc. (USF). In that matter the SEC addressed the question of deception of the auditor as follows:

While it appears that [the accountant] was deliberately misled in many respects by USF's management in the course of the 1970 and 1971 audits, [the accountant's] failure in a number of respects to conduct these engagements in accordance with generally accepted auditing standards makes [the accountant] responsible for certifying financial statements which proved to be materially false and misleading. As the Commission stated in its report on McKesson & Robbins, Inc.:

\[\ldots\] [W]e believe that\ldots [with respect to] examinations for corporations whose securities are held by the public, accountants can be expected to detect gross overstatements of assets and profits, whether resulting from fraud or otherwise. We believe that alertness on the part of the entire [audit] staff, coupled with intelli-

gent analysis by experienced accountants of the manner of doing business, should detect overstatements in the accounts, regardless of their cause, long before they assume the magnitude reached in this case. Furthermore, an examination of this kind should not, in our opinion, exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted. . . . [W]e feel that the discovery of gross overstatements in the accounts is a major purpose of . . . an audit . . . .”

The SEC also cited the following:

As stated in the AICPA’s recently issued Statement on Auditing Standards § 110.05 (1973), which was substantially a restatement of existing practice, in making an ordinary examination, the auditor must be alert to and recognize “the possibility that fraud may exist” and that fraud, “if sufficiently material, may affect his opinion on the financial statements . . . .” Accordingly, “his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility,” even though the ordinary examination is not “primarily or specifically designed” to detect fraud. The failure, therefore, to conduct an examination in accordance with generally accepted auditing standards means that the auditor is responsible for his failure to detect fraud when such failure results from a departure from auditing standards.12

The SEC further said, in pertinent part, as follows:

1. An independent examination is a check on representations of management however honest and competent that management may be, and reliance on managerial virtues is not a check.
2. Banks sometimes make character loans, but there is no such thing as a character audit.
3. Defalcations are nearly always perpetrated by old and trusted employees of good reputations.13

11. 6 Fed. Sec. L. Rep. (CCH) ¶ 72,175 at 62,360 (footnotes omitted).
12. Id. at 62,363 n.11.
13. Id. at 62,364 n.14.
C. Materiality

The commonly applied test of materiality under section 10(b) and rule 10b-5 is whether a reasonable person would attach importance to the fact misrepresented or omitted in determining his choice of action in the transaction in question. In most cases involving accountant's liability, materiality seems obvious where the financial statements are inaccurate, because financial statements are usually the cornerstone of an investment decision.

For instance, there is little doubt about the significance to any investor of the fact that a company might be: (1) holding vast numbers of uncollectible accounts on its books; (2) computing its provisions and allowances for doubtful accounts under a false formula; or (3) accruing and reporting revenues on false assumptions. Nor can anyone doubt the importance to an investor of the fact that a company was piling up massive deficits when its accountants were reporting that the financial statements to the contrary had been audited and were fairly presented.

In some instances, however, accountants could counter with the argument that the investment decision involves the purchase of a “concept” instead of tangible assets. This argument, of course, derives from the situation where many

14. This test is from Restatement of Torts, § 528(2)a (1938), quoted in Northwest Paper Corp. v. Thompson, 421 F.2d 137 (9th Cir. 1970). In Lewelling v. First Cal. Co., 564 F.2d 1277 (9th Cir. 1977), the Ninth Circuit Court of Appeals said, “[T]he Supreme Court has yet to announce a precise test for materiality under Rule 10b-5. In the Ninth Circuit, the Northwest Paper formulation still controls.” See also Robinson v. Cupples Container Co., 513 F.2d 1274, 1277 (9th Cir. 1975); Marx v. Computer Sciences Corp., 507 F.2d 485, 489 (9th Cir. 1974); Gilbert v. Nixon, 429 F.2d 348, 355-56 (10th Cir. 1970); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965), cert. denied sub nom. List v. Lerner, 382 U.S. 811 (1965). In TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976), materiality with respect to fact or omissions in proxy solicitation material governed by rule 14a-9 was defined by the Supreme Court as follows:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Cf. ALI Proposed Code § 298 (adopting the TSC Industries definition of "material").
fledgling companies are purchased based on a product, marketing device, or other unique quality which combined with the audited financial statements makes the company look very attractive. Often in these situations the price earning multiple may be extraordinarily high, evidencing excellent growth possibilities.

While in most cases materiality will not be disputed, where it is, the accountant's argument will more likely be seen as addressing the issue of reckless disregard and the scienter standard under section 10b and rule 10b-5. For example, in McLean v. Alexander, the Third Circuit Court of Appeals segmented discrepancies in the underlying facts from those present in the financial statements, finding that these minimal discrepancies did not constitute reckless disregard.\textsuperscript{15}

\textbf{D. Scienter}

In \textit{Ernst & Ernst v. Hochfelder},\textsuperscript{16} an accountant's liability case where only negligent nonfeasance was claimed, the Court ruled that the existence of scienter was a necessary element in establishing liability under section 10(b) of the 1934 Act and rule 10b-5, and defined scienter for the purpose of the case before it, as a "mental state embracing intent to deceive, manipulate, or defraud."\textsuperscript{17} It is axiomatic that knowing falsity constitutes scienter. The Court acknowledged this in \textit{Hochfelder}, holding that the words of section 10(b) "strongly suggest that §10(b) was intended to proscribe \textit{knowing or intentional misconduct}."\textsuperscript{18} Because the issue was not before it, the Court declined to address the question of liability for reckless behavior after stating in the oft-cited footnote twelve that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act."\textsuperscript{19}

The concept that a defendant may be held liable for statements made with reckless disregard for truth or falsity is, of course, rooted in the common-law concept enunciated by then

\textsuperscript{15} See text accompanying notes 16-53 infra.
\textsuperscript{17} Id. at 194 n.12.
\textsuperscript{18} Id. at 197 (emphasis added)(footnotes omitted). See also Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27, 33 (2d Cir. 1976).
\textsuperscript{19} Id. at 193-94 n.12.
Judge Cardozo in the landmark case of *Ultramares Corp. v. Touche*, 20 where the court said:

> Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud.

... . . .

We conclude, to sum up the situation, that in certifying to the correspondence between balance sheet and accounts the defendants made a statement as true to their own knowledge, when they had, as a jury might find, no knowledge on the subject. If that is so, they may also be found to have acted without information leading to a sincere or genuine belief when they certified to an opinion that the balance sheet faithfully reflected the condition of the business. 21

The Seventh Circuit in several recent cases 22 has quoted from *Franke v. Midwestern Oklahoma Development Authority*, 23 which describes the applicable recklessness standard in the context of omissions as follows:

> [R]eckless conduct may be defined as a highly unreasonable omission, 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. 24

The Second Circuit in *Lanza v. Drexel & Co.*, 25 explained the recklessness standard as follows:

> In determining what constitutes "willful or reckless disregard for the truth" the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or failed or refused, after being put on

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21. *Id.* at 189, 192-93, 174 N.E. at 448-50.
22. Wright v. Heitzer Corp., 560 F.2d 236, 251-52 (7th Cir. 1977); Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044 (7th Cir.), cert. denied, 434 U.S. 875 (1977), where the court stated that while scienter involved an objective test, "the circumstances must be viewed in their contemporaneous configuration rather than in the blazing light of hindsight." *Id.* at 1045 n.19.
24. *Id.* at 725.
25. 479 F.2d 1277 (2d Cir. 1973)(en banc).
notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort.\textsuperscript{26}

A number of courts have, subsequent to \textit{Hochfelder}, considered whether recklessness fulfills the scienter requirement of section 10(b) and rule 10b-5, and a number of them have held that it does.\textsuperscript{27}

For example, the Ninth Circuit in \textit{Nelson v. Servold}\textsuperscript{28} addressed the question squarely and held as follows:

Although the Supreme Court left undecided the question whether recklessness is sufficient to support liability under Rule 10b-5, distinguished jurists have long considered it so . . . And since \textit{Ernst & Ernst}, courts have continued to assess Rule 10b-5 liability for reckless behavior.

\textit{Ernst & Ernst}, we think, only went so far as to eliminate

\textsuperscript{26} Id. at 1306-n.98.


\textsuperscript{28} 576 F.2d 1332 (9th Cir.), \textit{cert. denied}, 439 U.S. 970 (1978). While adhering to the \textit{Hochfelder} scienter standard, an issue of the foreseeable persons and purview of the accountant's "duty to disclose" has been raised by the Ninth Circuit and other courts. \textit{See} Spectrum Financial Cos. v. Marconsult, Inc., 608 F.2d 377, 381 (9th Cir. 1979), \textit{cert. denied}, 48 U.S.L.W. 3631 (1980); Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979); Competitive Assocs., Inc. v. Laventhal Krekstein, 478 F. Supp. 1328, 1341 (S.D.N.Y. 1979). As such, this consideration is a part of the reliance requirement but may affect the evaluation of recklessness in a specific factual setting. \textit{See}, e.g., Pegasus Fund v. Laraneta, [Current] \textit{Fed. Sec. L. Rep. (CCH)} \textsuperscript{1} 97,281 at 96,992-93, (9th Cir., Feb. 14, 1980).
negligence as a basis for liability. We agree with those courts which have found that Congress intended the ambit of § 10(b) to reach a broad category of behavior, including knowing or reckless conduct. 28

In McLean v. Alexander 30 the Third Circuit Court of Appeals, which had approved the recklessness standard in Coleco Industries, Inc. v. Berman, 31 sought to define the legal standard for recklessness with respect to accountants. After a careful review of Hochfelder, post-Hochfelder decisions and the common-law criteria, 32 the Third Circuit formulated the test as follows:

It seems to us that the purpose of footnote 12 of the Hochfelder opinion was to preserve, at least in the context of accountants' liability, the standards of scienter developed in Ultramares and O'Connor v. Ludlam. And the core requirement of those cases is that the plaintiff establish that the defendant lacked a genuine belief that the information disclosed was accurate and complete in all material respects . . . .

We stress that to prove scienter the plaintiff need not produce direct evidence of the defendant's state of mind. Circumstantial evidence may often be the principal, if not

30. 599 F.2d 1190 (3d Cir. 1979).

As Judge Swan made clear in O'Connor v. Ludlam, 92 F.2d 50, 54 (2d Cir. 1937), also an accountants' liability case, in an action for fraud under the Ultramares standard:

the issue [is] whether the defendants had an honest belief that the statements made by them were true. "If they did have that belief, whether reasonably or unreasonably, they are not liable. If they did not have an honest belief in the truth of their statements, then they are liable, so far as [scienter] is concerned."
the only, means of proving bad faith. A showing of shoddy accounting practices amounting at best to a "pretended audit," or of grounds supporting a representation "so flimsy as to lead to the conclusion that there was no genuine belief back of it" have traditionally supported a finding of liability in the face of repeated assertions of good faith, and continue to do so. In such cases, the factfinder may justifiably conclude that despite those assertions the "danger of misleading . . . [was] so obvious that the actor must have been aware of it." \(^33\)

The Third Circuit found that the accountants' liability at trial had been based solely on the inaccuracy of the accounts receivable entry on the balance sheet. The court then concluded that the circumstantial evidence did not support an inference that the accountants must have been aware of the risk that the accounts receivable item was misleading. \(^34\) In doing so, the Third Circuit segmented its analysis of each purported sale and found that even where there were clear questions no factors standing alone were evidence that the accountants knew that they lacked the knowledge required to form an opinion on the sales. \(^35\) In short, the Third Circuit made conclusions based on its interpretation of the facts (which differed from the district court's findings) and found that the accountants' misfeasance only amounted to negligence, and that the requisite scienter was not present. \(^36\)

34. Id. at 1199, where the court said: Although the defendants contended these sales had occurred, testimony by agents of L.B. Smith, Robbins, and Southern Laser established to the satisfaction of the court that the sixteen transactions were in the nature of consignments. There was no evidence that Schiavi, the C & S partner in charge of the audit, had actual knowledge of the consignment arrangements, or even that he was aware of the risk that they were consignment sales. Thus C & S could be held to have the requisite scienter only if the investigation it made, and the knowledge it had, give rise to an inference that it "must have been aware" of the risk that the accounts receivable item was misleading. Upon examination of the evidence bearing on Schiavi's investigation of the four questioned accounts, we conclude that such an inference was not permissible in this case.
35. The court also noted that the plaintiff had "presented no testimony as to the standard of care in the accounting profession." Id. at 1200 n.19. This failure to present such proof may have been the decisive factor of the case.
36. At trial the district court found that the accountants, in order to check ac-
Consequently, *McLean* does not seem to affect the legal standard for accountants' liability. Its factual findings, however, are instructive and will fuel the accountant's arguments that (1) recklessness must be the equivalent of willful fraud. The accountants, sent out four positive confirmation requests, only one of which was returned. The returned request disputed more than one third of the amount shown on the company's books. With respect to two of the other requests, the accountants received telegram messages which referred to the customers' respective purchase orders but which did not confirm an amount due and owing. The accountants made no efforts to contact the customers and verify the telegrams and in fact one of the telegrams was a fake and the other was fraudulently obtained by the company. In addition, the "purchasing" companies stated at trial that these were only consignments. The district court found:

Thus, without having received positive confirmations from three of four accounts representing nearly 90% of the dealer receivables and having no personal knowledge about any of the dealers since they were all new accounts, Schiavi issued a certified audit indicating that the accounts receivable were genuine. Further, without any documentation or management inquiry as to the dealers' financial status, he stated that the accounts were "Considered Fully Collectible."


The district court also found other serious deficiencies in the accountant's conduct of the audit: (1) conflicting dates for payment between invoices and purchase orders; and (2) invoices issued without delivery where the accountants made no inquiry as to whether the units had been sold at all or were merely assigned to the dealers on a consignment basis.

The Third Circuit held as follows:

If we were applying a negligence standard we could affirm a finding that given the one month discrepancy in the due dates between the invoice and the purchase order, the late issuance of the invoice, and the ambiguity in the telegraphic confirmation, Schiavi should have made further inquiry of management or of L.B. Smith before concluding that the account receivable was genuine. But we cannot hold that these factors, standing alone, were evidence that C & S was aware that it was without sufficient knowledge to form that opinion. Such a holding would obliterate the distinction between tortious conduct requiring scienter, which the *Hochfelder* construction of § 10(b) demands, and negligence, which *Hochfelder* found insufficient.

599 F.2d at 1199-1200.


See also Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir.) cert. denied, 434 U.S. 87 (1977); Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977), where the court stated as follows:

In view of the Supreme Court's analysis in *Hochfelder* of the statutory scheme of implied private remedies and express remedies, the definition of 'reckless behavior' should not be a liberal one lest any discernible distinction between 'scienter' and 'negligence' be obliterated for these purposes. We believe 'reckless' in these circumstances comes closer to being a lesser form of intent than...
and (2) the accountants possess a good faith defense.

In *Sharp v. Coopers & Lybrand*, the District Court for the Eastern District of Pennsylvania, based on the special verdict of a jury, found that an agent of the accountants possessed the requisite scienter. The jury found there were material misrepresentations and omissions in an opinion letter regarding the tax status of tax shelter partnerships. Although the court employed the recklessness scienter standard, it avoided the pitfalls of the district court in *McLean*. The *Sharp* court's selection of the recklessness scienter standard was founded upon the Third Circuit's pronouncement in *Coleco Industries, Inc. v. Berman*, and its instruction to the jury was based upon the definition of recklessness stated in *Franke v. Midwestern Oklahoma Development Authority*. It should be noted that, unlike *McLean*, the plaintiffs in *Sharp* presented expert testimony that the accountant's opinion letter was reckless on its face.

In *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, defendant accounting firm was held liable for its "materially misleading" treatment, in its submitted audit, of facts known to it. There, the accounting firm was presented with documentation of purported real estate sales transactions and determined, in consultation with and under pressure from its client, on a form of inclusion and presentation of those transactions in the client's financial statements with footnotes and a qualified opinion. Specifically, land was sold with a small down payment to a weakly capitalized corporation under circumstances making collection problematical and the nature of the contract doubtful. The auditors, Laventhol and Krekstein, after extensive study by various members of the firm, refused to recognize the full $2,030,500 gross profit and instead lim-

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merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree, but also in kind.


41. *540 F.2d* 27 (2d Cir. 1976).

42. *Id.* at 34.
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itted recognition to $235,000 consisting of $50,000 cash received and $185,000 promised as liquidated damages in the event of the buyer's default. A footnote to the income statement described the contract and the accountants' letter accompanying the report stated that the opinion was qualified "subject to the collectibility of the balance receivable on the contract of sale."\(^{43}\)

Both the district court\(^{44}\) and the Second Circuit found the financial statements to be materially misleading, the circuit court holding that the "vice of the report was its representation that the Monterey transactions were consummated and the concomitant statement that current and deferred profit had been realized."\(^{45}\) The Second Circuit further found that the labelling of a portion of the profit as "deferred" as opposed to "unrealized" gross profit aggravated the misleading impression, rendering the qualified opinion insufficient because the accountants "did not provide a clear explanation of the reasons for the qualification."\(^{46}\)

The Second Circuit found the Hochfelder scienter requirement to be fully satisfied, stating that "[t]he accountants here are not being cast in damages for negligent nonfeasance or misfeasance, but because of their active participation in the preparation and issuance of false and materially misleading accounting reports upon which Herzfeld relied to his damage."\(^{47}\) Consequently, the Herzfeld case is authority for accountants' liability for knowingly and recklessly issuing false and materially misleading statements.\(^{48}\)

\(^{43}\) Id. at 31.


\(^{45}\) 540 F.2d at 37.

\(^{46}\) Id. at 36.

\(^{47}\) Id. at 37 (emphasis added).

\(^{48}\) Defendant accountants successfully avoided liability on these grounds in Oleck v. Fischer, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,898 (S.D.N.Y. 1979). There the court found that the financial statements were not materially misleading. Specifically, it was held that a footnote describing loans guaranteed by the defendant corporation to a former subsidiary was not materially misleading. Consequently, the court, in holding there was no scienter under either the specific intent or reckless disregard standard, found that the issuance of a "clean opinion" (i.e., one with no qualifications) was judgmental and amounted to no more than mere negligence. Id. at 95,701. The court also found that the plaintiffs, who were sophisticated businessmen, had failed to fulfill the due diligence requirement and that the accountants' financial statements were not a proximate cause of plaintiffs' loss. Id. at 95,701-
The result on appeal in the Sixth Circuit in *Adams v. Standard Knitting Mills Inc.*,49 however, paralleled the *McLean* case. The district court in *Adams* found that defendant Peat Marwick Mitchell & Co. (Peat) had exhibited the requisite scienter in that it was aware *inter alia* of a serious weakness in its client's electronic data processing system and other internal weaknesses yet "conducted the audit as though these problems did not exist."50 Peat was held liable by the district court in part for relying on its client's system of internal control without reasonable or satisfactory verification and departing from standard accounting and auditing procedures exhibiting scienter.

The Sixth Circuit, in a two to one opinion, reversed, with the majority taking a different view of the facts, finding as follows:

The evidence simply suggests a mistake, an oversight, the failure to forsee a problem. We find nothing in the record indicating an intent to deceive or a motive for deception. . . . No stockholder testified that he was deceived. An erroneous statement cannot *ipso facto* prove fraud, and here we find no evidence of anything other than a negligent error.51

The majority of the Sixth Circuit painstakingly dismissed the district court's findings of liability characterizing each as negligent or immaterial and concluded that Peat "did not forsee

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50. [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,683 at 90,356 (E.D. Tenn. 1976). The district court found that the EDP problems "were of such a pervasive nature and importance that their existence did, or at a minimum, could have significantly affected the entire operation of [the corporation] and would therefore most directly relate to matters contained in the financial statement." *Id.* at 90,365. Additionally, the district court found:

Finally, with full knowledge of [the corporation's] deficient EDP and other internal weaknesses, defendant conducted its 1969 audit as though [the corporation] was as sound as a dollar used to be — clearly deviating from GAAP [Generally Accepted Accounting Principles], GAAS [Generally Accepted Auditing Standards] and the provisions of Peat's own audit manual. *Id.* at 90,367.

that the bottom would drop out of [the acquirer’s] earnings and that what appeared to be a minor error at the time would become a major bone of contention.”52 The dissent was sting-
ing and noted that the majority opinion had usurped the fact-
finding functions of the trial court.53

Thus while the standard criteria for scienter are now well
established, the application of the law to the facts continues to present problems in several circuits.

E. Reliance

“In order to establish reliance sufficient to recover under
Rule 10b-5, plaintiff must prove that defendants’ misrepre-
sentations were a ‘substantial factor’ in determining the
course of conduct which resulted in [its] loss.”54 With respect
to the financial statements, “[t]here is no requirement that
the plaintiff establish sole reliance or even primary reliance
upon the audit, only that it was a ‘substantial factor’ in [its]
decision.”55 As explained in Herzfeld, “substantial factor”
means a “significant contributing cause.”56

52. Id. at 97,514.
53. Id. at 97,520. The dissent stated:
Despite all this evidence of deliberate fraud, Peat has the audacity to assert
that the false, untrue and misleading statements in footnotes 7(c) and 7(d) of
its audit were only ‘lapsus calami’ (Br. at 5), ‘slip of the pen’ (Br. at 29), and a
‘footnote mistake’ (Br. at 1). It is unbelievable that the majority of this panel
would swallow with hook, line and sinker such an outrageous and ridiculous
proposition and to hold that Peat’s misrepresentation was only negligent and
use it as a basis for reversing a well reasoned opinion of the District Court
thereby depriving the many shareholders of Standard of millions of dollars of
compensation in which they were justly entitled because of the fraud perpe-
trated on them by Peat. Id. at 97,525.
Laventhal, Krekstein, Horwath & Horwath, 540 F.2d 27, 33 (2d Cir. 1976) and List v.
Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied sub nom. List v. Lerner,
382 U.S. 811 (1965)). Cf. ALI PROPOSED CODE § 220 (stating that both the substantial
factor and reasonable foreseeability tests must be met).
Hopkins Univ. v. Hutton, 326 F. Supp. 250, 260 (D. Md. 1971), aff’d in part and rev’d
in part on other grounds, 488 F.2d 912 (4th Cir. 1973), cert. denied, 416 U.S. 916
(1974) and List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied sub
nom. List v. Lerner, 382 U.S. 811 (1965)). See Herzfeld v. Laventhal, Krekstein, Hor-
wath & Horwath, 540 F.2d 27, 34 (2d Cir. 1976).
56. 540 F.2d at 34. See Oleck v. Fischer, [1979 Transfer Binder] FED. SEC. L. REP.
(CCH) ¶ 96,898 (S.D.N.Y. June 8, 1979). With respect to misrepresentations, there
must be an element of causation. Moody v. Bache & Co., 570 F.2d 523 (5th Cir. 1978);
Vervaecke v. Chiles, Hieder & Co., 578 F.2d 713 (8th Cir. 1978); Fridrich v. Bradford,
Similarly, in *Affiliated Ute Citizens v. United States*, the Supreme Court held:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.\(^5\)

1. The "Due Diligence" Defense

Accountants often contend that the plaintiffs should be denied recovery because they failed to exercise "due diligence" in the acquisition or other transaction.\(^6\) For any such defense

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58. *Id.* at 153-54 (citations omitted).


In *Vanderboom* the court formulated the following test for reasonable reliance under section 10(b) and rule 10b-5: "[W]hether a reasonable investor, in light of the facts existing at the time of the misrepresentation and in the exercise of due care, would have been entitled to rely upon the misrepresentation." *Id.* at 230.

In footnote 10 to its opinion, the *Vanderboom* court amplified on plaintiff’s burden of proof:

Not only should the plaintiff have to prove that he relied on the defendant’s statements, but he must convince the trier of fact that his reliance was reasonable under all the circumstances at the time. In this way recovery would be denied to those who, because of their “business sophistication,” acumen, or ready access to the information involved, could reasonably be expected to exercise a higher degree of care and investigation in their dealings.

\[\ldots\] The objective standard of a reasonable investor exercising due care in light of all facts effectively imposes a duty of reasonable investigation, thereby limiting the class of investors who will be protected under 10b-5(2) to conscientious buyers and sellers in good faith.

*Id.* at 230 n.10 (quoting Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. Chi. L. Rev. 824, 842-43 (1965)).
the burden of proof is, of course, on defendants.\(^6^0\)

In the wake of the Hochfelder decision, the courts have held that, for such a defense to prevail, the plaintiff's so-called lack of due diligence must have risen to the level of recklessness conduct. The notion is that, if in a 10b-5 case the defendants' conduct must be shown to have reached the level of recklessness, then also the defendant cannot prevail unless he can show that the plaintiff's conduct reached that same level.\(^6^1\)

In *Dupuy v. Dupuy*,\(^6^2\) the Fifth Circuit said:

We consider that *Ernst & Ernst v. Hochfelder* prompts a change in the law of due diligence, as it is applicable in 10b-5 cases. Both tort law and federal securities policy support imposing on the plaintiff only a standard of care not exceeding that imposed on the defendant. Although the "scienter" requirement may still be unsettled, the Supreme Court has imposed on defendants a standard not stricter than recklessness. In this case, then, the question should not be whether Milton acted unreasonably by failing to investigate the condition of Lori Corporation. Instead, the Court should ask whether Milton intentionally refused to investigate "in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow."\(^6^3\)

In *Holdsworth v. Strong*,\(^6^4\) and *Sundstrand Corp. v. Sun Chemical Corp.*,\(^6^5\) the Tenth and Seventh Circuits respectively have reached the same conclusion.\(^6^6\)

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63. Id. at 1020 (citation omitted).

64. 545 F.2d 687, 693 (10th Cir. 1976), cert. denied, 430 U.S. 955 (1977).

65. 553 F.2d 1033, 1048 (7th Cir.), cert. denied, 434 U.S. 875 (1977).

66. Cf. ALI PROPOSED CODE § 1704(e) (providing a defense if plaintiff had knowl-
Accountants also might argue that certain investors were given preacquisition access to the audited company's records and should have discovered any problems through the exercise of due diligence in an independent review of these records. This defense might arise where the company acquiring the stock of another engages its own staff, outside consultants or investment advisors, or its own accountants to do a "limited review." 67

2. Other Defenses

Closely connected to this defense is the additional assertion that the investment decision is made prior to seeing the final certified financial statements and on the basis of an independent investigation. This defense has been upheld on appeal where the trial court found that there was "nothing that could be said or done . . . [which] would have overcome the buyer's insistence in investing." 68 Similarly, another trial court has stated as follows:

For purposes of a Rule 10b-5 claim, events occurring after the commitment to purchase stock has been made are irrelevant. Issues of non-disclosure, misrepresentation, materiality and reliance are to be determined by the situation edge of relevant facts or if alleged falsity was obvious). See also Holmes v. Bateson, 583 F.2d 542, 559 n.21 (1st Cir. 1978). But see Oleck v. Fischer, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,898 (S.D.N.Y. June 8, 1979), in which plaintiffs did not satisfy the due diligence requirement. The Oleck court quoted as follows from Hirsch v. du Pont, 553 F.2d 750, 762 (2d Cir. 1977): "The securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment. Such investors must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information." The Oleck court did not apply a recklessness standard but found that reasonable investors of the sophistication and experience of plaintiffs would have conducted a more thorough investigation.


67. With respect to third parties engaged by the acquiring company additional questions might arise as to the character of the relationship and the imputation of the third party's knowledge to the acquiring company.

68. Chelsea Assocs. v. Rapanos, 527 F.2d 1266, 1272 (6th Cir. 1975) (quoting from the district court's findings).
and knowledge of the parties at the time they committed themselves, and not on the basis of subsequent events, even though they occur prior to "the formal closing date when the delivery and payment are formally completed and cleared."  69

The success of these defenses, of course, will depend on the factual circumstances. Such arguments were squarely rejected by the Second Circuit in *Metro-Goldwyn-Mayer, Inc. v. Ross.*  70 In that case plaintiff's own accountants, Arthur Anderson, had been engaged to conduct a purchase investigation and had been given access to certain of defendant's records which, it was claimed, could have revealed certain facts that had been misrepresented. The court considered the defenses raised therein, and said:

However, Rule 10b-5, as well as the terms of the exchange agreement, required the Ross brothers to state all material facts necessary to make other statements not misleading. . . . Such a duty is not discharged merely by giving the purchaser access to company records and letting him piece together the material facts if he can.  71

While, in hindsight, defendant-accountants may argue that the acquisition was a mistake, in most cases not even hindsight can justify any claim that the pre-acquisition conduct was reckless. As the district court said of the certified public accountants in *McLean v. Alexander,*  72 "The defendant cannot engage in games of hide and seek by first holding himself out as an independent expert and then demanding that plaintiff himself uncover the inaccuracy of the certified financial statement."  73

F. Damages Under the Federal Securities Law

1. Compensatory Damages

Under the federal securities laws a plaintiff is clearly enti-

70. 509 F.2d 930 (2d Cir. 1975).
71. Id. at 933 (citations omitted).
73. Id. at 1079.
tled to recover for losses attributable to and flowing from defendants’ misconduct. The measure of damages recoverable for securities law violations is “actual damages on account of the act complained of.” Except in a merger transaction where the defect in the proxy solicitation relates to the specific terms of a proposed merger, the actual damage rule prescribed by section 28 is the “out-of-pocket” rule, viz: (1) the difference between the amount paid and the value received, and (or) (2) the profits or economic gain realized by the defendants at the expense of the plaintiffs by reason of the stock sale or merger exchange. Under the out-of-pocket rule “it is a well recognized rule that the complaining party is entitled to be made whole” and that damages are recoverable only “to the extent that they can be shown.”

2. Consequential Damages and Causation

Damage causation in fact must be present and is shown where “but for” the misrepresentations the investment outlays would not have been expended and such losses were a reasonably foreseeable consequence of those misrepresentations. The amount of the loss must have been paid because of the defendant’s acts and omissions, and not due to a super-


78. Richardson v. MacArthur, 451 F.2d 35, 43 (10th Cir. 1971).


80. Foster v. Financial Technology, Inc., 517 F.2d 1068, 1072 (9th Cir. 1975); Madigan, Inc. v. Goodman, 498 F.2d 233, 239 (7th Cir. 1974); cf. ALI Proposed Code § 1708(b) & (c) (where the burden of proof is on the defendant).
With respect to expenditures made by the defrauded purchaser in an attempt to save a business he purchased, the Seventh Circuit has stated the following rule:

We agree that if plaintiffs can establish the requisite causal nexus at trial, they are entitled to recover out-of-pocket consequential damages suffered as a result of holding Fidelity stock.

Accordingly, capital contributions and other expenses of attempting to save Fidelity may be recoverable. Plaintiffs must show that each expenditure for which recovery is sought was a reasonable effort to, e.g., minimize plaintiffs' losses, or fulfill a fiduciary obligation to Fidelity policyholders, or comply with the requirements of regulatory agencies. They must also show that the danger from which Fidelity was being saved was the pre-existing insolvency concealed by defendants, and that but for defendants' misrepresentations, plaintiffs would not have made these expenditures. We also think that the $18,384 broker's commission or finder's fee is recoverable, if but for the misrepresentation it would not have been spent.

In McLean, plaintiff, after discovery of the fraud perpetrated on him, put another $464,751 into the company he had acquired in an effort to protect his investment and turn the

81. See, e.g., Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1049-51 (7th Cir.), cert. denied, 434 U.S. 875 (1977). During merger negotiations, plaintiff entered into an agreement with the defendant individual to purchase his exercised option on shares of the merger candidate owned by a third party. At that time, the defendant individual who had paid 5% of the purchase price to the third party, was compensated by plaintiff corporation, which agreed to pay the balance of the purchase price due a month later. The merger fell through for reasons which included plaintiff's discounting the defendant's representations. Thereafter, however, plaintiff purchased the third party shares paying 95% of the purchase price ($6,356,915). The Seventh Circuit found that the agreement was only an option and that the shares had been purchased not because of the defendant's misrepresentations, but because plaintiff's attorneys had advised plaintiff incorrectly that it was legally obligated to make the purchase. Accordingly, the court held that the "incorrect legal advice, in conjunction with sufficient knowledge to show that forfeiture of its down payment was better than further payments, serves as the superseding cause which breaks the damage causation chain running to the defendants." Id. at 1051.

company around. The defendant argued that plaintiff should have closed up the business promptly after discovery of the fraud. The district court held that for plaintiff "to have ceased operations when he first learned of the bogus sales and the true nature of the Amvit relationship may well have been imprudent" and went on to state as follows:

After an early infusion of funds, decreasing amounts were expended until the close of business in October. There is no evidence that the business was conducted other than responsibly. From all that is evident, there was no attempt to foreclose creditors or to throw the business into bankruptcy. Nor should a businessman who values his reputation have to resort to such measures in order to confer a benefit upon those who defrauded him.

A review of the evidence results in the conclusion that the $464,751 lost during the nine months of McLean's ownership and operation was a not unreasonable amount and in addition was an amount that defendants could reasonably have foreseen that McLean would invest. Therefore, the amount of $464,751 will be added to the $100,000 expended immediately after the closing and a total of $564,751 will be awarded as consequential damages.

3. Prejudgment Interest

An award of prejudgment interest in a case involving violations of the federal securities laws rests within the equitable discretion of the court to be exercised according to considerations of fairness and equity. Factors considered by the court in exercising discretion include fairness, defendants' degree of wrongdoing, whether interest would be truly compensatory, plaintiff's alternate investment opportunities, plaintiff's delay before and during the trial, the delay between the commencement of the action and the trial, consideration of plaintiff's otherwise nonreimbursable expenses (including attorney's

83. 449 F. Supp. at 1270.
84. Id.
85. Blau v. Lehman, 368 U.S. 403, 414 (1962); Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1345 n.8 (9th Cir. 1976) (Sneed, J., concurring); Thomas v. Duralite Co., 524 F.2d 577, 589 (3d Cir. 1975); Wolf v. Frank, 477 F.2d 467, 479 (5th Cir.), cert. denied, 414 U.S. 975 (1973); Wessel v. Buhler, 437 F.2d 279, 284 (9th Cir. 1971). Cf. ALI PROPOSED CODE § 1723(c) (where interest must be awarded unless the court directs otherwise).
fees) and inflation.86

Prejudgment interest appears to be calculated on a simple interest basis87 and can begin to accrue on either the date of the fraudulent transaction or date of outlay,88 on the date of the discovery of the fraud89 or on the date of the filing of the action.90 Prejudgment interest is computed on the amount of the general damage award and naturally can be substantial.91

II. PROPOSED FEDERAL SECURITIES CODE

The principles of accountants' liability are much the same under the American Law Institute's Proposed Federal Securities Code,92 presently being studied by the Securities and Exchange Commission, which attempts to establish a unified scheme of liability. Sections 26293 and 29794 of the ALI Pro-

87. Speed v. Transamerica Corp., 235 F.2d 369, 374 (3d Cir. 1956).
92. See note 5, supra.
93. ALI PROPOSED CODE § 262 provides in pertinent part as follows:
(a) [General.] "Fraudulent act" includes an act, device, scheme, practice, or course of conduct that (1) is fraudulent or (2) operates or would operate as a fraud.
(b) [Inaction or silence.] Inaction or silence when there is a duty to act or speak may be a fraudulent act.
(c) [Knowledge or recklessness.] Notwithstanding section 262(a), a person engages in a fraudulent act only if he acts with knowledge that his conduct is of a type specified in that section, or in reckless disregard of whether that is so.
(e) [Company mismanagement.] The existence of a fraudulent act is not precluded by the fact that it constitutes company mismanagement.
94. ALI PROPOSED CODE § 297 provides as follows:
posed Code define “fraudulent act” and “misrepresentation” basically in the language of rule 10b-5. These definitions are supplemented by the traditional definitions of “fact” and “material” in section 256 and 293. Section 1602(a) makes it “unlawful for any person to engage in a fraudulent act or to make a misrepresentation” in connection with purchases, sales, proxy solicitations, tender requests and investment advice.

Express liabilities for fraud and misrepresentation are set forth in sections 1703 through 1707. Two sections in particular are pertinent to accountant’s liability. First, under section 1704 applying to false registration statements, offering state-

(a) [General.] “Misrepresentation” means (1) an untrue statement of a material fact, or (2) an omission to state a material fact necessary to prevent the statements made from being misleading in the light of the circumstances under which they are made.

(b) [Estimates, etc.] A statement of fact within the meaning of section 256(a) is not a misrepresentation if it (1) is made in good faith, (2) has a reasonable basis when it is made, and (3) complies with any applicable rule so far as underlying assumptions or other conditions are concerned.

95. ALI PROPOSED CODE § 256 provides as follows: “‘Fact’ includes (a) a promise, prediction, estimate, projection, or forecast, or (b) a statement of intention, motive, opinion or law. See also section 297(b).”

96. ALI PROPOSED CODE § 293 provides as follows:
(a) [General.] A fact is “material” if there is a substantial likelihood that a reasonable person would consider it important under the circumstances in determining his course of action.

(b) [Communication with a small number.] When a person is communicating with a small number of other persons, (1) a fact is “material” also with respect to a recipient of the communication if the maker of the communication knows that the recipient considers the fact important in determining his course of action, or that there is a substantial likelihood that he would so consider it, although there is no substantial likelihood that a reasonable person would so consider it, and (2) a fact is not “material,” notwithstanding section 293(a), with respect to a recipient of the communication if the maker of the communication knows that the recipient does not consider the fact important in determining his course of action, or that there is no substantial likelihood that a reasonable person would so consider it. The burden of proof with respect to section 293(b)(1) is on the recipient and with respect to section 293(b)(2) is on the maker.

97. ALI PROPOSED CODE § 1602(a).

98. ALI PROPOSED CODE § 1704 provides in pertinent part as follows:
Sec. 1704 [False registration statements, offering statements, and annual reports.] (a) [Scope of section.] Section 1704 applies (whether or not the particular registration has terminated or been withdrawn) on proof that an effective registration statement, an effective offering statement . . . an annual report filed with the Commission . . . , or any other report so filed and
ments and annual reports, accountants are liable as experts, provided their consent has been filed,99 but only with respect to statements that purport to have been made by them.100 Under section 1704 it is not necessary for a plaintiff to prove knowledge or scienter. The defense, however, currently available under section 11(b)(3) of the 1933 Act prevails; specifically, that “after reasonable investigation, [they] reasonably believed” that their statements were true.101 Second, under section 1707 accountants may be liable for a press release or other form of publicity102 which contains a misrepresentation incorporated by reference in any such filing (1) contained a misrepresentation or (2) omitted a material fact or document required.

(b) [Defendants.] The following persons are liable for damages under section 1704:

\[\ldots\]

(5) every expert whose consent has been filed under section 2003(e) (but only with respect to statements that purport to have been made by him); \ldots

99. ALI PROPOSED CODE § 2003(e) provides in pertinent part as follows:

(e) [Consents.] (1) If an accountant, engineer, appraiser, or other expert is named as having prepared, certified, or reported on a part of a registration, offering, or distribution statement, or an annual report filed with the Commission, or is named as having prepared, certified, or reported on a report, opinion, or valuation for use in connection with such a filing, his written consent shall be filed with the filing.

(Emphasis added).

100. ALI PROPOSED CODE § 1704(b)(5).

101. ALI PROPOSED CODE § 1704(f)(3)(B), which provides as follows:

(B) with respect to any part of the filing purporting to be made on the defendant's own authority as an expert (or purporting to be a copy of or extract from his own report or valuation as an expert), (i) he, after reasonable investigation, reasonably so believed at the time \ldots, or (ii) that part of the filing did not fairly represent his statement as an expert (or was not a fair copy of or extract from his report or valuation as an expert), and on learning of the unfair use of his statement (or report or valuation) he forthwith advised the Commission and the registrant in writing that he would not be responsible for that part of the filing;

and is explained further in § 1704(g):

(g) [Standard of reasonableness.] In determining what constitutes reasonable investigation or care and reasonable ground for belief under section 1704(f)(3), the standard of reasonableness is that required of a prudent man under the circumstances in the conduct of his own affairs \ldots

102. ALI PROPOSED CODE § 1604(c) defines “publicity” as follows:

(c) [Publicity.] it is unlawful for any company, or a person acting on its behalf, to engage in a fraudulent act in connection with, or to make a misrepresentation in, a press release or other form of publicity (other than a filing) relating to the company if it is reasonably foreseeable that the fraudulent act or misrepresentation will induce other persons to buy, sell, or not to buy or sell securities of the company or of a controlling, controlled, or commonly con-
made by the defendant with scienter. "Scienter", however, is defined in terms of "reckless disregard" in accord with current lower court case law rather than the "intent to deceive, manipulate, or defraud" language of the Supreme Court in *Ernst & Ernst v. Hochfelder*.103

Both of the above liability sections, 1704 and 1707, provide for a defense based upon plaintiff's knowledge if the defendant proves "(1) that the plaintiff bought or sold with knowledge of the relevant facts or documents as they should have been disclosed or corrected, or (2) that any alleged falsity was obvious."104

Reliance is not a requisite for liability in most instances under the ALI Proposed Code. Section 1707 liability merely requires that it is foreseeable that the fraudulent act or misrepresentation will induce a purchase or sale.

In determining damages, the emphasis under the ALI Proposed Code is on cause, defined in section 220 in terms of "legal cause" rather than "causation in fact."105 Where liability to buyers or sellers under the above sections arises in connection with false filings or publicity, fraudulent sales or purchases, or manipulative acts, the burden is shifted to the defendant to show either partial or complete lack of causation.106

Finally, under the ALI Proposed Code accountants may be liable as principals if they "knowingly" cause conduct or give substantial assistance to conduct of another person with "knowledge" that the conduct is unlawful or involves a fraud-

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103. ALI PROPOSED CODE § 299.50 defines "scienter": "[Scienter.] A person makes (or, within the meaning of section 2006(c), causes or gives substantial assistance in the making of) a misrepresentation with "scienter" if he knows that he is making a misrepresentation (or a misrepresentation is being made) or acts in reckless disregard of whether that is so."

The ALI Proposed Code in § 287 expressly declines to define "knowledge," however: "[Knowledge.] (a) [Dependent on context.] "Know" and its derivatives are not defined. Their meaning is left to construction in context. But see the definition of "scienter" in section 299.50."

104. ALI PROPOSED CODE § 1704(e), 1707(e).

105. ALI PROPOSED CODE § 220 provides as follows: "[Caused.] A loss is "caused" by specified conduct to the extent that the conduct (a) was a substantial factor in producing the loss and (b) might reasonably have been expected to result in loss of the kind suffered."

106. ALI PROPOSED CODE §§ 1708(b) and (e).
ulent act or misrepresentation.\textsuperscript{107}

III. Conclusion

\textit{McLean v. Alexander} is the latest in a growing number of federal court decisions with respect to accountants and auditors allowing less than intentional conduct to satisfy the scienter requirement in establishing a cause of action under section 10(b) and rule 10b-5, thereby filling in the \textit{Hochfelder} gap left by the Supreme Court. The tests formulated by these courts have proved workable, and are reflected in the Proposed Federal Securities Code promulgated by the American Law Institute. Under that Code, section 1707 liability requires proof of scienter defined in terms of reckless disregard, echoing the language of those federal courts allowing less than intentional conduct to satisfy the scienter requirement of a section 10b and rule 10b-5 action. While section 1704 does not expressly require proof of scienter, a reckless disregard standard is effectively established by the reasonable belief-reasonable investigation defense available to accountants.

Under either the federal case law or the ALI Proposed Code, it appears that the post-\textit{Hochfelder} shakeout period has passed for the development of law on the scienter required for accountant’s liability. Accountants, whose work forms the cornerstone of business decisions, must provide the services they hold themselves out as providing, or must bear the consequences.

\textsuperscript{107} ALI Proposed Code § 1724(b).
Accountant's Liability Under State Law

An analysis of state law supports the following comparison of New York and California law regarding accountant's liability:

<table>
<thead>
<tr>
<th>I. Fraud</th>
<th>California</th>
<th>New York</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elements</td>
<td>material representation falsity scienter reliance damage</td>
<td>Substantially the same; the element of reliance is often referred to as “deception” in N.Y.</td>
</tr>
</tbody>
</table>

| Scienter | Satisfied by recklessness; Yellow Creek Logging Corp. v. Dare, 216 Cal. App. 2d 50, 30 Cal. Rptr. 629 (1963). | Satisfied by gross negligence or recklessness; State Street Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416 (1938). |


| Damages | Out-of-pocket; CAL. CIV. CODE § 3343 (West 1970) provides for significant additional damages, including lost profits. | Out-of-pocket; “Actual pecuniary loss sustained”; no lost profits; Reno v. Bull, 226 N.Y. 546, 124 N.E. 144 (1919); it is uncertain how flexible this rule might be. One case held that “as long as the fraud continued to operate all loss flowing naturally from the fraud is recoverable; Hotaling v. Leach & Co., 247 N.Y. 84, 159 N.E. 870 (1928). |

| Punitive Damages | Discretionary with trier of fact; CAL. CIV. CODE § 3294 (West 1970). | None, unless fraud was wanton or malicious; Walker v. Shelton, 10 N.Y.2d 401, 179 N.E.2d 497, 223 N.Y.S.2d 488 (1961). |

II. Negligent Misrepresentation

Form of deceit; intent to induce action is sufficient and this may be inferred from knowledge that third party will rely on representation. Gagne v. Bertran, 43 Cal. 2d 481, 275 P.2d 15 (1954). As a form of deceit, there is no privity requirement.

III. Negligence

Evidence


Damages


Punitive Damages


Interest


No separate cause of action for negligent misrepresentation. It exists as such only as a form of negligence; privity required unless it can be shown defendant could anticipate parties would rely on their representations. CIT Financial Corp. v. Glover, 224 F.2d 44 (2d Cir. 1955); White v. Guarante, 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977); Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931).

Same; for negligent misrepresentation the courts also require that defendant know the information is desired for a serious purpose; that the recipient will rely on it and that he will be injured if it is false or erroneous. International Products Co. v. Erie Railroad, 244 N.Y. 331, 155 N.E. 662 (1927).


Same; Steitz v. Gifford, 280 N.Y. 15, 19 N.E.2d 661 (1939).


