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Accountants' Liability and Responsibility: Securities, Criminal and Common Law

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ACCOUNTANTS' LIABILITY AND RESPONSIBILITY: SECURITIES, CRIMINAL AND COMMON LAW

By
Samuel H. Gruenbaum and Marc I. Steinberg***

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INTRODUCTION

The twentieth century, especially the last four decades, has brought about significant developments and changes in the accounting profession and in the exposure of accountants to liability. The aggregation of great sums of capital by commercial enterprises, the increased complexity of modern business, the high degree of government regulation of business affairs and the repeated occurrence of major financial debacles have been elemental factors in bringing about these developments and changes.¹ Concomitantly, increasing reliance has been placed on independent accountants to scrutinize financial statements and detect financial improprieties.² This increased reliance has occasioned significant developments in accountants' exposure to liability.

In the past, accountants were "watchdogs," but they were not expected to be "bloodhounds."³ Their liability was limited by traditional common law principles,⁴ and the practice of the accounting profession was controlled largely by the profession itself, with relatively little government involvement.⁵ In addition, business did not rely as heavily on the investing public for capital, and thus there was considerably less exposure of accountants to public scrutiny.⁶

Significant changes in common law liability principles,⁷ enactment of the Securities Act of 1933 (Securities Act) and the Securities Ex-

1. See generally J. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION* (1969); D. CAUSEY, *DUTIES AND LIABILITIES OF THE CPA* (1973); N. MILLER, *THE GREAT SALAD OIL SWINDLE* (1965); SEC Accounting Series Release No. 19 (1940), 5 FED. SEC. L. REP. (CCH) ¶ 72,020; Shaw, *Liability of Public Accountants to Third Parties*, 46 A.L.R.3d 979 (1972); Gormley, *Accountants' Professional Liability — A Ten-Year Review*, 29 BUS. LAW. 1205 (1974).

2. See, e.g., Committee on Corporate Law and Accounting, *Corporate Responsibility In the Financial Accounting and Disclosure Areas: Who Makes and Who Implements the Rules?* 34 BUS. LAW. 1979, 1999-2005 (1979) (remarks of A.A. Sommer, Jr.).

3. *Derry v. Peek*, 14 App. Cas. 337 (1889). See *In re Kingston Cotton Mill Co.*, 2 Ch. 279 (1896).

4. See generally Adams, *Lessening the Legal Liability of Auditors*, 32 BUS. LAW. 1037, 1039 (1977). See notes 325-62 *infra* and accompanying text.

5. See generally Committee on Corporate Law and Accounting, *Corporate Responsibility In the Financial Accounting and Disclosure Areas: Who Makes And Who Implements the Rules*, 34 BUS. LAW. 1979 (1979); J. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION*, 181-92 (1969).

6. See, e.g., Hawes, *Truth in Financial Statements: An Introduction*, 28 VAND. L. REV. 1 (1975); Earle, *The Fairness Myth*, 28 VAND. L. REV. 147 (1975). Cf. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934) (increased reliance on public for aggregation of great sums of capital requires heightened awareness of responsibilities by professionals involved in the process).

7. See notes 325-62 *infra* and accompanying text.

change Act of 1934 (Exchange Act), the increasing dependence of the business sector on the public for capital, coupled with an increasing dependence on the expertise of independent accountants, have antiquated many of the principles thought to be true decades ago. This increased dependence on accountants has brought about a considerable increase in the number of lawsuits against accountants and accounting firms, and has resulted in some of the largest judgments awarded by the judiciary.⁸ As Judge Timbers, writing for the United States Court of Appeals for the Second Circuit in a recent case involving an accounting firm, said: "This is another in a series of cases which are occupying with increasing frequency the attention of the federal courts. They involve the responsibility of certified public accountants in preparing and certifying financial documents."⁹

As recently as the late 1970's, federal legislation was enacted that places substantial responsibility on accountants and, in all likelihood, foreshadows new territory in the area of accountants' liability.¹⁰ In addition, the 1970's ended with significant governmental attention and debate on the accounting profession's ability to govern and police itself.¹¹ Finally, the past decade ended with the distinct possibility that new regulatory proposals will be implemented that will add to the already far-reaching responsibilities of the profession.¹²

This article examines the developments and changes that have occurred in the accounting profession during the last several decades. The article will first examine these subjects in the context of the federal securities laws, including the Foreign Corrupt Practices Act of 1977 and administrative proceedings by the Securities and Exchange Commission (SEC). The article next explores the developing exposure of accountants to criminal liability. Finally, it addresses accountants' liability under the common law.

I. DEVELOPMENTS UNDER THE FEDERAL SECURITIES LAWS

Some areas of accountants' liability and responsibility under the federal securities laws have received considerable attention,¹³ while

8. See, e.g., Hawes *Truth in Financial Statements: An Introduction*, 28 VAND. L. REV. 1 (1975); Earle, *The Fairness Myth*, 28 VAND. L. REV. 147 (1975); New York Times, May 1, 1971, at 41, col. 6 (a \$4.95 million settlement in connection with the *Mills Factor* case).

9. *Robertson v. Seidman & Seidman*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,100, at 96,055 (2d Cir. Aug. 29, 1979).

10. See notes 213-45 *infra* and accompanying text.

11. See notes 242-45 *infra* and accompanying text.

12. See notes 236-45 *infra* and accompanying text.

13. See notes 22-94 *infra* and accompanying text.

others are uncharted, or are still in the proposal stage of the regulatory process.¹⁴ For example, accountants' liability has been examined in cases involving the express liability provisions,¹⁵ as well as the antifraud provisions¹⁶ of the federal securities laws. On the other hand, the recent enactment of the Foreign Corrupt Practices Act of 1977¹⁷ may result in the imposition of new responsibilities on accountants,¹⁸ and will no doubt bring about new claims of liability on behalf of public investors and others. In addition, the SEC is actively scrutinizing the ability of the profession to regulate itself,¹⁹ posing the undeniable threat that federal legislation may eventually regulate the profession.²⁰ Finally, in the interest of providing increased protection to the investing public, the SEC has recently adopted rules designed to encourage accountants to associate themselves with filed quarterly financial statements. These developments could heighten the exposure of accountants to liability.²¹ All of these factors, and others, place the accounting profession in a dynamic state of affairs.

A. *Civil Liability Under the Securities Acts — An Overview*

The express liability provisions under the federal securities laws germane to accountants are found in sections 11 and 12 of the Securities Act²² and section 18 of the Exchange Act.²³ In addition, liability

14. See notes 213-45 *infra* and accompanying text.

15. See notes 29-51 *infra* and accompanying text.

16. See notes 52-94 *infra* and accompanying text.

17. 15 U.S.C. §§ 78a-78kk (1976).

18. See notes 213-35 *infra* and accompanying text.

19. See notes 242-45 *infra* and accompanying text.

20. See note 245 *infra*.

21. See notes 236-45 *infra* and accompanying text.

22. 15 U.S.C. §§ 77k-77l (1976). Section 11 of the Securities Act of 1933 [hereinafter Securities Act] imposes liability on a host of persons, expressly including accountants, for material misstatements or omissions in a registration statement filed with the SEC which has become effective. A "due diligence" defense is expressly provided in section 11(b) which is applicable to accountants. The contours of this defense were shaped in the landmark cases of *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971), and *Escott v. BarChris Const. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

Section 12 of the Securities Act imposes liability on any person who offers or sells a security in violation of the registration provisions of the Act or who offers or sells a security by means of a prospectus or oral communication which includes an untrue statement of material fact or omits to state a material fact. In the usual case, liability under Section 12 may only be imposed by persons purchasing directly from the person who offers or sells a security in violation of the section. See *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 692 (5th Cir. 1971); *McFarland v. Memorex Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,368 (N.D. Cal. Feb. 11, 1980). See also *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967) (provision of section affords relief to purchasers only); *Jenkins v. Fidelity Bank*, 365 F. Supp. 1391 (E.D. Pa. 1973) (issuing corporation had no right under

has been imposed on accountants via judicially implied private rights

§ 12(2) to recover from one who participated in the preparation of a misleading offering circular); *Ruszkowski v. Hugh Johnson & Co.*, 302 F. Supp. 1371 (W.D.N.Y. 1969) (brokerage house not liable to investor since no privity existed between brokerage house and plaintiff at time of sale of bonds). *But see* *Freed v. Szabo Food Serv., Inc.*, [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,317 (N.D. Ill. 1964) (lack of privity will not bar an action where plaintiff's purchase was in reliance on misrepresentation and defendant participated in the misrepresentation).

When the alleged violator is not the person who offers or sells the security, but is integrally connected or substantially involved with the offer or sale, liability may be imposed on him. *See* *Lewis v. Walston & Co.*, 487 F.2d 617, 621 (5th Cir. 1973); *Mendelsohn v. Capital Underwriters, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,169, at 96,445 (N.D. Cal. Oct. 24, 1979). *See also* *Lawler v. Gilliam*, 569 F.2d 1283, 1287 (4th Cir. 1978). While one could argue that an accountant is integrally connected or substantially involved in the offer or sale of a client's securities because the securities could not be sold without the audit certification of the accountant, the countervailing argument would appear to have merit. *See* *Katz v. Amos Treat & Co.*, 411 F.2d 1046 (2d Cir. 1969). The accountant performs his professional function by rendering an opinion on the financial statements of the entity whose securities are offered or sold and has no direct involvement in the distribution process. Under section 12, the alleged violator's liability is expressly limited "to the person purchasing such security from him." An accountant who renders an opinion on financial statements does not offer or sell securities. Moreover, no person purchases securities from the accountant.

23. 15 U.S.C. § 78r (1976). Section 18 imposes liability on any person who makes or causes to be made any materially false or misleading statement in any application, report or document filed with the SEC under the Securities and Exchange Act of 1934 [hereinafter Exchange Act]. Several courts have held that section 18, by its express language, is limited to documents actually "filed" with the SEC. *Rich v. Touche Ross & Co.*, 415 F. Supp. 55 (S.D.N.Y. 1976) (language of section construed according to its terms and is no broader than its plain meaning); *In re Falstaff Brewing Corp. Antitrust Lit.*, 441 F. Supp. 62 (E.D. Mo. 1977) (complaint failing to indicate that alleged material misrepresentations were contained in reports filed pursuant to section 18 was insufficient to sustain an action). *But see* *SEC v. Keller Indus., Inc.*, 342 F. Supp. 654 (S.D.N.Y. 1972) (an interim quarterly report circulated to the public can be actionable if materially misleading).

Until recently, because annual reports to stockholders were often separate and apart from the Annual Reports on Form 10-K filed with SEC, section 18, under the majority view, presumably did not apply to the reports disseminated to stockholders. Thus, accountants were not subject to section 18 liability for such reports. *See* *Kulchok v. Government Employees Life Ins. Co.*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,002 (D.D.C. Mar. 31, 1977). They were subject, however, to the liability created by the section for financial statements which they certified and which were included in reports or documents such as Annual Reports on Form 10-K filed with the SEC. *See id.* However, on August 2, 1980, the SEC adopted amendments to Form 10-K, regulation S-K, and rules 14a-3 and 14c-3. In part, these amendments are designed to facilitate integration of the Securities Act and Exchange Act disclosure systems. The annual report to shareholders, under the amendments, may become the cornerstone disclosure document upon which the integrated disclosure system is to be built. In this regard, the principal feature is the establishment of uniform disclosure requirements for both the Form 10-K and the annual report to shareholders. The restructured Form 10-K requires that certain basic financial information must be set forth and that this same information, in turn, may be incorporated by reference from the shareholder's report into the Form 10-K. The amendments call for a more meaningful analysis of the registrant's business and financial condition including the market price of the registrant's securities and its statement of dividend policy, selected financial data, management's discussion and analysis of the registrant's financial condition, and supplementary

of action under section 17(a) of the Securities Act²⁴ and section 10(b) of the Exchange Act.²⁵ While there are certain differences between all of these liability provisions,²⁶ as a general proposition, accountants' liabil-

financial information. The amendments also call for discussion of the financial statements and changes in financial condition in their entirety, hence, prompting registrants to focus on liquidity and capital resources in addition to income. Apparently due to commentator concern that incorporation might affect readability of the stockholder report, the SEC elected to make such incorporation from the Annual Report to shareholders into the Form 10-K optional, rather than mandatory, on the part of reporting companies. For those companies that opt to incorporate by reference, the effect on accountants' exposure to increased liability, if any, remains to be seen. See Securities Act Releases Nos. 6176-79 (Jan. 15, 1980) and 6231-34 (Sept. 2, 1980), 20 SEC DOCKET 1060 (Sept. 16, 1980), 568 SEC. REG. & L. REP. (BNA) D-1 (Aug. 27, 1980).

24. Lower courts have differed on the question of whether there exists an implied private right of action under section 17(a) of the Securities Act. See *Schaefer v. First Nat'l Bank of Lincolnwood*, 509 F.2d 1287, 1293 (7th Cir. 1975), *cert. denied*, 425 U.S. 943 (1976); *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1283-84 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). Some courts have held that such an action exists, while other courts have held that it does not. See notes 96-98 *infra* and accompanying text. The Supreme Court, on at least three occasions, has expressly referred to the issue without resolving it. See *Aaron v. SEC*, 100 S. Ct. 1945, 1949-52 (1980); *International Bhd. of Teamsters v. Daniel*, 99 S. Ct. 790, 795 n.9 (1979); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 n.6 (1975).

25. See note 96 *infra* for a discussion of accountants' liability under section 14(a) of the Exchange Act. An implied private cause of action for damages has been held to exist under section 10(b) of the Exchange Act. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). A controversial issue that has arisen is whether an action under section 10(b) and rule 10b-5 can be brought even though the alleged material misstatements are also actionable under sections 11 and 12(2) of the Securities Act and/or section 18 of the Exchange Act. For recent decisions regarding this issue, see *Ross v. A. H. Robins Co.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,115, at 96,181 (2d Cir. Sept. 24, 1979) ("even as to those documents filed with the S.E.C. plaintiffs may seek to prosecute their claim under § 10(b) and Rule 10b-5"); *McFarland v. Memorex Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,368 (N.D. Cal. Feb. 11, 1980) (express remedy provided in § 11 precludes relief under § 10(b) and rule 10b-5); *McKee v. Federal's, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,958, at 96,020 (E.D. Mich. Aug. 8, 1979) ("[s]ince the § 18 remedy [an express statutory provision] is not available to plaintiff, the invocation of an implied Rule 10b-5 remedy may not be countenanced"); *Wachovia Bank & Trust v. National Student Marketing*, 461 F. Supp. 999 (D.D.C. 1978), *appeal docketed*, No. 79-1595 (D.C. Cir.) ("[A]n implied cause of action [under § 10(b)] should be available even where the alleged misconduct also falls completely within the confines of an express remedy.").

26. For example, sections 11(b) and 12(2) of the Securities Act expressly place the burden upon the alleged violator to prove that he exercised the degree of care necessary to exculpate himself from liability. Similarly, section 18(a) of the Exchange Act expressly places the burden upon the alleged violator to show that he acted in good faith and had no knowledge that the allegedly false or misleading statement was false or misleading. On the other hand, section 17(a) of the Securities Act and section 10(b) of the Exchange Act are both silent on the culpability requirement and on whom the burden of proof rests. However, the Supreme Court has expressly held that "scienter" must be alleged in a private damage action under section 10(b). *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Furthermore, the party alleging the violation has the burden of proof. As stated by the Third Circuit:

In placing the burden of negating scienter upon the defendant, the court appears to

ity for false or misleading financial statements will turn on the degree of care exercised in the auditing of and reporting on the statements.

In the landmark case of *Escott v. BarChris Construction Corp.*,²⁷ a national accounting firm and several of its individual members were charged with violating section 11 of the Securities Act, which creates express civil liability for material misstatements or omissions in a registration statement.²⁸ Because certified financial statements are required in registration statements,²⁹ the exposure of accountants under the section is directly implicated. Section 11(a), which designates the persons who may be held liable, expressly lists accountants.³⁰ A party alleging violations of the section need not establish privity with the defendant,³¹

have relied upon language in the Senate Report on S. 3420, S. Rep. No. 792, 73d Cong., 2d Sess. 12-13 (1934), referring to the express civil liability provisions in the 1934 Act. While the district court's opinion is not completely clear on this issue, and while we think that a shift in the burden of proof would not have influenced the outcome of this litigation, we know of no judicial authority relieving a plaintiff of the burden of going forward or of persuasion on each element of an implied cause of action under § 10(b)—including scienter. We therefore disapprove any suggestion in the lower court's opinion that the defendant must affirmatively show the absence of intent.

McLean v. Alexander, 599 F.2d 1190, 1196-97 (3d Cir. 1979). See FED. R. EVID. 301. See also *Aaron v. SEC*, 100 S. Ct. 1945 (1980); text accompanying notes 139-45 *infra*.

27. 283 F. Supp. 643 (S.D.N.Y. 1968). See also *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971), for an extensive discussion of liability under section 11 of the Securities Act.

28. Section 11(a) liability reaches certain designated persons, see note 30 *infra*, for "an untrue statement of a material fact or [the omission] to state a material fact required to be stated [in a registration statement] or necessary to make the statements therein not misleading."

29. *E.g.*, items 25 and 26 of Schedule A under the Securities Act.

30. Section 11(a) of the Securities Act provides that any person acquiring a security sold pursuant to a registration statement which contains material misstatements or omissions may sue the following parties, unless it is proved that at the time of such acquisition the person acquiring the security knew of the untruth or omission:

- (1) every person who signed the registration statement;
- (2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
- (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
- (4) every *accountant*, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
- (5) every underwriter with respect to such security.

15 U.S.C. § 77k(a) (1976) (emphasis added).

31. 3 L. LOSS, SECURITIES REGULATION 1731 (2d ed. 1961).

nor need he ordinarily prove reliance.³² Assuming that a timely claim is made,³³ the two principal defenses available to an accountant are, (1) the complainant knew of the material misstatement or omission,³⁴ and (2) the accountant exercised due diligence and care in auditing and reporting on the financial statements.³⁵ The burden of proving due dili-

32. The only time that reliance is an issue in a suit brought under section 11 is when the issuer has issued an earnings statement covering a period of at least twelve months subsequent to the effective date of the registration statement. In that case, the right of recovery is conditioned upon proof that the person who acquired the security acquired it in reliance upon the untrue statement in the registration statement or upon reliance on the registration statement without knowing of the material omission. However, "reliance may be established without proof of the reading of the registration statement" by the aggrieved purchaser. 15 U.S.C. § 77k(a) (1976). See generally *Turner v. First Wis. Mortgage Trust*, 454 F. Supp. 899 (E.D. Wis. 1978) (plaintiff must prove he purchased a security which was issued in connection with allegedly false registration statement); *Kramer v. Scientific Control Corp.*, 365 F. Supp. 780 (E.D. Pa. 1973) (a purchaser is presumed to have relied on a prospectus if he purchased within twelve months of offering); *In re Gap Stores Sec. Lit.*, 79 F.R.D. 283 (N.D. Cal. 1978) (purchaser must prove reliance on statement issued within twelve months of registration effectiveness but need not prove he read the statement); *JENNINGS & MARSH, SECURITIES REGULATION 833* (4th ed. 1977).

33. Section 13 of the Securities Act provides that no action to enforce any liability created under section 11 may be brought later than one year after discovery of the untrue statement or omission contained in the registration statement, or after one year from the date which such untrue statement or omission should have been, by the exercise of reasonable diligence, discovered. 15 U.S.C. § 77m (1976). In any case, suit to enforce a liability created under section 11 may not be brought more than three years after the security acquired was offered to the public. For purposes of the three-year outside limitation provided in section 13, the date when the time period starts to run "is not earlier than the effective date of [the] last amendment to the registration statement and not later than the date when the prospectus is released to, or other solicitation is made of, the public." *Fischer v. International Tel. & Tel. Corp.*, 391 F. Supp. 744, 747-48 (E.D.N.Y. 1975). At least one case has held that the issuer's active concealment of violations tolls the running of the three-year outside limitation for the duration of the concealment. *In re Home-Stake Prod. Co. Sec. Lit.*, 76 F.R.D. 337, 344-45 (N.D. Okla. 1975).

34. Section 11(a) provides that any person who acquires a security issued by means of a registration statement containing material misstatements or omissions may sue "unless it is proved that at the time of such acquisition he [the person acquiring the security] knew of such untruth or omission." 15 U.S.C. § 77k(a) (1976). See *In re Gap Stores Sec. Lit.*, 79 F.R.D. 283 (N.D. Cal. 1978) (a defendant may escape liability by proving plaintiff acquired the security with knowledge of the alleged untruth or omission); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971) (plaintiff's knowledge of omission of material fact provides affirmative defense).

35. Section 11(b)(3)(B) permits a person upon whose authority as an expert a materially false or misleading statement is made in a registration statement to escape liability under the section if such person proves that after reasonable investigation he had reasonable ground to believe and he did believe that the statements contained in the registration statement were true and that there was no omission to state a material fact. 15 U.S.C. § 77k(b)(3)(B) (1976). See *Goldstein v. Alodex Corp.*, 409 F. Supp. 1201 (E.D. Pa. 1976) (reasonable investigation and belief of truth of statements exonerates defendant); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971) (reasonable investigation and reasonable belief requirements vary with the degree of defendant's involvement, expertise and access to

gence and care is on the defendant.³⁶

In *BarChris*, convertible debentures of BarChris Construction Corporation, the registrant, were sold to the public by means of a registration statement filed with the SEC. Plaintiffs, who were purchasers of these debentures, alleged that the registration statement contained material misstatements and omissions.³⁷ Relief was sought against various defendants,³⁸ including a national accounting firm.

When the court in *BarChris* turned to consider the liability of the accountants, it did so with respect to that "part of the registration statement purporting to be made upon the authority of [the accountant] as an expert."³⁹ The only part of the registration statement made on the authority of the accountants in *BarChris* was, as is usually the case, the financial statements. In considering the defense that the accountants acted with due diligence, the court stated that this defense must be assessed at the time that the part of the registration statement containing the allegedly false and misleading financial statements became effective.⁴⁰ To accomplish this task, the court scrutinized the audit as well as the accountants' review of events which occurred after the date of the certified balance sheet contained in the registration statement but before the effective date of the registration statement.⁴¹

The most blatant error found by the court was the accountants' failure to discover that a bowling alley constructed by the registrant, which had been recorded on the books as having been sold, had not been sold.⁴² In determining whether the accountants should be held liable for the resulting misstatements in the financial statements, the court carefully considered the various internal documentary evidence examined by the accountants during the course of their audit. In addition, the court considered certain accounting records which had not been examined but which, if examined, would have put the accountants

data; accountants must investigate to the same extent a reasonably prudent person in that position would).

36. *Feit v. Leasco Data Processing Equip. Co.*, 332 F. Supp. at 576.

37. 283 F. Supp. at 652.

38. The defendants fell into three categories: (1) the persons who signed the registration statement (*i.e.*, the registrant, nine of its directors, some of whom were also officers, and the registrant's controller); (2) eight investment banking firms which acted as underwriters in the offering; and (3) the registrant's auditors, a national accounting firm. 283 F. Supp. at 652.

39. *Id.* at 698.

40. *Id.* Section 11(b) requires that the due diligence defense be considered as of "the time such part of the registration statement [containing the misstatement or omission] became effective." 15 U.S.C. § 77k(b)(3)(B)(i) (1976).

41. 283 F. Supp. at 697-703.

42. *Id.* at 699.

on notice of the impropriety.⁴³ After reviewing the audit procedures in this context, the court concluded that the accountants failed to prove that they had conducted a reasonable investigation and consequently, their ignorance of the true facts was unjustified.⁴⁴

In this aspect of the case, it is unclear whether the court's conclusion was based on the finding that the accountants failed to examine certain records which would have put them on notice of the impropriety, or whether the documents examined put them on notice and they failed to follow up.⁴⁵ The facts suggest the latter, which appears to be the proper and reasonable standard of care to impose on accountants with respect to certified financial statements contained in a registration statement. Once put on notice of an impropriety, an accountant should be required to diligently unearth sufficient information to establish a complete understanding of the matter if he is to render an audit opinion on the financial statements.⁴⁶

In scrutinizing the accountants' review of events subsequent to the date of the certified financial statements but prior to the effective date of the registration statement, the court concluded that the written work program utilized for the review conformed to generally accepted auditing standards (GAAS),⁴⁷ and would have provided the accountants with the due diligence defense had it been complied with.⁴⁸ The program, with limited exceptions, only required a cursory review of the financial statements and certain specific accounts. Significantly, however, the court criticized the accountants for obtaining answers which they considered satisfactory without attempting to verify them.⁴⁹ Thus, while limited review procedures may suffice as to "subsequent events," the court added the gloss that information obtained and examined in the course of such a review must be independently verified.

43. *Id.* at 699-700.

44. *Id.* at 700.

45. *Id.* at 698-700.

46. *See* *United States v. Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964). The court in *BarChris* stated: "But there were enough danger signals in the materials which [the accountant] did examine to require some further investigation on his part. Generally accepted accounting standards required such further investigation under these circumstances." 283 F. Supp. at 703. *See* *SEC v. Chatham*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,911, at 95,757 (C.D. Utah June 6, 1979).

47. 283 F. Supp. at 701.

48. *Id.* at 701-03.

49. For example, at one point the court stated: "He asked questions, he got answers which he considered satisfactory, and he did nothing to verify them." *Id.* at 702. *See also id.* at 703. The court was also critical of the accountants' review of subsequent events in that it noted that there were records that the accountants should have examined in conducting their review but did not. *Id.* at 702.

From an overall perspective, the court in *BarChris* believed that accountants "should not be held to a standard higher than that recognized in their profession."⁵⁰ Presumably then, proof of compliance with GAAS is sufficient to establish a due diligence defense. In addition, in conducting a subsequent events review, an accountant need not perform a complete audit, but any danger signals in materials must be pursued and answers must be verified.⁵¹

In the court of appeals decision in *Hochfelder v. Ernst & Ernst*,⁵² subsequently reversed by the Supreme Court on different grounds, the Seventh Circuit was content to follow the lead of *BarChris*.⁵³ This case involved a fraudulent securities scheme perpetrated by the president of a brokerage firm. The plaintiff-investors sought recovery against a national accounting firm that had audited the brokerage firm, alleging that the negligent audit aided and abetted the fraud perpetrated by the president.⁵⁴

Although the Supreme Court subsequently reversed the decision, holding that negligence did not suffice to state a private cause of action for damages under section 10(b) of the Exchange Act and rule 10b-5,⁵⁵ the court of appeals decision is instructive on the standards by which an accountant's audit must be judged. In this regard, the court held that in performing an audit, accountants "are required to meet only the standard of care reasonably expected of persons holding themselves out as skilled accountants."⁵⁶ The court, therefore, agreed with the opinion in *BarChris*, which stated that "accountants should not be held to a standard higher than that recognized in their profession."⁵⁷ Thus, despite the fact that *Ernst & Ernst* involved alleged violations of section 10(b) of the Exchange Act and rule 10b-5, while *BarChris* involved violations of section 11 of the Securities Act, the standard of care imposed on accountants in both cases apparently was the same.⁵⁸ This, however, does not change the fact that the level of culpability required to

50. *Id.* at 703. See notes 74-94 *infra* and accompanying text.

51. *Id.* at 700-03.

52. 503 F.2d 1100 (7th Cir. 1974), *rev'd on other grounds*, 425 U.S. 185 (1976).

53. *Id.* at 1107-11.

54. *Id.* at 1103-04.

55. See notes 106-114 *infra* and accompanying text.

56. 503 F.2d at 1107-08.

57. *Id.* at 1108.

58. For a case in which a court looked to generally accepted auditing standards to determine the adequacy of an accounting firm's audit of financial statements included in a proxy statement, and thus involving alleged violations of section 14(a) of the Exchange Act and rule 14a-9 thereunder, see *Adams v. Standard Knitting Mills*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,382 (6th Cir. May 2, 1980). See note 96 *infra*.

establish violations of these sections is different.⁵⁹

The court in *Ernst & Ernst*, however, was careful to point out that compliance with GAAS is not an absolute defense to a charge of negligence or carelessness in the performance of an audit.⁶⁰ Relying on an earlier decision by Judge Learned Hand,⁶¹ the court stated that compliance with GAAS should not bar recovery where GAAS is found to be faulty.⁶² Rather, a court should first be satisfied that GAAS reflects professional practice constituting reasonable prudence before it allows compliance therewith to be invoked as a shield to liability. While GAAS may be quite persuasive in determining the proper standard of care, the "[c]ourts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission."⁶³

Recently, in *SEC v. Arthur Young & Co.*,⁶⁴ the Ninth Circuit affirmed the principle that compliance with GAAS is, in the usual case, a viable defense.⁶⁵ *Arthur Young* involved a suit by the SEC against a national accounting firm and certain of its individual members alleging violations of section 17(a) of the Securities Act, section 10(b) of the Exchange Act and rule 10b-5 and certain reporting provisions of the Exchange Act.⁶⁶ The claimed violations by the accounting firm and its auditors allegedly resulted from their audits of false and misleading financial statements.

The SEC argued that a standard different from compliance with GAAS should be applied in assessing liability. The court noted that:
During oral argument the SEC appeared to take the position

59. See notes 93-146 *infra* and accompanying text.

60. 503 F.2d at 1113.

61. The T. J. Hooper, 60 F.2d 737 (2d Cir. 1932).

62. As the court stated, "the teaching of The T. J. Hooper, 60 F.2d 737 (2d Cir. 1932), is not lost to us for we recognize that we are not constrained to accept faulty standards of practice otherwise generally accepted in an industry or profession." 503 F.2d at 1113.

63. *Id.* at 1113 n.16 (quoting, The T. J. Hooper, 60 F.2d at 740).

64. 590 F.2d 785 (9th Cir. 1979).

65. *Id.* at 787-89. As the court noted:

"Generally Accepted Accounting Principles" (GAAP) establish guidelines relating to the process by which the transactions and events of a business entity are measured, recorded, and classified in accordance with a conventional format. GAAS [Generally Accepted Auditing Standards] thus differs from GAAP; the former involves how an auditor goes about obtaining information, while the latter involves the format in which to present the information.

Id. at 789 n.4. As for GAAS, the court stated:

"Generally Accepted Auditing Standards" (GAAS) are general standards of conduct relating to the auditor's professional qualities as well as to the judgments exercised by him in the performance of his examination and issuance of his report.

Id. at 788 n.2 (citation omitted).

66. *Id.* at 786.

that the proper standard is whether the accountant performed his audit functions in a manner that would have revealed to an ordinary prudent investor, who examined the accountant's audits or other financial statements, a reasonably accurate reflection of the financial risks such an investor presently bears or might bear in the future if he invested in the audited endeavor.⁶⁷

The court flatly rejected the SEC's argument, stating that to accept it would make the accountant "an insurer of his client's honesty and an enforcement arm of the SEC."⁶⁸ The SEC's position would, according to the court, "conscript" accountants to the service of the SEC, which the court refused to do.⁶⁹ It went on to hold, without distinguishing between the sections of the securities acts alleged to have been violated, that the accountants discharged their professional obligation by complying with GAAS. In holding that GAAS was the proper measure by which to assess the accountants' liability, the court was careful to point out, as other courts have done in the past, that actual knowledge or a deliberate disregard of material misstatements or omissions destroys the defense.⁷⁰

Generally speaking, the lead of *BarChris* as to the proper standard of care, but not as to state of mind, has been followed⁷¹ irrespective of which section of the Securities Acts was allegedly violated.⁷² Accordingly, it appears that compliance with GAAS, adequately pleaded,⁷³

67. *Id.* at 787-88.

68. *Id.* at 788.

69. The court was quite critical of the SEC's position: "The difficulty with this [the SEC's position] is that Congress has not enacted the conscription bill that the SEC seeks to have us fashion and fix as an interpretive gloss on existing securities laws." *Id.*

70. The basis for the court's qualification of the principle that compliance with GAAS will act as a shield from liability was its agreement with the Second Circuit's decision in *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970). See notes 82-94 & 303-10 *infra* and accompanying text.

71. See notes 53-70 *supra* and accompanying text; Fiflis, *Current Problems of Accountant's Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 67-87 (1975) [hereinafter cited as Fiflis].

72. See *Adams v. Standard Knitting Mills*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,382 (6th Cir. May 2, 1980) (role of GAAS in case of alleged violations of sections 14(a) and 14(e) of the Exchange Act); *Seiffer v. Topsy's Int'l*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,352 (D. Kan. Mar. 19, 1980).

73. In an action against an accountant alleging fraud, it is not sufficient to simply plead that audited financial statements are materially false and misleading and that the accountant acted recklessly or willfully in not discovering or disclosing it. The specificity requirement of FED. R. CIV. P. 9(b) requires that the plaintiffs: specifically identify the acts or omissions on which the charge is based; describe the documents in which the allegedly false and misleading statements appear and state with specificity what items in these documents are false; state the factual basis from which an inference of the defendant's recklessness or willfulness

will, in the usual case, be a shield to charges of carelessness. It is vitally important, however, to point out that this shield only relates to an accountant's care in obtaining essential underlying facts. Compliance with GAAS will not be a shield to liability where an unreasonable judgment is made on the basis of adequate information properly obtained. The decisions scrutinizing accountants' audit procedures have at the same time considered the reasonableness of the judgments made on the basis of the information unearthed during the audit.⁷⁴

In addition, compliance with GAAS will not act as a shield from liability for misleading presentation of information obtained during the course of a properly conducted audit.⁷⁵ In other words, the "investigative" portion of the audit, in which the accountant obtains evidential matter to support the information ultimately presented in financial statements, is only the first step in the evaluation of liability. The next step is to scrutinize the judgments made by the accountant on the basis of the information obtained,⁷⁶ and the final step is to scrutinize the fairness of the financial statements taken as a whole.⁷⁷ When financial statements are alleged to be false or misleading, carelessness at any of the three levels can lead to liability.

can be drawn; state the factual basis from which an inference that the defendant had a duty to act or disclose can be drawn; and, where the pleadings are based on information and belief, state the facts upon which the belief is founded. *See, e.g.*, *Ross v. A.H. Robins Co.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,115, at 96,191-92 (2d Cir. Sept. 24, 1979); *Denny v. Barber*, 576 F.2d 465, 468-70 (2d Cir. 1978); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 378-79 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *McFarland v. Memorex Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,368 (N.D. Cal. Feb. 11, 1980); *Trio Laboratories, Inc. v. Herman*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,284 (S.D.N.Y. Jan. 11, 1980); *Harris v. Emerson*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,196, at 96,573 (S.D.N.Y. Dec. 3, 1979). According to a number of courts, a general allegation that an item in the financial statements was inadequately presented will not satisfy FED. R. CIV. P. 9(b). *Harris v. Emerson*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,196, at 96,573 (S.D.N.Y. Dec. 3, 1979); *Gross v. Diversified Mortgage Investors*, 438 F. Supp. 190, 194-95 (S.D.N.Y. 1977). *See* *Ross v. Warner*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,194 (S.D.N.Y. Nov. 29, 1979); *Wildman v. Wills*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,152 (E.D. Pa. Nov. 24, 1978); *Weinberger v. Kendrick*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,378 (S.D.N.Y. Apr. 4, 1978).

74. *See* notes 76-94 *infra* and accompanying text.

75. *See* notes 78-94 *infra* and accompanying text.

76. In *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970), involving a criminal prosecution of accountants, the court stated that expert testimony concerning the accountants' "honest judgment" in preparing financial statements was "highly persuasive" evidence, but not "conclusive." *Id.* at 806.

77. *See, e.g.*, *SEC v. Arthur Young & Co.*, 590 F.2d 785, 788-89 (9th Cir. 1979); *Herzfeld v. Laventhol, Krekstein, 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); *In re Commonwealth Oil/Tesoro Petroleum Corp. Sec. Lit.*, 467 F. Supp. 227, 255 (W.D. Tex. 1979).

It is in the last of the three steps, *i.e.*, presentation of the financial statements, that generally accepted accounting principles (GAAP) come into play. GAAP deals with the proper reflection of economic events in comprehensible financial statements.⁷⁸ Thus, while an accountant may comply with GAAS in an audit, the failure to comply with GAAP in the presentation of financial statements may be a basis for liability.⁷⁹ On the other hand, and more importantly, compliance with GAAP in financial statement presentation will not necessarily absolve an accountant of liability.

The shield from liability provided by GAAP seems less protective than the shield provided by GAAS. Generally, compliance with GAAP demonstrates adherence to professional norms and thus evidences some measure of propriety.⁸⁰ This concept derives from the tort law principle that compliance with the standards established by a profession reflects due care.⁸¹ In the case of accountants' liability for materially false or misleading financial statements under the federal securities laws, however, this principle is far from absolute.

In *United States v. Simon*,⁸² a criminal suit was brought against a national accounting firm for allegedly false and misleading disclosures in publicly disseminated financial statements. The government alleged inadequate disclosure of and accounting for a large sum reflected in the financial statements as an amount receivable which, although not disclosed in the financial statements, was indirectly owed by the company's president.⁸³

Numerous expert witnesses testified on behalf of the accountants; each witness essentially agreeing that the disclosure made was in accordance with GAAP and thus was fair.⁸⁴ Defendants argued that the

78. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD, *Accounting Principles* §§ 1026.01-.02 (1970). See note 65 *supra*.

79. *United States v. Simon*, 425 F.2d at 806.

80. See *id.*

81. As Judge Learned Hand stated in *The T.J. Hooper*, 60 F.2d 737 (2d Cir. 1932):

There are, no doubt, cases where courts seem to make the general practice of calling the standard of proper diligence; we have indeed given some currency to the notion ourselves. . . . Indeed in most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages. (citations omitted).

Id. at 740. See also *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1113 (7th Cir. 1974), *rev'd on other grounds*, 425 U.S. 185 (1976).

82. 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

83. *Id.* at 801.

84. As the court in *Simon* stated:

The defendants called eight expert independent accountants, an impressive array of leaders of the profession. They testified generally that, except for the error with

test of the fairness of disclosure should be judged on the basis of GAAP⁸⁵ and that because GAAP did not require disclosure other than that made, liability should not follow. The court concluded, however, that the fairness of the disclosure did not turn on whether it complied with GAAP. Judge Friendly, writing for the court and agreeing with the lower court, stated that the litmus test is whether the financial statements as a whole are fair, and proof of conformity with GAAP is persuasive but not conclusive.⁸⁶ While testimony of experts may be considered, the ultimate question of fairness rests with the jury.⁸⁷

Five years after *Simon*, the district court for the Southern District of New York, later affirmed in pertinent part by the Second Circuit, decided *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*.⁸⁸ *Herzfeld* involved a suit by shareholders of a bankrupt company against the company's independent accountants. Plaintiffs alleged that the accountants violated section 10(b) of the Exchange Act and rule 10b-5 by certifying false and misleading financial statements. The alleged deficiencies centered around a \$13 million transaction as a result of which the company reported approximately two million dollars in current and deferred income.⁸⁹ The accountants qualified their audit opinion because of this transaction and explained it in footnotes to the financial statements.

The accountants asserted compliance with GAAS in the conduct of their audit and with GAAP in making the disclosure as a defense.⁹⁰ The district court rejected these arguments, referring to GAAP as "esoteric accounting norms, comprehensible only to the initiate."⁹¹ The court added that liability should be based on whether the financial statements presented "the true financial position of [the company] . . .

respect to netting, the treatment of the Valley receivable in Note 2 was in no way inconsistent with generally accepted accounting principles or generally accepted auditing standards, since it made all the informative disclosures reasonably necessary for fair presentation of the financial position of Continental as of the close of the 1962 fiscal year.

425 F.2d at 805.

85. *Id.*

86. *Id.* at 806. *But cf.* *Hirsch v. duPont*, 553 F.2d 750, 761 (2d Cir. 1977), in which the Second Circuit appears to have assumed that compliance with GAAP is a defense to an allegation of violations of rule 17a-5 of the Exchange Act which deals with net capital statements required by broker-dealers.

87. 425 F.2d at 805-06.

88. 540 F.2d 27 (2d Cir. 1976), *aff'g in part, rev'g in part*, 378 F. Supp. 112 (S.D.N.Y. 1974).

89. 378 F. Supp. at 118.

90. *Id.* at 121.

91. *Id.*

to the untutored eye of an ordinary investor."⁹²

Thus, it may be that compliance with GAAP may not act as a shield from liability. Instead, the ultimate test is simply the "fairness" of the financial statements taken as a whole. As stated by the district court in *Herzfeld*:

Compliance with generally accepted accounting principles is not necessarily sufficient for an accountant to discharge his public obligation. Fair presentation is the touchstone for determining the adequacy of disclosure in the financial statements. While adherence to generally accepted accounting principles is a tool to help achieve that end, it is not necessarily a guarantee of fairness.⁹³

The function of financial statements is enlightenment. Enlightenment means more than mathematical or literal accuracy. Taken as a whole, financial statements must fairly present the financial status of a company. While GAAP may be a useful guide in determining fairness, it is by no means dispositive.

A determination that an accountant did not comply with GAAS in the conduct of an audit or that financial statements do not fairly present the financial status of a company does not end the inquiry on the issue of liability. While the inquiry may be at an end in the case of a claim asserted, for example, under section 11 of the Securities Act, it certainly is not in many other cases. In these other cases, the issue of liability will require a determination of the accountant's culpability, assuming the complainant did not know and should not have known of the misstatement or omission.⁹⁴

92. *Id.*

93. *Id.* at 122 (quoting Sonde, *The Responsibility of Professionals Under the Federal Securities Laws—Some Observations*, 68 NW. U.L. REV. 1, 3 (1973)). *Accord*, *In re Commonwealth Oil/Tesoro Petroleum Corp. Sec. Lit.*, 467 F. Supp. 227, 255 (W.D. Tex. 1979).

94. The courts will not permit an aggrieved plaintiff to recover for alleged violations of the antifraud provisions of the federal securities laws where it is shown that the plaintiff was put on notice of the fraud and failed to investigate it with due diligence to learn the truth. In other words, purchasers must diligently follow up warnings or signals that a fraud has been perpetrated before they will be entitled to relief. *See, e.g.*, *Robertson v. Seidman & Seidman*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,100, at 96,057-60 (2d Cir. Aug. 29, 1979); *Hirsch v. duPont*, 553 F.2d 750, 763 (2d Cir. 1977); *Rice v. Baron*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,200, at 96,583-84 (S.D.N.Y. Dec. 7, 1979); *Oleck v. Fischer*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,898, at 95,701 (S.D.N.Y. June 8, 1979), *aff'd*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,525 (2d Cir. June 4, 1980). *But see* *Mallis v. Bankers Trust Co.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,262, at 96,854 (2d Cir. Jan. 25, 1980) ("a plaintiff's burden is simply to negate recklessness when the defendant puts that in issue, not to establish due care").

B. Culpability Standards

Liability against accountants for defective financial statements will often be sought on the basis of violations of section 17(a) of the Securities Act, or sections 10(b) or 18(a) of the Exchange Act.⁹⁵ Each of these sections contains, either expressly or by judicial implication, a culpability requirement.⁹⁶

The courts that have permitted implied private damage actions under section 17(a) of the Securities Act⁹⁷ have split on the culpability

95. In cases of mergers and tender offers, liability against accountants may also be sought under sections 14(a) and 14(e) of the Exchange Act and the rules promulgated thereunder. *See generally* Adams v. Standard Knitting Mills, [Current] FED. SEC. L. REP. (CCH) ¶ 97,382 (6th Cir. May 2, 1980).

96. *See* notes 84-93 *infra* and accompanying text. In Adams v. Standard Knitting Mills, [Current] FED. SEC. L. REP. (CCH) ¶ 97,382, at 97,516 (6th Cir. May 2, 1980), the Sixth Circuit took the position that scienter is required in private damage actions against accountants for audited false and misleading financial statements contained in proxy statements. In taking this position, the court noted that other circuits have prescribed a negligence standard under section 14(a) when the defendant is the corporation issuing the proxy statement. *Id.* at 97,514 (citing Gould v. American-Hawaiian Steamship Co., 535 F.2d 761, 777-78 (3d Cir. 1976), and Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1300-01 (2d Cir. 1973)). *Accord*, Bertoglio v. Texas Int'l Co., [Current] FED. SEC. L. REP. (CCH) ¶ 97,342, at 97,276 (D. Del. Mar. 7, 1980). The Supreme Court, however, has expressly left this question open. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 209 n.28 (1976). The Sixth Circuit in Adams went on to conclude that scienter was required in an action under section 14(a) against accountants because, among other things, accountants are so removed from the issuing corporation and do not stand to benefit from a misleading proxy statement. [Current] FED. SEC. L. REP. (CCH) ¶ 97,382, at 97,514-16. The validity of this analysis is debatable in view of the Supreme Court's recent decision in Aaron v. SEC, 100 S. Ct. 1945 (1980), where the Court refused to construe section 10(b) of the Exchange Act differently on the basis of the plaintiff's identity. *Id.* at 1952. Query whether sections 10(b) or 14(a) should be construed differently on the basis of the defendant's identity?

97. The principle that an implied private right of action for damages exists under section 17(a) of the Securities Act does not enjoy universal acceptance. *See, e.g.*, McFarland v. Memorex Corp., [Current] FED. SEC. L. REP. (CCH) ¶ 97,368 (N.D. Cal. Feb. 11, 1980) (no implied private right of action based on application of *Redington* and *Lewis*); *In re* New York Mun. Sec. Lit., [Current] FED. SEC. L. REP. (CCH) ¶ 97,258 (S.D.N.Y. Jan. 29, 1980) (no implied right of action under § 17(a) based on legislative history and construction of §§ 11 and 12(2)); Dyer v. Eastern Trust & Banking Co., 336 F. Supp. 890, 903-05 (N.D. Me. 1971) (legislative history and statutory construction clearly indicate that section 17(a) was not intended to provide a private damage remedy).

However, a substantial body of case law has either held or assumed that such an action exists. *See, e.g.*, Kirshner v. United States, 603 F.2d 234, 241 (2d Cir. 1978), *cert. denied*, 99 S. Ct. 2821 (1979) (by implication); Newman v. Prior, 518 F.2d 97, 99 (4th Cir. 1975) (section 17(a) provides implied private damage action to protect investors from fraudulent sale of securities); Demoe v. Dean Witter & Co., [Current] FED. SEC. L. REP. (CCH) ¶ 97,282 (D. Alaska Sept. 7, 1979) (private right of action under § 17(a)(3) but not under § 17(a)(1) or § 17(a)(2)); Valles Salgado v. Piedmont Capital Corp., 452 F. Supp. 853, 857-58 (D.P.R. 1978) (section 17(a) provides implied private damages remedy for fraudulent purchase of mutual fund shares). *Cf.* Johns Hopkins Univ. v. Hutton, 488 F.2d 912, 914 (4th Cir. 1973), *cert. denied*, 416 U.S. 916 (1974) (by implication) (action for rescission of oil and gas produc-

requirement of that section. Some have indicated that scienter is required to state a cause of action,⁹⁸ while others have concluded that only negligence is required.⁹⁹ The Supreme Court's recent decision in *Aaron v. SEC*¹⁰⁰ arguably may signify that if an implied private cause of action is ultimately held to exist under section 17(a), negligence will suffice for the last two of the three subparts of the section while scienter will be required for the first.¹⁰¹

tion payment; private cause of action under § 17(a)); *Smith v. Jackson Tool & Die, Inc.*, 419 F.2d 152, 154 (5th Cir. 1969) (by implication) (case remanded for trial on issue of liability for damages under § 17(a)); *Collins v. Signetics Corp.*, 443 F. Supp. 552, 555 (E.D. Pa. 1977) (by implication) (claim for relief under § 17(a)(2) must assert purchaser-seller privity); *Dorfman v. First Boston Corp.*, 336 F. Supp. 1089, 1095 (E.D. Pa. 1972) (upholding implied private right of action under §§ 17(a)(1) and 17(a)(3); section 17(a)(2) action subject to § 12 limitations). See generally *Hazen, A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641, 647-58 (1978); *Steinberg, Section 17(a) of the Securities Act of 1933 After Naftalin and Redington*, 68 GEO. L.J. 163, 172-85 (1979) [hereinafter cited as *Steinberg*]. The Supreme Court has repeatedly referred to the question without resolving it. See note 101 *infra*.

98. See, e.g., *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 795 (7th Cir. 1977) (scienter must be proven in a private cause of action for damages under §§ 17(a)(1) and 17(a)(3) because of the references to fraud in these subsections; § 17(a)(2) does not expressly refer to fraud, thus *implying*, but not explicitly stating that scienter is not necessary under this subsection.). But see *Wiener v. Oppenheimer & Co.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,764, at 95,002 (S.D.N.Y. Feb. 5, 1979) (scienter required in private suit for damages under section 17); *Dorfman v. First Boston Corp.*, 336 F. Supp. 1089, 1095 (E.D. Pa. 1972) (by implication) (negligence not sufficient to state a cause of action for damages under section 17(a)). See notes 99-101 *infra* and accompanying text.

99. See cases cited in note 98 *supra*. See also *Aaron v. SEC*, 100 S. Ct. 1945, 1956 (1980) (scienter not required under sections 17(a)(2) and 17(a)(3) in SEC injunctive actions); *Steadman v. SEC*, 603 F.2d 1126, 1132-33 (5th Cir. 1979), *pet. for cert. granted on other grounds*, 100 S. Ct. 1849 (1980) (scienter not required under sections 17(a)(2) and 17(a)(3) in SEC administrative proceedings; scienter required under section 17(a)(1)); *SEC v. Coven*, 581 F.2d 1020, 1026-27 & n.11 (2d Cir. 1978), *cert. denied*, 440 U.S. 950 (1979) (scienter not required under sections 17(a)(1) and 17(a)(3) in SEC injunctive action).

Section 17(a) of the Securities Act provides:

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

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1976). For an analysis of the various subsections of section 17(a), see *Steinberg, supra* note 97.

100. 100 S. Ct. 1945 (1980).

101. Since *Aaron* dealt with the state of mind requirement under section 17(a) in SEC injunctive actions, the Court did not determine whether an implied private right of action exists under the section. *Id.* at 1949-52. See *International Bhd. of Teamsters v. Daniel*, 99 S. Ct. 790, 795 n.9 (1979); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 n.6 (1975). The Court did decide, however, that scienter is required under section 17(a)(1) in

As for the culpability requirement under section 18 of the Exchange Act, the section expressly states that "good faith" is a defense to liability.¹⁰² The precise meaning of good faith is not clear. There is respectable authority, however, for the proposition that "good faith" means "something more than negligence" but something less than actual intent.¹⁰³ As Professor Loss put it, good faith "seems to be first

SEC injunctive suits, while it is not required under sections 17(a)(2) or (3). *Aaron v. SEC*, 100 S. Ct. 1945, 1956 (1980). The analysis followed in *Aaron* was similar to that followed in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), where the Court held that on the basis of the language of section 10(b) of the Exchange Act, scienter was required to state an implied private cause of action for damages under the section and rule 10b-5. Note, however, that regardless of *Aaron's* implications, due to the limitations contained in the express remedy under section 12(2), scienter may possibly be deemed to be required in private damage actions pursuant to section 17(a). See Steinberg, *supra* note 97, at 175-85. See also notes 105-10 & 136-45 *infra* and accompanying text.

102. Section 18(a) of the Exchange Act provides:

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, *unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading*. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

15 U.S.C. § 78r(a) (1976) (emphasis added). For an analysis of section 18(a), see *Ross v. A. H. Robins Co.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,115, at 96,186-90 (2d Cir. Sept. 24, 1979). See also *McKee v. Federal's Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,958, at 96,023-24 (E.D. Mich. Aug. 8, 1979). For a discussion of the possible limitations imposed by section 18 on section 10(b) and rule 10b-5, see note 25 *supra*.

103. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209 n.28, 211 n.31 (1976). In *Hochfelder*, the Supreme Court noted that with the exception of section 16, each of the express civil liability provisions of the Exchange Act, including section 18, contains a culpability requirement of "something more than negligence." *Id.* (emphasis added). The Court's discussion of the state of mind requirement under that section appears to support the argument that something less than actual intent will nevertheless suffice to state a cause of action under the section. As the Court stated:

Liability [under section 18] is limited, however, in the important respect that the defendant is accorded the defense that he acted in "good faith and has no knowledge that such statement was false or misleading." Consistent with this language, the legislative history of the section suggests something more than negligence on the part of the defendant is required for recovery. The original version of § 18(a), § 17(a) of S. 2693, H.R. 7852 and H.R. 7855, . . . provided that the defendant would not be liable if "he acted in good faith and in the exercise of reasonable care had no ground to believe that such statement was false or misleading." The accounting profession objected to this provision on the ground that liability would be created for honest errors in judgment. See Senate Hearings on Stock Exchange

cousin to *scienter*.”¹⁰⁴ In addition, under section 18(a) the burden of proving “good faith” is placed on the defendant.¹⁰⁵

The culpability requirement under section 10(b) has received differing treatment depending on the identity of the plaintiff and the forum in which suit has been brought.¹⁰⁶ In *Ernst & Ernst v. Hochfelder*,¹⁰⁷ the Supreme Court held that *scienter* is a required element of a private damage action under section 10(b) and rule 10b-5.¹⁰⁸ The Court defined *scienter* as “a mental state embracing intent to deceive, manipulate or defraud.”¹⁰⁹ In a footnote, however, the Court specifically refused to determine whether “recklessness” constitutes *scienter* under the section and the rule, stating 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. 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.”¹¹⁰ Since

Practices, . . . House Hearings on H.R. 7852 and H.R. 8720, . . . In subsequent drafts the current formulation was adopted.

Id. at 211-12 n.31.

104. 3 L. LOSS, SECURITIES REGULATION 1752 (2d ed. 1961).

105. See authorities cited in notes 102 & 103 *supra*.

106. Prior to *Aaron*, where the SEC had been the plaintiff in civil injunctive suits, some courts had held that negligence was sufficient to state a cause of action under section 10(b) and rule 10b-5, while other courts had held that *scienter* was required. See notes 105-10 & 136-45 *infra* and accompanying text. The Commission has rejected *Hochfelder's* application in SEC administrative proceedings. See notes 208-12 *infra* and accompanying text.

107. 425 U.S. 185 (1976). *Hochfelder* is one of several recent Supreme Court decisions restricting the reach, scope and effect of the federal securities laws. See, e.g., *Aaron v. SEC*, 100 S. Ct. 1945 (1980) (*scienter* required in SEC injunctive suits under section 10(b) of the Exchange Act and section 17(a)(1) of the Securities Act); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 100 S. Ct. 242 (1979) (no implied private right of action under section 206 of the Investment Advisers Act; limited implied private right of action under section 215); *Touche Ross & Co. v. Redington*, 99 S. Ct. 2479, 2486 (1979) (no implied private right of action for damages under § 17(a) of the Exchange Act); *International Bhd. of Teamsters v. Daniel*, 99 S. Ct. 790, 798 (1979) (interest in noncontributory compulsory pension plan not a “security” subject to regulation under Securities Acts); *SEC v. Sloan*, 436 U.S. 103, 111-12 (1978) (limiting SEC’s right to summarily suspend trading in registered securities for successive 10-day periods); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473-74 (1977) (breach of fiduciary duty, without fraud, deception, or misrepresentation not actionable under section 10(b) of the Exchange Act); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 28 (1977) (defeated tender offeror has no standing to bring implied private right of action for damages under section 14(e) of the Exchange Act); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749 (1975) (only purchasers and sellers have standing to bring implied private cause of action for damages under section 10(b) of the Exchange Act). See generally Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977).

108. 425 U.S. at 193.

109. *Id.*

110. *Id.* at n.12.

Hochfelder, numerous appellate courts, including the Second, Third, Fifth, Sixth, Seventh and Ninth Circuits have concluded that recklessness constitutes scienter as defined in *Hochfelder*.¹¹¹

It is clear from *Hochfelder* that negligence will not suffice to state a private cause of action for damages under section 10(b) and rule 10b-5, that recklessness may suffice and that actual intent does suffice.¹¹² While the lower courts since *Hochfelder* have not been unanimous in their interpretation of the scienter requirement,¹¹³ many have concluded that recklessness will suffice in a private damage action.¹¹⁴

"Recklessness" has been variously defined by the courts. For example, in what now appears to have become a seminal case, *Rolf v. Blyth, Eastman, Dillon & Co.*,¹¹⁵ the Second Circuit, quoting in part from an earlier Seventh Circuit decision, defined recklessness in the context of aider and abettor liability where a fiduciary duty existed, as "at the least, conduct which is highly unreasonable and which represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'"¹¹⁶

111. *E.g.*, *Healey v. Catalyst Recovery, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,268 (3d Cir. Jan. 29, 1980); *Keirnan v. Homeland, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,248 (9th Cir. Jan. 15, 1980); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024-25 (6th Cir. 1979); *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); *Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, 44 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir. 1977), *cert. denied*, 439 U.S. 830 (1978); *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1039-40 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

112. Various passages in the *Hochfelder* decision can be read to support each of these propositions. For example, at the outset of the decision, the Court stated:

Although the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent, we think the relevant portions of that history support our conclusion that § 10(b) was addressed to practices that *involve some element of scienter and cannot be read to impose liability for negligent conduct alone.*

425 U.S. at 201 (emphasis added). At another point in the decision, the Court stated: "There is no indication that Congress intended anyone to be made liable for such [manipulative and deceptive, or illicit] practices unless he acted *other than in good faith*. The catchall provision of § 10(b) should be interpreted no more broadly." *Id.* at 206 (emphasis added). In another portion of its opinion, the Court concluded: "[T]he judicially created private damages remedy under § 10(b) . . . *cannot be extended*, consistently with the intent of Congress, to actions premised on negligent wrongdoing." *Id.* at 210 (emphasis added). At yet another point, the Court stated: "[W]e are quite unwilling to extend the scope of the statute to negligent conduct." *Id.* at 214. Finally, the Court also noted "that § 10(b) and Rule 10b-5 might be held to require proof of more than negligent nonfeasance." *Id.* at 215.

113. See notes 114-42 *infra* and accompanying text.

114. See note 111 *supra* and accompanying text.

115. 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

116. 570 F.2d at 47 (quoting in part, *Sanders v. John Nuveen Co.*, 554 F.2d 790, 793 (7th Cir. 1977)).

In a footnote in the *Rolf* decision, the Second Circuit expressly left open the question of whether a less strict test than that quoted would satisfy the "recklessness" requirement in other situations.¹¹⁷ The lesser test referred to was the one set forth by the district court for the Eastern District of Wisconsin in *Stern v. American Bank Shares Corp.*¹¹⁸ In *Stern*, the court described what must be asserted to establish a charge of recklessness:

What the plaintiff must allege is that the defendants knew or should have known of the facts and circumstances concerning the fraud, *i.e.*, the transaction which forms the basis for the violations, and that they either actively rendered assistance in an effort to further that transaction or failed to disclose the material facts in violation of a duty to do so.¹¹⁹

The *Rolf* definition of recklessness is manifestly different than the *Stern* definition in that *Rolf* requires a higher degree of culpability. *Hochfelder* can be read to have held only that negligence does not suffice to state a private cause of action for damages under section 10(b) and rule 10b-5.¹²⁰ Consequently, an allegation that the defendant "should have known" but for his negligence is not actionable. Presumably, however, an allegation that the defendant "should have known" but for conduct in excess of negligence might be actionable. Indeed, this appears to be the standard that the *Stern* court adopted. Unlike the language used by the Second Circuit in *Rolf*, which viewed recklessness as "highly unreasonable" conduct that represents "an extreme departure from standards of ordinary care," the *Stern* court was satisfied that the standard of "should have known of the facts and circumstances concerning the fraud" would suffice.

Courts in a number of decisions have preferred alternative approaches.¹²¹ For example, the Ninth Circuit, which, prior to

117. 570 F.2d at 47 n.16.

118. 429 F. Supp. 818 (E.D. Wis. 1977).

119. *Id.* at 827.

120. *See* notes 106-14 *supra* and accompanying text.

121. The Second Circuit itself, prior to *Hochfelder*, adopted an alternative approach. *See, e.g.,* *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 n.98 (2d Cir. 1973) ("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 notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort"). *Accord,* *Cohen v. Franchard Corp.*, 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973). *See generally* *Steinberg v. Carey*, 439 F. Supp. 1233 (S.D.N.Y. 1977). *But see* *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112, 126 (S.D.N.Y. 1974) (more stringent standard applied; actual knowledge required), *aff'd in part and rev'd in part*, 540 F.2d 27 (2d Cir. 1976); *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879, 889 (E.D. Pa. 1978) (more stringent standard applied; recklessness sufficient). For a discussion of the

Hochfelder rejected an unequivocal application of scienter and instead adopted a flexible duty standard in private damage actions under rule 10b-5,¹²² now appears to have adhered to the flexible duty standard, with some modification, after *Hochfelder*.¹²³ In the view of the Ninth Circuit, the "terminology, analysis, and citation to authority [in *Hochfelder*] lend credence to a broad interpretation of scienter."¹²⁴ In broadly interpreting "scienter," the Ninth Circuit has concluded that "knowing" conduct is within the ambit of section 10(b) and rule 10b-5.¹²⁵ If the alleged wrongdoer is "aware"¹²⁶ of the relevant facts which form the basis for the alleged fraud, a cause of action exists. The wrongdoer's conduct need not be so extreme as to be labeled "deliberate and cold-blooded."¹²⁷ At times, the Ninth Circuit has deviated from the flexible duty standard.¹²⁸ One such occasion was in *Keirnan v.*

different standards, see *Oleck v. Fischer*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,898, at 95,698-701 (S.D.N.Y. June 8, 1979), *aff'd*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,525 (2d Cir. June 4, 1980). Some district courts in the Second Circuit treat the pre-*Hochfelder* standard as good law. See *Greene v. Emersons*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,266, at 96,865-68 (S.D.N.Y. Jan. 30, 1980); *Oleck v. Fischer*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,898, at 95,678-701. In a recent decision, the Ninth Circuit adopted a liberalized pre-*Hochfelder* Second Circuit standard. *Keirnan v. Homeland, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,248, at 96,748 (9th Cir. Jan. 15, 1980). For a detailed discussion of the various recklessness standards adopted by the courts, see Steinberg & Gruenbaum, *Variations of "Recklessness" after Hochfelder and Aaron*, 8 SEC. REG. L.J. 179 (1980) [hereinafter cited as Steinberg & Gruenbaum].

122. Prior to *Hochfelder*, the circuits varied on the scienter requirement in private damage actions under section 10(b). Compare *White v. Abrams*, 495 F.2d 724, 730 (9th Cir. 1974) (flexible duty standard; negligence can suffice) and *Myzel v. Fields*, 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (negligence suffices), with *Clegg v. Konk*, 507 F.2d 1351, 1361-62 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975) (some element of scienter or conscious fault required) and *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (willful or reckless disregard of truth required). See generally, Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. REV. 562, 568-70 (1972).

123. *E.g.*, *Kidwell v. Meikle*, 597 F.2d 1273, 1294 (9th Cir. 1979); *Spectrum Financial Cos. v. Marconsult, Inc.*, 608 F.2d 377 (9th Cir. 1979), *cert. denied*, 100 S. Ct. 2153 (1980); *Nelson v. Serwold*, 576 F.2d 1332, 1336-38 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978). *Cf.*, *SEC v. Blazon Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,212, at 96,614 (9th Cir. Dec. 17, 1979). The Ninth Circuit's statement in *Blazon* that negligence suffices to state a cause of action under section 10(b) in an SEC injunctive suit is consistent with its prior liberal interpretations of the section. But see *Aaron v. SEC*, 100 S. Ct. 1945 (1980) (scienter required to state cause of action under § 10(b) in SEC injunctive suit). See also *White v. Abrams*, 495 F.2d 724, 730 (9th Cir. 1974).

124. *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978).

125. *Id.*

126. *Kidwell v. Meikle*, 597 F.2d 1273, 1294 (9th Cir. 1979).

127. *Spectrum Financial Cos. v. Marconsult, Inc.*, 608 F.2d 377 (9th Cir. 1979), *cert. denied*, 100 S. Ct. 2153 (1980); *Nelson v. Serwold*, 576 F.2d 1332, 1338 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978).

128. See, *e.g.*, *Keirnan v. Homeland, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,248 (9th Cir. Jan. 15, 1980); *Lewis v. Anderson*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,153 (9th

Homeland, Inc.,¹²⁹ where the court adopted a liberalized pre-*Hochfelder* Second Circuit approach,¹³⁰ concluding that the defendants acted recklessly "if they had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although they could have done so without extraordinary effort."¹³¹

The *Rolf* court's acceptance of a recklessness standard was predicated on the condition that the defendant first be found to have either a fiduciary duty or a duty to disclose to the defrauded party.¹³² In cases where there is no such duty, the logic of *Rolf* may not apply and recklessness may not suffice.¹³³ There are, however, cases that have applied the recklessness standard even when such a duty did not exist.¹³⁴ These cases have found recklessness to be sufficient when it was foreseeable by the defendant that the defrauded party would rely on the defendant's conduct. Thus, while an independent accountant may not have a fiduciary responsibility to investors in general with respect to his audit opinion, it may often be foreseeable that investors will rely on the accountant's opinion. As stated by one court, the recklessness standard will apply when "an accountant has reason to foresee that his audit or opinion letter will be relied upon by third parties."¹³⁵ As for the ques-

Cir. Oct. 29, 1979); *Ritzau v. Warm Springs West*, 589 F.2d 1370, 1374 (9th Cir. 1979). See *Steinberg & Gruenbaum*, *supra* note 121.

129. [Current] FED. SEC. L. REP. (CCH) ¶ 97,248 (9th Cir. Jan. 15, 1980).

130. *Id.* at 96,748. See Second Circuit cases cited in note 121 *supra*.

131. [Current] FED. SEC. L. REP. (CCH) ¶ 97,248, at 96,748.

132. 570 F.2d at 44.

133. The *Rolf* court expressly left open the question of whether recklessness suffices when there is no fiduciary duty to the defrauded party. *Id.* at 44 n.9. In a subsequent decision, however, the Second Circuit declined to hold a defendant liable as an aider and abettor under a recklessness theory when the defendant lacked a fiduciary relationship with the plaintiff, and an actual intent to aid in the fraud could not be established. *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 485 (2d Cir. 1979). See *Competitive Assocs., Inc. v. Laventhol*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,150, at 96,346-48 (S.D.N.Y. Oct. 18, 1979); *Steinberg & Gruenbaum*, *supra* note 121.

134. *Oleck v. Fischer*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,898, at 95,699 (S.D.N.Y. June 8, 1979), *aff'd*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,525 (2d Cir. June 4, 1980). *Accord*, *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879, 888 (E.D. Pa. 1978); *McLean v. Alexander*, 420 F. Supp. 1057, 1082 (D. Del. 1976), *rev'd on other grounds*, 599 F.2d 1190, 1196-97 (3d Cir. 1979). See *Steinberg & Gruenbaum*, *supra* note 121.

135. *Oleck v. Fischer*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,898, at 95,699 (S.D.N.Y. June 8, 1979), *aff'd* [Current] Fed. Sec. L. Rep. (CCH) ¶ 97,525 (2d Cir. June 4, 1980). See *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879, 888 (E.D. Pa. 1978).

When an accountant has reason to foresee that third parties will rely on his certification or other work, he may be deemed to have a duty of disclosure running to the third parties. *E.g.*, *Mendelsohn v. Capital Underwriters, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,169, at 96,449-50 (N.D. Cal. Oct. 24, 1979); *Wessel v. Buhler*, 437 F.2d 279, 283 (9th Cir. 1971); *In re Equity Funding Corp. of Am. Sec. Lit.*, 416 F. Supp. 161 (C.D. Cal. 1976). See

tion of whether an accountant in the ordinary case has a disclosure duty to persons who utilize certified financial statements, the answer may well be in the affirmative:

The task of an independent accountant is fairly to report a company's financial status at a particular time. It is by now basic that when an accountant certifies a financial statement it represents to those who see the statement that the figures are accurate in all material respects; a relationship is thus created between the accountant and those who see the statement which gives rise to certain duties of disclosure. On the basis of this representation, the accountant may be held liable under Rule 10b-5 for the preparation of false or misleading financial statements which portray an inaccurate picture for the period covered by the report.¹³⁶

With respect to whether scienter is required in SEC injunctive suits, the Court, in a footnote in *Hochfelder*, expressly left this question open.¹³⁷ While the lower courts had split on the question, with some holding that scienter is required and others holding that it is not,¹³⁸ the

generally *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973) (liability imposed for silence or inaction when duty to disclose has arisen); *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147, 154 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (silence or inaction can be basis for aiding and abetting liability); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) (silence can be basis for liability).

For an analysis of when a duty to disclose on the part of an accountant arises, see *Spectrum Financial Cos. v. Marconsult, Inc.*, 608 F.2d 377 (9th Cir. 1979), *cert. denied*, 100 S. Ct. 2153 (1980). See *generally* *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979).

136. *Ingenito v. Bernec Corp.*, [1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,214, at 92,487 (S.D.N.Y. Oct. 21, 1977) (citations omitted). See *Gold v. DCL, Inc.*, 399 F. Supp. 1123, 1127 (S.D.N.Y. 1973). See also *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976). The court in *Ingenito*, added: "Where financial statements have been certified and released to the public, courts have imposed a continuous duty to disclose after-acquired information which casts doubt on the reliability of the certified figures with respect to the period covered by the audit." *Id.* at 92,487 (emphasis added) (citing *Hirsch v. duPont*, 553 F.2d 750, 761 (2d Cir. 1977)); *United States v. Natelli*, 527 F.2d 311 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976); *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879 (E.D. Pa. 1978); *Fischer v. Kletz*, 266 F. Supp. 180, 189-94 (S.D.N.Y. 1967)). *But see* *Seiffer v. Topsy's Int'l*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,352 (D. Kan. Mar. 19, 1980).

137. 425 U.S. at 194 n.12.

138. Compare those cases that upheld the scienter requirement, *e.g.*, *SEC v. Blatt*, 583 F.2d 1325 (5th Cir. 1978); *SEC v. Wills*, 472 F. Supp. 1250 (D.D.C. 1978); *SEC v. Cenco, Inc.*, 436 F. Supp. 193, 200 (N.D. Ill. 1977); *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1241 (S.D.N.Y. 1976), *aff'd on other grounds*, 565 F.2d 8 (2d Cir. 1977) (not reaching scienter issue), with those cases that suggested or held that negligence sufficed, *e.g.*, *SEC v. Blazon Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,212, at 96,614 (9th Cir. Dec. 17, 1979); *SEC v. Arthur Young & Co.*, 590 F.2d 785 (9th Cir. 1979); *SEC v. World Radio Mission, Inc.*, 544 F.2d 535, 541 n.10 (1st Cir. 1976); *SEC v. Geotek*, 426 F. Supp. 715, 726 (N.D. Cal. 1976). See *generally* *Lowenfels, Scienter or Negligence Required for SEC Injunctions Under Section*

question was definitively answered in the Supreme Court's recent decision in *Aaron v. SEC*,¹³⁹ which applies the analysis used in *Hochfelder*, and holds that scienter is a necessary element in an SEC injunctive action brought under section 10(b) and rule 10b-5.¹⁴⁰

The pre-*Aaron* rationale underlying the argument that scienter is not required in SEC injunctive actions was that such actions are for the purpose of maximizing the protection of public investors and therefore, the government should not be as constrained in implementing these protections as private investors are when they seek monetary damages.¹⁴¹ As a matter of policy, limiting the government's burden to showing negligence in enforcement actions increases the effectiveness of the government's efforts and this increased effectiveness outweighs the potential harm to those enjoined from violating the law.¹⁴²

The pre-*Aaron* logic supporting the argument that scienter is required in government enforcement actions is also plausible. The argument asserts that it is inappropriate to construe the statute differently on the basis of the plaintiff's identity.¹⁴³ If scienter is required in private damage actions and this requirement is compelled by the language of the statute itself, scienter should be required in government enforcement actions under the statute. Indeed, this is the rationale that the Court used in *Aaron*.¹⁴⁴ As a side note, it merits attention that this argument does not rebut the assertion, as the Court in *Aaron* concluded, that negligent culpability suffices in SEC injunctive actions brought under some subsections of section 17(a) of the Securities Act,¹⁴⁵ where the language is nearly identical to rule 10b-5 or where the

10(b) and Rule 10b-5: A Fascinating Paradox, 33 BUS. LAW. 789 (1978); Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder*, 51 N.Y.U. L. REV. 769 (1976); Comment, *Scienter and SEC Injunctive Suits*, 90 HARV. L. REV. 1018 (1977).

139. 100 S. Ct. 1945 (1980).

140. *Id.* at 1952. The Court, however, also held that while scienter is required under section 17(a)(1) of the Securities Act, it is not required in SEC injunctive suits brought under sections 17(a)(2) and 17(a)(3). *Id.* at 1956.

141. *SEC v. Aaron*, 605 F.2d 612, 621 (2d Cir. 1979), *vacated*, 100 S. Ct. 1945 (1980). See generally *SEC v. World Radio Mission, Inc.*, 544 F.2d 535, 541 n.10 (1st Cir. 1976); *SEC v. Spectrum, Ltd.*, 489 F.2d 535, 541-42 (2d Cir. 1973).

142. *SEC v. Aaron*, 605 F.2d at 612.

143. *Id.* See *SEC v. Blatt*, 583 F.2d 1325, 1333 (5th Cir. 1978); *SEC v. Wills*, 472 F. Supp. 1250 (D.D.C. 1978). See also *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 217 (1976) (Blackman, J., dissenting) ("the question whether negligent conduct violates the Rule should not depend upon the plaintiff's identity").

144. 100 S.Ct. at 1952-53.

145. *Id.* See Steinberg & Gruenbaum, *supra* note 121, at 197-99, and cases cited therein. In *Aaron*, the Court concluded that scienter was required under section 17(a)(1) but not under 17(a)(2) or (3).

language does not dictate the conclusion that Congress intended to include a scienter requirement.

C. *Injunctive and Other Equitable Relief Against Accountants*

Related to the question of scienter is the role that culpability plays in the relief that courts are willing to grant in SEC enforcement actions. Historically, suits by the SEC were limited to injunctive relief¹⁴⁶ because the pertinent provisions of both securities acts¹⁴⁷ expressly limit the right of the SEC to such relief. While a literal reading of the statutes may arguably dictate such a limitation, the courts in recent years have gone further and have granted various forms of ancillary or other equitable relief.¹⁴⁸

1. Injunctive actions

The critical issue in determining whether an injunction should issue is whether there is a reasonable likelihood or threat of future violations.¹⁴⁹ Absent an affirmative answer to this question, an injunction should not issue. This principle is well settled by federal case law.¹⁵⁰

In *United States v. Oregon State Medical Society*,¹⁵¹ the Supreme Court refused to enjoin a defendant medical society from violations of the Sherman Antitrust Act when the illegal activity had stopped and there was no threat of future violations. The violations in question were voluntarily abandoned seven years prior to the commencement of the government's suit.¹⁵² In discussing the appropriateness of an injunction under such circumstances, the Court pointed out that, "[t]he sole function of an action for an injunction is to forestall future violations."¹⁵³ Finding that the trial court record did not unearth any threat of a resumption of the illegal activities, the Court concluded that an

146. See Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976) [hereinafter cited as Farrand].

147. Securities Act of 1933, § 20(b), 15 U.S.C. § 77(b) (1970); Securities Exchange Act of 1934, § 21, 15 U.S.C.A. § 78u(d) (West Supp. 1979). See notes 166-67 *infra* and accompanying text.

148. See notes 168-69 *infra* and accompanying text.

149. See, e.g., *Aaron v. SEC*, 100 S. Ct. 1945, 1957 (1980); *SEC v. Koracorp Indus., Inc.*, 575 F.2d 692, 697-99 (9th Cir.), *cert. denied*, 439 U.S. 953 (1978); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 98-101 (2d Cir. 1978); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 18-19 (2d Cir. 1977); *United States v. W.T. Grant Co.*, 345 U.S. 629, 633-36 (1953); *United States v. Oregon State Medical Soc'y*, 343 U.S. 326, 333-34 (1952); *SEC v. Parklane Hosiery Co.*, 558 F.2d 1083, 1089-90 (2d Cir. 1977). See notes 160-61 *infra* and accompanying text.

150. See cases cited in note 149 *supra*, and notes 151-61 *infra* and accompanying text.

151. 343 U.S. 326 (1952).

152. *Id.* at 329-30.

153. *Id.* at 333.

injunction should not issue.¹⁵⁴

In *United States v. W. T. Grant Co.*,¹⁵⁵ the Supreme Court affirmed summary judgment for several defendant corporations in a suit in which the government sought to enjoin W. T. Grant Co. and others from future violations of the Clayton Act. The Court accepted the lower court's findings that the defendants' past violations had been voluntarily terminated and that the defendants had no intention of resuming the practices sought to be restrained.¹⁵⁶ While noting that the voluntary cessation of the allegedly illegal activities did not automatically require the denial of an injunction, the Court emphasized that "[t]he moving party must satisfy the court that relief is needed. The necessary determination is that there exists some cognizable danger of recurrent violation, something more than the mere possibility which serves to keep the case alive."¹⁵⁷ In addition, the Court noted that the determination of whether to issue an injunction is within the discretion of the trial court.¹⁵⁸

In recent years, the SEC has failed in a number of cases to obtain injunctions against various defendants, including accountants, for alleged violations of the federal securities laws.¹⁵⁹ In most of these cases, the controlling question has been whether there existed a reasonable likelihood or danger of future violations.¹⁶⁰ To answer this question,

154. *Id.* at 334. ("The record discloses no threat or probability of resumption of the abandoned warfare against prepaid medical service and the contract practice it entails. We agree with the trial court that conduct discontinued in 1941 does not warrant the issuance of an injunction in 1949."). See *Industrial Ass'n v. United States*, 268 U.S. 64, 83-84 (1925).

155. 345 U.S. 629 (1953).

156. *Id.* at 634-36.

157. *Id.* at 633. See generally *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 18 (2d Cir. 1977); *SEC v. Parklane Hosiery Co.*, 558 F.2d 1083, 1089 (2d Cir. 1977); *United States v. Edwards*, 333 F.2d 575, 579 (5th Cir. 1964); *SEC v. Culpepper*, 270 F.2d 241, 249 (2d Cir. 1959).

158. *United States v. W.T. Grant Co.*, 345 U.S. at 633. See *Hecht Co. v. Bowles*, 321 U.S. 321, 328 (1944); *Meredith v. Winter Haven*, 320 U.S. 228, 235 (1943); *United States v. Oregon State Medical Soc'y*, 343 U.S. 326, 338-39 (1952) (lower court's findings not clearly erroneous); *SEC v. Blazon Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,212, at 96,614-15 (9th Cir. Dec. 17, 1979).

159. See, e.g., *SEC v. Arthur Young & Co.*, 590 F.2d 785 (9th Cir. 1979) (Big Eight accounting firm); *SEC v. Koracorp Indus., Inc.*, 575 F.2d 692 (9th Cir.), cert. denied, 439 U.S. 953 (1978) (Big Eight accounting firm). See generally *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8 (2d Cir. 1977); *SEC v. Parklane Hosiery Co.*, 558 F.2d 1083 (2d Cir. 1977); *SEC v. Bangor Punta Corp.*, 331 F. Supp. 1154 (S.D.N.Y. 1971), aff'd sub nom. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973); *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. 1971); *SEC v. Pearson*, 426 F.2d 1339 (10th Cir. 1970); *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978) (mem.).

160. The courts appear to vary on the degree of the threat or danger of future violations that must exist before an injunction will issue. The vast majority of courts, however, employ

the courts have looked at a number of factors, including: the seriousness and number of the defendant's past violations; the cessation or continuance of the illegal conduct; the defendant's promises of reformation and acts of contrition; evidence of the defendant's remorse; changed circumstances relating to the defendant's job or health; and the degree of the defendant's culpability, or lack thereof, in committing the alleged violations.¹⁶¹ As the Court recently observed in *Aaron*, proof of past violations is only one factor in determining whether to issue an injunction.¹⁶²

In several recent cases involving suits against professionals and professional firms, the courts have questioned the appropriateness of enjoining an entire firm for the alleged misconduct of only one or a few of its members.¹⁶³ There is clearly a stigma associated with the issuance of an injunction. In the accounting profession, as well as in other

the "reasonable likelihood" standard. *See, e.g., SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 18 (2d Cir. 1977) ("reasonable likelihood that past wrongdoing will occur"); *SEC v. Parklane Hosiery Co.*, 558 F.2d 1083, 1089-90 (2d Cir. 1977) ("reasonable likelihood of recurrence"); *SEC v. Culpepper*, 270 F.2d 241, 249 (2d Cir. 1959) ("reasonable expectation of recurrence"). *Cf. Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 405 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973) ("must be a showing of cognizable risk of future violation, something more than the mere possibility which serves to keep the case alive;" defendant must have a propensity or natural inclination to commit future violations); *SEC v. Cenco, Inc.*, 436 F. Supp. 193, 200 (N.D. Ill. 1977) (there must be more than a "mere possibility of recurrence"); *SEC v. Griffin*, 296 F. Supp. 883, 887 (S.D. Miss. 1968) (court must look to the "likelihood or probability, as distinguished from the possibility, of future violations").

161. *SEC v. Bonastia*, 614 F.2d 908 (3d Cir. 1979). *See SEC v. Blatt*, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978); *SEC v. Koracorp Indus., Inc.*, 575 F.2d 692, 698-99 (9th Cir. 1978); *SEC v. Bangor Punta Corp.*, 331 F. Supp. 1154 (S.D.N.Y. 1971), *aff'd sub nom. Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1100-02 (2d Cir. 1972); *SEC v. Keller, Corp.*, 323 F.2d 397, 402-03 (7th Cir. 1963); *SEC v. Culpepper*, 270 F.2d 241, 249-50 (2d Cir. 1959).

162. 100 S. Ct. at 1947. *See cases cited in note 161 supra.*

163. *See SEC v. Geon Indus., Inc.*, 531 F.2d 39, 53-56 (2d Cir. 1976) (injunction denied after balancing the needs against the hardships imposed). *Cf. Touche Ross & Co. v. SEC*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,854, at 95,483 n.21 (2d Cir. May 10, 1979) (action to enjoin SEC proceeding; question of liability of entire firm for conduct of a few individual members must await the conclusion of the administrative process because it was unclear whether SEC discipline was forthcoming and issue not raised before the Commission or the appeals court); *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1170-71 nn. 48 & 49 (D.C. Cir. 1978) (case remanded to resolve questions under § 20(a) of the Exchange Act); *Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, 48 & nn. 17-19 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978) (private fraud action; on appeal the firm conceded liability if employee found liable); *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682, 701 n.42 (D.D.C. 1978) (mem.) (question avoided because firm did not challenge SEC on appeal). *See also Securities Act of 1933*, § 15, 15 U.S.C. 77o (1976) (lack of knowledge or reasonable ground to believe is a defense for a person who "controls" another who is liable); *Securities Exchange Act of 1934*, § 20(a), 15 U.S.C. § 78t(a) (1976) (good faith is a defense).

professions, where reputation and image are of great importance, the stigma of an injunction can have severe negative consequences.¹⁶⁴

Injunctions are designed to deter future violations, not to punish. As such, the potential hardship on a firm occasioned by an injunction should be balanced against the need to restrain action. Courts should exercise caution and restraint when this issue arises. At the same time, however, courts should also recognize that when the private interest conflicts with the public interest, the latter may be considered paramount.¹⁶⁵

2. Ancillary or other equitable relief

Section 20(b)¹⁶⁶ of the Securities Act and section 21(d)¹⁶⁷ of the Exchange Act authorize the SEC to seek injunctive relief in federal court to halt existing or threatened violations. Relying, however, on their broad equitable powers,¹⁶⁸ the federal courts have granted various

164. *See* SEC v. Geon Indus., Inc., 531 F.2d 39, 55 (2d Cir. 1976). In SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90 (2d Cir. 1978), Judge Friendly stated:

It is fair to say that the current judicial attitude toward the issuance of injunctions on the basis of past violations at the SEC's request has become more circumspect than in the earlier days. Experience has shown that an injunction, while not always a "drastic remedy" . . . often is much more than [a] "mild prophylactic". . . .

Id. at 99 (citations omitted).

Section 15 of the Securities Act and section 20 of the Exchange Act impose liability on persons who control the violator, but these statutes expressly require a showing of willfulness on the part of the controlling persons before such liability may be imposed. In addition, liability may be imposed on a firm based on a *respondeat superior* theory, but such liability does not necessarily follow a showing of violations by a member of the firm. *See* cases cited in note 163 *supra*. *See also* SEC v. Lum's Inc., 365 F. Supp. 1046, 1061-65 (S.D.N.Y. 1973) (rejecting *respondeat superior* theory). *Cf.* Fey v. Walston & Co., 493 F.2d 1036, 1051-53 (7th Cir. 1974) (liability imposed on brokerage firm for churning); Lewis v. Walston & Co., 487 F.2d 617, 623-24 (5th Cir. 1973) (liability imposed on brokerage firm for sale of unregistered stock).

165. SEC v. Culpepper, 270 F.2d 241, 250 (2d Cir. 1959). *Accord*, SEC v. Advance Growth Capital Corp., 470 F.2d 40, 53 (7th Cir. 1972); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1102 (2d Cir. 1972). It bears mentioning that the considerations applicable in determining the liability of a firm for the conduct of members of the firm may differ when the liability sought to be imposed is for damages rather than an injunction. For example, in a case seeking contract damages, traditional agency principles are applicable to a determination of an accounting firm's liability for the conduct of one of its partners. *See In re F.W. Koenecke & Sons, Inc.*, 605 F.2d 310, 312-13 (7th Cir. 1979).

166. 15 U.S.C. § 77t(b) (1976).

167. 15 U.S.C. § 78u (1976).

168. The Supreme Court has repeatedly held that the federal courts have broad equitable powers under the Securities Acts to fashion such relief as is necessary under the circumstances. *See, e.g.*, Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); J. I. Case Co. v. Borak, 377 U.S. 426 (1964); Deckert v. Independence Shares Corp., 311 U.S. 282 (1940).

forms of far-reaching ancillary or other equitable remedies.¹⁶⁹

On several occasions the Supreme Court has affirmed the principle that the securities acts grant the federal courts broad equitable powers to fashion such relief as is considered necessary.¹⁷⁰ Although none of the Supreme Court cases has involved suit by the SEC, the guidance taken from these decisions has led lower courts to grant a variety of ancillary remedies in SEC actions.¹⁷¹ For example, these remedies have included appointment of receivers,¹⁷² appointment of new directors,¹⁷³ appointment of independent professionals to monitor the conduct of companies,¹⁷⁴ rescission, disgorgement, restitution and various other remedies.¹⁷⁵

Generally, most of the cases involving ancillary or other equitable relief have been consent cases. Rather than taking the time and expense of litigation against the SEC and risking the potential hazards of an adverse decision,¹⁷⁶ defendants frequently have been willing to settle claims by the SEC through the negotiated consent process.¹⁷⁷ A negotiated consent will usually include an injunction and may include

169. See generally Farrand, *supra* note 146, *passim*.

170. See cases cited in note 168 *supra*.

171. See notes 172-75 *infra* and accompanying text.

172. See, e.g., SEC v. United States Financial Group, Inc., 474 F.2d 354 (9th Cir. 1973); SEC v. Fifth Ave. Coach Lines, Inc., 435 F.2d 510 (2d Cir. 1970); Lankenau v. Coggeshall & Hicks, 350 F.2d 61 (2d Cir. 1965). See Farrand, *supra* note 146, at 1784-89.

173. See, e.g., SEC v. International Controls Corp., SEC Lit. Rel. No. 5643, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,210 (S.D.N.Y. Nov. 27, 1973); SEC v. Equity Funding Corp., SEC Lit. Rel. No. 5849, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,955 (C.D. Cal. Apr. 16, 1973); SEC v. Mattel, Inc., SEC Lit. Rel. No. 6531, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,807 (D.D.C. Oct. 1, 1974). See Farrand, *supra* note 146, at 1796.

174. See, e.g., International Controls Corp. v. Vesco, 490 F.2d 1334 (2d Cir.), *cert. denied*, 417 U.S. 932 (1974); SEC v. Mattel, Inc., SEC Lit. Rel. No. 6531, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,807 (D.D.C. Oct. 1, 1974). See Farrand, *supra* note 146, at 1793-94.

175. See Farrand, *supra* note 146, at 1800-05.

176. The risks attendant to an adverse decision in litigation against the SEC were significantly heightened by the Supreme Court's recent decision in *Shore v. Parklane Hosiery Co.*, 439 U.S. 322 (1979). In *Parklane Hosiery*, the Supreme Court held that under some circumstances collateral estoppel may be used offensively against a party who suffers an adverse decision in a litigated case against the SEC. Thus, an adverse decision in such a case could trigger subsequent lawsuits by investors and others who conceivably could use the adverse decision in the SEC suit offensively by asserting collateral estoppel. See generally Note, *Mutuality of Estoppel and the Seventh Amendment: The Effect of Parklane Hosiery*, 64 CORNELL L. REV. 1002 (1979).

177. See Levine & Herlihy, *How SEC Will Continue to Use Consent Decrees*, Legal Times Wash., June 5, 1978, at 16, col. 2; Mathews, *Recent Trends in SEC Requests for Ancillary Relief in SEC Civil Injunctive Actions*, 31 BUS. LAW. 1323 (1976).

various forms of ancillary relief.¹⁷⁸ It should be stressed, however, that in a number of cases the SEC has obtained such ancillary relief through litigation.¹⁷⁹

In recent years, the SEC has obtained a variety of ancillary remedies against accountants and accounting firms. The first major inroad in this area was in *SEC v. Everest Management Corp.*,¹⁸⁰ wherein a major accounting firm agreed to adopt internal supervisory and control procedures with respect to its audit practice. The firm also consented to a "peer review" of its professional practice by independent third persons. These elements of ancillary relief were incorporated into a consent injunction entered into by the accounting firm. In a simultaneous administrative proceeding brought by the SEC, the firm consented to certain prohibitions against taking on new business which required filing reports with the SEC.¹⁸¹

Similarly, in *SEC v. Republic National Life Insurance Co.*,¹⁸² an accounting firm consented to an injunction which required the firm to adopt certain audit procedures relating to future audits of its clients and to retain a special consultant to review the firm's audits of a designated percentage of its clients. More importantly, the injunction against the firm extended to the firm's audits of other clients that had substantial transactions similar in character to those that gave rise to the suit against the firm.

In another consent action, an accounting firm agreed to implement new audit procedures, to conduct a "peer review" and to refrain from accepting new business requiring filings with the SEC for a designated period of time.¹⁸³ In addition, an individual member of the firm was

178. See generally 1 MATHEWS, NEGOTIATING SEC CONSENT DECREES: TARGETS & TACTICS FOR SETTLING CIVIL INJUNCTIVE ACTIONS (1979).

179. E.g., *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 103 n.13 (2d Cir. 1978) (disgorgement); *SEC v. Aydin Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,111 (D.D.C. Oct. 25, 1979) (independent auditors); *SEC v. The Fundpack, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,951 (D.D.C. Aug. 10, 1979) (special master to supervise election of new board).

180. SEC Lit. Rel. No. 5209 (S.D.N.Y. Nov. 8, 1971). See Olson, *SEC Proceedings Against Accountants*, 1 NEGOTIATING SEC CONSENT DECREES: TARGETS & TACTICS FOR SETTLING CIVIL INJUNCTIVE ACTIONS 496 (1979) [hereinafter cited as *Proceedings Against Accountants*].

181. See authorities cited in note 180 *supra*.

182. SEC Lit. Rel. No. 6273, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,426 (S.D.N.Y. Mar. 8, 1974); *Proceedings Against Accountants*, *supra* note 180, at 496-97.

183. *SEC v. Allegheny Beverage Corp.*, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,183 (D.D.C. 1973); *Ex rel. Benjamin Botwinick & Co.*, SEC Accounting Series Release [hereinafter referred to as ASR] No. 168 (Jan. 13, 1975), 6 FED. SEC. L. REP. (CCH) ¶ 72,190; *Proceedings Against Accountants*, *supra* note 180, at 497-98.

required to attend continuing education classes for a fixed number of hours, was prohibited from practicing before the SEC without supervision and was prohibited from acting as or being a partner of the firm for a designated period of time. The firm also was required to implement a policy whereby its partners would attend continuing education courses for a minimum number of hours over a period of time.

In 1975, one of the major accounting firms in the United States consented to injunctions and various forms of ancillary relief in four separate SEC suits.¹⁸⁴ The firm agreed to implement various internal procedures with respect to new audit clients and to new engagements following the resignation by a predecessor auditor. It also consented to a "second partner" review of reports prior to their issuance and agreed to study certain accounting principles and implement audit procedures. The firm also agreed to institute a "peer review" program and to refrain from accepting new SEC clients for a period of six months.

In addition to obtaining ancillary relief against individual accountants and accounting firms in civil injunctive suits, the SEC has obtained such relief in its administrative proceedings, in which it has meted out a variety of disciplinary sanctions.¹⁸⁵ The Commission's imposition of sanctions in its administrative proceedings, including cases where professionals have been barred or suspended from appearing or practicing before the Commission, has been undertaken without any finding that the alleged misconduct is likely to reoccur, as in some state bar disciplinary proceedings.¹⁸⁶

D. Administrative Proceedings

Under rule 2(e) of its Rules of Practice,¹⁸⁷ the Commission may deny any person the privilege of appearing or practicing before it if such person is found:

- (1) not to possess the requisite qualifications to represent others, or
- (2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or
- (3)

184. Peat, Marwick, Mitchell & Co., ASR No. 173 (July 2, 1975), 6 FED. SEC. L. REP. (CCH) ¶ 72,195; *Proceedings Against Accountants*, *supra* note 180, at 498. In another suit, a Big Eight firm consented to review its internal procedures relating to matters such as those raised in the SEC's complaint. The firm agreed to adopt such new procedures as it deemed advisable as a result of that review. The firm also agreed to a "peer review" and a refund of \$120,000 in audit fees relating to the audits for the years in question. *In re Price Waterhouse & Co. Lit.*, 6 FED. SEC. L. REP. (CCH) ¶ 72,260 (Jan. 16, 1978); *Proceedings Against Accountants*, *supra* note 180, at 499.

185. *See* note 191 *infra*.

186. *See, e.g.*, *State v. Rogers*, 226 Wis. 39, 275 N.W. 910 (1937).

187. 17 C.F.R. § 201.2(e) (1979).

to have willfully violated, or willfully aided and abetted a violation of any provision of the federal securities law . . . or the rules and regulations thereunder.¹⁸⁸

"Practicing before the Commission" is defined to include "the preparation of any statement, opinion or other paper by an attorney, accountant, engineer or other expert, filed with the Commission . . . with the consent of such attorney, accountant, engineer or other expert."¹⁸⁹

In recent years, the SEC has imposed a variety of sanctions on professionals,¹⁹⁰ including accountants and accounting firms,¹⁹¹ under

188. *Id.* § 201.2(e)(1).

189. *Id.* § 201.2(g). The definition of practice before the Commission also includes "transacting any business with the Commission." *Id.*

190. An area which has attracted a great deal of attention is the Commission's disciplinary proceedings against lawyers. See Gruenbaum, *Clients' Frauds and Their Lawyers' Obligations: A Response to Professor Kramer*, 68 GEO. L.J. 191, 200-04 (1979) [hereinafter cited as Gruenbaum, *A Response*]; Gruenbaum, *Corporate/Securities Lawyers: Disclosure, Responsibility, and Liability to Investors*, and National Student Marketing Corp., 54 NOTRE DAME LAW. 795 (1979).

191. See, e.g., *In re Darrel L. Nielsen*, ASR No. 275 (1980), 6 FED. SEC. L. REP. (CCH) ¶ 72,297, at 62,780 (temporary suspension of accountant enjoined from violations of the antifraud provisions of the federal securities laws made permanent); *In re Touche Ross & Co.*, ASR No. 153A (1979), 6 FED. SEC. L. REP. (CCH) ¶ 72,175A, at 62,363 (censure of firm; firm agreed to institute a "peer review" and to implement recommendations resulting therefrom; firm agreed that the working papers, files and other documentation of the examination would be available to the Commission); *In re Ernst & Ernst*, ASR No. 248 (1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,270, at 62,734 (censure of firm; suspension of one firm partner for one year and another firm partner for three months from appearing or practicing before the Commission); *In re LaLande*, ASR No. 229 (1977), 6 FED. SEC. L. REP. (CCH) ¶ 72,251, at 62,641 (three partners of firm suspended from appearing or practicing before the Commission for six months; each partner also undertook to notify the Commission's Office of the Chief Accountant prior to appearing or practicing before the Commission in the future); *In re Thomas Leger & Co.*, ASR No. 223 (1977), 6 FED. SEC. L. REP. (CCH) ¶ 72,245, at 62,605 (firm submitted to review of its policies, practices and procedures by unrelated reviewer and agreed to implement his recommendations; firm and one partner agreed not to engage any new public clients for period ending thirty days after completion of final report by reviewer; reviewer's working papers, files and other documentation would be available to the Commission); *In re Reich, Weiner & Co.*, ASR No. 210 (1977), 6 FED. SEC. L. REP. (CCH) ¶ 72,232, at 62,588-89 (firm agreed to participate in AICPA's program of voluntary quality control review for firms with general audit practices for period of three years; firm agreed to implement new procedures and to submit review report to the Commission; firm agreed to suspend efforts to obtain and to refuse new professional engagements which would involve practicing before the Commission for a period of twenty days); *In re S. D. Leidesdorf & Co.*, ASR No. 209 (1977), 6 FED. SEC. L. REP. (CCH) ¶ 72,231, at 62,579-84 (firm agreed to institute "peer review" and to implement recommendations resulting from that review; firm agreed that working papers, files and documents of review committee would be made available to the Commission; firm agreed, with certain exceptions, not to accept or negotiate new SEC audit engagements for period of sixty days; and two firm members agreed to severely limit their audit practice involving filings with or practice before the Commission for periods of nine and seven months, respectively); *In re Seidman & Seidman*, ASR No. 196 (1976), 6 FED. SEC. L. REP. (CCH) ¶ 72,218, at 62,543-56 (firm agreed to conduct "peer review" and

rule 2(e). The Commission's use of power under rule 2(e) has been criticized both from within and without the Commission. The criticism, generally, has been that the Commission overuses and abuses its power under the rule. While on the Commission, one former SEC Commissioner who opposed broad use of the rule, argued that disciplinary proceedings against professionals should be limited to cases in which the conduct of the professional interferes with the administrative processes of the SEC.¹⁹² One commentator has criticized the SEC's imposition of sanctions under rule 2(e) as an "inordinate intrusion of government into professional activity."¹⁹³ Other commentators have argued that the SEC's rule 2(e) proceedings violate due process.¹⁹⁴

Despite these criticisms, the SEC's authority under rule 2(e) has

to implement recommendations resulting therefrom; firm agreed that working papers, files and documents of review committee would be available to the Commission; firm undertook, with certain exceptions, not to accept new SEC audit engagements for period of three and one-half months; and four members of the firm undertook not to perform any SEC audit work for periods ranging from two months to six months); *In re Peat, Marwick, Mitchell & Co.*, ASR No. 173 (1975), 6 FED. SEC. L. REP. (CCH) ¶ 72,195, at 62,455-57 (firm agreed to conduct "peer review" and to implement recommendations resulting therefrom; firm agreed that working papers, files and documents of review committee would be made available to the Commission; firm agreed not to negotiate for or accept new SEC audit engagements for period of six months; firm agreed to entry of final judgment of permanent injunction in each of four civil injunctive suits brought by the Commission against the firm; and firm agreed to revise and implement certain procedures relating to its second partner review procedure); *In re Benjamin Botwinick & Co.*, ASR No. 168 (1975), 6 FED. SEC. L. REP. (CCH) ¶ 72,190, at 62,406 (firm and one partner consented to final judgments of permanent injunction against violations of certain provisions of the federal securities laws; firm consented to "peer review" and to implement recommendations resulting therefrom; partner agreed to attend continuing professional education courses or seminars for at least 100 hours during a ten-month period in subjects relating to public accounting or auditing; partner agreed not to practice before the Commission for ten months and not to act as or be a partner in the firm for ten months; and firm agreed to resign audit engagement of client with respect to which the Commission's proceeding related). See also *In re Haskins & Sells*, ASR No. 241 (1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,263, at 62,695-97; *In re Rudolph, Palitz & Co.*, ASR No. 191 (1976), 6 FED. SEC. L. REP. (CCH) ¶ 72,213, at 62,511-12; *In re Hertz, Herson & Co.*, ASR No. 176 (1975), 6 FED. SEC. L. REP. (CCH) ¶ 72,198, at 62,471-72; *In re Harris, Kerr, Forster & Co.*, ASR No. 174 (1975), 6 FED. SEC. L. REP. (CCH) ¶ 72,196, at 62,468; *In re Westheimer, Fine, Berger & Co.*, ASR No. 167 (1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,189, at 62,404; *In re Loux, Gose & Co.*, ASR No. 160 (1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,182, at 62,380-81; *In re Arthur Andersen & Co.*, ASR No. 157 (1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,179, at 62,374-75; *In re Touche Ross & Co.*, ASR No. 153 (1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,175, at 62,361-62; *In re Laventhol, Krekstein, Horwath & Horwath*, ASR No. 144 (1973), 5 FED. SEC. L. REP. (CCH) ¶ 72,166, at 62,329-30; *In re Touche, Niven, Bailey & Smart*, ASR No. 78 (1957), 5 FED. SEC. L. REP. (CCH) ¶ 72,100, at 62,223.

192. *In re Keating, Muething & Klekamp*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,981 (July 2, 1979) (Karmel, Comm'r dissenting).

193. Fifis, *supra* note 71, at 63-64. See Downing & Miller, *The Distortion and Misuse of Rule 2(e)*, 54 NOTRE DAME LAW. 774 (1979) [hereinafter cited as Downing & Miller].

194. Downing & Miller, *supra* note 193, at 782-86.

been upheld by the Second Circuit in *Touche Ross & Co. v. SEC*.¹⁹⁵ Initially, the SEC instituted public administrative proceedings against Touche Ross & Co., a national accounting firm, under rule 2(e).¹⁹⁶ The firm challenged the Commission's 2(e) authority in federal district court. In affirming the district court's decision, the Second Circuit in *Touche Ross* agreed that the Commission has the authority to discipline professionals under the rule, observing that there is no express statutory prohibition against the promulgation of rule 2(e) in the federal securities laws. Furthermore, the *Touche Ross* court believed the Commission's utilization of the rule is a proper attempt to preserve the integrity of the Commission's procedures by assuring the fitness of those professionals who represent others before the Commission and to determine whether a professional's qualifications, including his character and integrity, are such that he is fit to appear and practice before the Commission. Moreover, the rule is consistent with the Commission's statutory authority under the federal securities laws.¹⁹⁷

195. 609 F.2d 570 (2d Cir. 1979). The district court in *Touche Ross* was careful to point out that its decision against the accounting firm was based on the firm's failure to exhaust its administrative remedies and the court therefore did not reach "the substantive question of the validity of Rule 2(e)." *Id.* at 574.

196. *In re Touche Ross & Co.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,720 (1976).

197. 609 F.2d at 581-82.

The court in *Touche Ross* went out of its way to raise the issue of whether the Commission could hold an entire accounting firm vicariously liable under Rule 2(e) for the alleged misconduct of only some of its partners:

Touche Ross chose to remain loyal to its retired partners [the alleged wrongdoers] and to challenge Rule 2(e) in a broadside attack on the right of the Commission to discipline *anyone*. Our opinion today rejects this sally. Nothing in the complaint, or the district court proceedings, or the briefs and oral argument before us purports to raise the question of the extent to which the Commission has the power, in a disciplinary action, to hold Touche Ross and its 525 partners vicariously liable to the extent of permanent revocation of the right to practice for the acts of its erstwhile partners. It may be argued, for example, that the Commission may not proceed against Touche Ross on a theory of *respondeat superior* without first establishing that Congress has delegated such authority and that the Commission has, through a rulemaking proceeding, set standards for such an adjudication, including a definition of "willful conduct. . . ." We express no view on this question, but it is one that the Commission might want to consider. In any event, since it is far from clear that the Commission will in fact determine to discipline Touche Ross, and since the question was *not* raised before the Commission or this court, the resolution of such issues should await the conclusion of the administrative process.

609 F.2d at 582 n.21 (citation omitted). See Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353, 373 (1978).

The court's statements in *Touche Ross* raise due process issues with respect to the Commission's authority and ability to hold an entire firm responsible for the unlawful conduct of one or a few of its members. See Downing & Miller, *supra* note 193, at 782-86. The Commission's position on this issue appears to be as follows: "[W]e have consistently held that where . . . a firm of public accountants permits a report or certificate to be executed in its

The courts have not decided whether the proper standard of proof in rule 2(e) proceedings against accountants should be a "preponderance of the evidence" or a "clear and convincing" standard. Traditionally, the SEC has applied the "preponderance of the evidence" standard in its administrative proceedings. In *Collins Securities Corp. v. SEC*,¹⁹⁸ however, which involved the revocation of broker-dealer and investment advisor registrations, the Court of Appeals for the District of Columbia Circuit rejected this longstanding administrative practice.¹⁹⁹

The court in *Collins* emphasized that when fraud allegations are the subject of a disciplinary proceeding, and, more importantly, when the sanction sought to be imposed is the disbarment of a professional from practice, a "clear and convincing" rather than a "preponderance of the evidence" standard should be used.²⁰⁰ The underlying rationale for this decision was that a finding of fraud and the concomitant disbarment from practice constituted a severe deprivation to the respondent and was more than mere prophylactic relief. Therefore, a higher degree of proof was required.²⁰¹

The District of Columbia Circuit in *Whitney v. SEC*²⁰² extended the *Collins* rationale to encompass a nine-month suspension of a broker-dealer based on allegations of fraud.²⁰³ The Fifth Circuit, however, in *Steadman v. SEC*,²⁰⁴ rejected *Collins*, reasoning that the preponderance standard, in a case involving fraud allegations and permanent disbarment from association with any investment advisor, was appropriate in light of the Commission's interest in adequately policing the securities industry to protect the investing public.²⁰⁵ Thus, the deci-

name, it will be held responsible therefor." *In re Ernst & Ernst*, ASR No. 248 (1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,270, at 62,733 (footnotes omitted). See *In re Touche Ross & Co.*, ASR No. 153 (1974), 6 FED. SEC. L. REP. (CCH) ¶ 72,175; *In re Touche, Niven, Bailey & Smart*, ASR No. 78 (1957), 5 FED. SEC. L. REP. (CCH) ¶ 72,100.

198. 562 F.2d 820 (D.C. Cir. 1977).

199. *Id.* at 825-26.

200. *Id.*

201. *Id.*

202. 604 F.2d 676 (D.C. Cir. 1979).

203. The court stated: "Like the revocation in *Collins*, a suspension for nine months imposes a serious loss, both as a short-run matter of foregone business and, perhaps more grievously, as a permanent injury to reputation." *Id.* at 681.

204. 603 F.2d 1126 (5th Cir. 1979), cert. granted, 100 S. Ct. 1849 (1980).

205. The *Steadman* court stated:

The burden of proof serves to allocate between the litigants the risk of erroneous decision in a proceeding. Balanced against the risk to *Steadman* is the risk that the investing public will be inadequately protected. The public interest in high standards of conduct in the securities business is a great one. If the burden of proof imposed on the Commission is too high, its ability to police the industry is im-

sions on the issue of the proper standard of proof are irreconcilable. In an effort to resolve this conflict, the Supreme Court has granted *certiorari* in *Steadman*,²⁰⁶ and thus, will be the final arbiter.²⁰⁷

paired We subscribe to the common-sense notion that the greater the sanction the Commission decides to impose, the greater is its burden of justification. Where, as here, the most potent weapon in the Commission's "arsenal of flexible enforcement powers" is used, the Commission has an obligation to explain why a less drastic remedy would not suffice.

Id. at 1139 (citations omitted). See also *Schultz v. SEC*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,234 (7th Cir. Jan. 7, 1980), in which the Seventh Circuit expressly left the standard of proof issue open:

This court has never held and does not hold today that a clear and convincing standard of proof is required in proceedings like the one at bar. In *Collins Securities Corp. v. S.E.C.*, 562 F.2d 820 (D.C. Cir. 1977), cited by petitioner, wherein a clear and convincing standard was used, the violation alleged involved fraud and the penalty was disbarment. In *Whitney v. S.E.C.*, 604 F.2d 676 (D.C. Cir. 1979), a violation of the anti-fraud provisions of the Securities Exchange Act was found and the clear and convincing standard of proof was used. However, at least one court has explicitly refused to follow *Collins* and did not use the clear and convincing standard in a case which also involved fraud. *Steadman v. S.E.C.*, [602 F.2d 1126, cert. granted, 100 S. Ct. 1849 (1980)]. The issue of what standard we would use in a case involving fraud is not before us.

Id. at 96,687 n.17. See *Decker v. SEC*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,614 (10th Cir. Aug. 18, 1980) (civil charge of aiding and abetting violation of section 17(e)(1) of Investment Co. Act requires preponderance of the evidence standard); *Investors Research Corp. v. SEC*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,526 (D.C. Cir. Apr. 24, 1980) (clear and convincing standard held not applicable in SEC administrative action based on violations of section 17(e)(1) of the Investment Company Act wherein finding of fraud was not required and no severe sanction was imposed). See also *Charlton v. FTC*, 543 F.2d 903 (D.C. Cir. 1976), which involved the issue of whether the FTC used the proper standard of proof in imposing upon an attorney a one-year suspension of practice before the Commission. The standard utilized by the FTC, which the court rejected, was that of "substantial evidence" which the Commission defined as "not 'the preponderance of the evidence,' but 'something less than the weight of the evidence,' [constituting] 'such relevant evidence as a reasonable mind might accept as adequate to support a conclusion.'" *Id.* at 907.

The *Charlton* court rejected the "substantial evidence" standard:

Disciplinary proceedings against attorneys do not involve any departure from the orthodox rule governing resolution of civil evidentiary contents. Almost seventy years ago, this court declared that the "charge should be supported by a preponderance of satisfactory evidence. The case should be clear and free from doubt." The same view, though variously articulated is the touchstone of judicial decisions across the Nation; the bare minimum for a finding of misconduct is the greater convincing power of the evidence. That the proceeding is administrative rather than judicial does not diminish this wholesome demand, and the requirement should not have been relaxed in the case at bar We reverse the District Court's summary judgment against Charlton and remand the case for further proceedings. The District Court will vacate the Commission's disciplinary order and will, in turn, remand to the Commission with instruction that it reconsider the evidence and redetermine the charge by application of the *preponderance-of-the-evidence rule*.

Id. at 907-08 (emphasis added).

206. 603 F.2d 1126 (5th Cir. 1979), cert. granted, 100 S. Ct. 1849 (1980).

207. It is no doubt true that administrative or civil injunctive proceedings against professionals such as accountants and lawyers can have a harsher impact than similar proceedings against persons of different occupations. See *SEC v. National Student Marketing Corp.*, 457

Finally, the Commission has rejected the *Hochfelder* scienter requirement in its rule 2(e) proceedings, defining "willfully" as meaning the intentional commission of the act which constitutes the violations.²⁰⁸ The argument supporting the Commission's position is that its administrative proceedings are prophylactic in character, designed to protect investors, and it therefore should not be burdened with the more difficult standard established by *Hochfelder*.²⁰⁹ This policy rationale is similar to that applied by those courts holding that the Commission need not prove scienter in civil injunctive suits.²¹⁰ By arguably not requiring evil motive, recklessness or even gross negligence, the question arises whether the Commission's interpretation of the term "willfulness" runs afoul of *Aaron*,²¹¹ particularly in view of the literal linguistic analysis²¹² employed there. The answer to this question, like

F. Supp. 682, 701 n.43 (D.D.C. 1978); Mathews, *Liability of Lawyers Under the Federal Securities Laws*, 30 BUS. LAW. 105, 106 (1975) (special issue). See notes 171-74 *supra* and accompanying text. However, as one court put it: "[T]he incremental effect does not seem sufficient to justify the extraordinary step of requiring a higher standard of proof against lawyers [and presumably accountants] than that which would be applicable to others." SEC v. National Student Marketing Corp., 457 F. Supp. at 701 n.43.

208. Thus the Commission has consistently taken the position that the culpability requirement set forth in *Tager v. SEC*, 344 F.2d 5 (2d Cir. 1965), should be applied in its administrative proceedings. In *Tager*, the Second Circuit stated that "'willfully' . . . means intentionally committing the act which constitutes the violation." *Id.* at 8. In *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978), the Second Circuit noted that the SEC has consistently held that "willfully" in the context of section 15 of the Exchange Act only requires proof that the defendant was aware of what he was doing.

This standard of culpability was recently applied in a rule 2(e) administrative proceeding against two lawyers. See *In re Carter & Johnson*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175 (Mar. 7, 1979). See Gruenbaum, *A Response*, *supra* note 190, at 203 n.65 for a discussion of the conflict between SEC's recognition of the *Tager* test to determine "fraud" and the American Bar Association's interpretation of "fraud" in the Code of Professional Responsibility which requires an intention to deceive.

209. See cases cited in note 208 *supra*.

210. See notes 137-45 *supra* and accompanying text.

211. See notes 101 & 144-45 *supra* and accompanying text. *But see* *Arthur Lipper v. SEC*, 547 F.2d 171, 180-81 n.6 (2d Cir. 1976). See also 566 SEC. REG. & L. REP. (BNA) AA-5 (Aug. 13, 1980).

212. In *Aaron v. SEC*, 100 S. Ct. 1953 (1980), the Court refused to construe section 10(b) differently than it had in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), on the basis that the SEC, as opposed to a private litigant, was the plaintiff in the case and the suit was for injunctive relief as opposed to damages. 100 S.Ct. at 1953. Instead, the Court concluded that its holding in *Hochfelder* that scienter is required in private damage actions under section 10(b) of the Exchange Act was based on a literal reading of the statute, and this literal reading must control irrespective of the identity of the plaintiff and the fact that injunctive relief rather than monetary damages is the remedy sought. *Id.* at 1954. In light of *Aaron*, there is an issue whether a different construction of section 10(b) in SEC administrative proceedings could withstand analysis. See also *Decker v. SEC*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,614 (10th Cir. Aug. 18, 1980) (*Tager* standard applies only to principals; for

the state of mind and standard of proof issues, may be left to Supreme Court resolution.

E. *The Foreign Corrupt Practices Act of 1977*

In 1977, Congress enacted the Foreign Corrupt Practices Act (FCPA).²¹³ The impetus for passage of the Act was the scandals that emerged regarding questionable and illegal payments by United States companies, both domestically and abroad.²¹⁴

The FCPA imposes book-keeping and internal accounting control responsibilities on public companies,²¹⁵ prohibits the payment of bribes by public and nonpublic companies,²¹⁶ and imposes both civil liability and criminal penalties for violations of its requirements and proscriptions.²¹⁷ Virtually no case law has developed regarding the FCPA's recent enactments,²¹⁸ but commentators have begun to explore the

aider and abettor liability, scienter must be shown); 566 SEC. REG. & L. REP. (BNA) AA-5 (Aug. 13, 1980).

213. Title I of Pub. L. No. 95-213, 91 Stat. 1494 (Dec. 1977) (amending § 13(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(b) (Supp. 1979)).

214. *See generally Foreign Corrupt Practices Act of 1977 and the Regulation of Questionable Payments*, 34 BUS. LAW. 623 (1979); Committee on Corporate Law and Accounting, *A Guide to the New Section 13(b)(2) Accounting Requirements of the Securities Exchange Act of 1934*, 34 BUS. LAW. 307 (1978) [hereinafter cited as *Guide to New Section 13(b)(2)*].

215. Section 13(b)(2) of the Exchange Act, 15 U.S.C.A. § 78m(b)(2) (Supp. 1979).

216. Section 103 of the FCPA amends section 30 of the Exchange Act by adding a new section 30A, which prohibits public companies and persons acting on their behalf from bribing foreign government officials to obtain or retain business or to direct business to any other person.

Section 104 of the FCPA imposes similar prohibitions on certain individuals and on non-public domestic business entities and foreign business entities having a principal place of business in the United States. *See Impact of the Antibribery Prohibitions in Section 30A of the Securities Exchange Act of 1934*, Securities Exchange Act Release No. 16593 (Feb. 21, 1980), [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,454.

Enforcement of the FCPA is divided between the SEC as to public companies and the Department of Justice as to all others. *See generally Timmeny, SEC Enforcement of the Foreign Corrupt Practices Act*, 2 LOY. L.A. INT'L & COMP. L. ANN. 25, 26-27 (1979) [hereinafter cited as Timmeny].

217. *See notes 223-25 infra* and accompanying text.

218. The Commission has instituted a number of injunctive suits to enforce the provisions of the FCPA. *See, e.g., SEC v. Sfisco*, SEC Lit. Rel. 8483, 15 SEC DOCKET 536 (1978); *SEC v. Katy Indus., Inc.*, 15 SEC DOCKET 891 (N.D. Ill. 1978); *SEC v. Page Airways*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,393 (D.D.C. 1978), *settled*, [Current] FED. SEC. L. REP. (CCH) ¶ 97,341 (W.D.N.Y. Apr. 8, 1980); *SEC v. Aminex, Res. Corp.*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,352 (D.D.C. 1978); Timmeny, *supra* note 216, at 38-39. *Cf. SEC v. Joseph Schlitz Brewing Co.*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,464 (E.D. Wis. 1978). Recently, Playboy Enterprises, Inc. consented to the first section 15(c)(4) administrative proceeding brought by the SEC to enforce the accounting control requirements of the FCPA. *In re Playboy Enterp., Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 82,635 (Aug. 13, 1980).

Act's many implications.²¹⁹

The most significant aspect of the FCPA that affects accountants is the amending of section 13 of the Exchange Act to add new section 13(b)(2). Subsection (A) of section 13(b)(2) requires publicly-held companies to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the[ir] assets."²²⁰ Subsection (B) of section 13(b)(2) requires every publicly-held company to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that" transactions are executed in accordance with management's authorization and recorded in conformity with generally accepted accounting principles, and that access to and accountability for assets are adequately controlled.²²¹

The express language of section 13(b)(2) clearly places the onus of compliance on the public company rather than on the accountant. However, because the mandated "books and records" and "internal accounting control" provisions of the FCPA involve matters within the technical expertise of accountants, companies subject to the Act are likely to engage and rely upon their accountants to develop and review adequate internal compliance systems.²²² This no doubt foreshadows charges against accountants when the companies themselves are charged with violating the requirements of section 13(b)(2).

Under section 21(d) of the Exchange Act, the SEC is authorized to bring civil injunctive suits for violations of any of the provisions of that

219. See note 214 *supra*; Timmeny, *supra* note 216; Baruch, *Foreign Corrupt Practices Act*, 57 HARV. BUS. REV. 32 (1979); Atkinson, *The Foreign Corrupt Practices Act of 1977: An International Application of SEC's Corporate Governance Reforms*, 12 INT'L LAW. 703 (1978); Best, *The Foreign Corrupt Practices Act*, 11 REV. SEC. REG. 975 (1978); *Accounting Provisions of Foreign Corrupt Practices Act Discussed at New York Law Journal Seminar*, 451 SEC. REG. & L. REP. (BNA) D-1, D-2 (May 3, 1978); Olson, *Internal Accounting Control Mandated by the FCPA of 1977*, 372 N.Y.L.J. 26 (1978).

220. For a discussion of the requirements of section 13(b)(2)(A) of the Exchange Act, see *Guide to the New Section 13(b)(2)*, *supra* note 214, at 313-16.

221. For a discussion of the requirements of section 13(b)(2)(B) of the Exchange Act, see *id.* at 316-20.

222. *Id.* at 323-24. Established standards in the accounting profession already require an auditor to disclose any material weaknesses in internal accounting control to management. *Required Communication of Material Weaknesses in Internal Accounting Control*, AICPA Statement on Auditing Standards No. 20. In addition, an auditor is required to disclose to management any errors or irregularities which he believes may exist. *The Independent Auditor's Responsibility for the Detection of Errors and Irregularities*, AICPA Statement on Auditing Standards No. 16. Thus, to some degree auditors already are required to bring information to the attention of their clients which will facilitate compliance with section 13(b)(2).

Act.²²³ Therefore, such suits against accountants for violations of section 13(b)(2) could clearly follow. As compliance with the Act is primarily the responsibility of the subject companies, suits against accountants will probably be based on aider and abettor liability. In addition, the Commission may institute administrative proceedings for violations of section 13(b)(2). Further, rule 2(e) may be invoked as a means of disciplining accountants for alleged violations of the section.²²⁴ Finally, violations of section 13(b)(2) may be prosecuted criminally *vis-a-vis* section 32 of the Exchange Act, and presumably, criminal charges could be leveled against accountants for aiding and abetting violations of section 13(b)(2).²²⁵

The express language of the FCPA makes no mention of private rights of action for violations of any of its provisions. Thus, if such an action exists, it must be implied,²²⁶ although the legislative history of the Act is not entirely clear on this question.²²⁷ Such silence or ambiguity, however, does not preclude the implication of a private right of action.²²⁸ While the Supreme Court has been reluctant to imply private rights of action in recent years,²²⁹ both that Court and the lower courts have implied such actions in the past under various provisions of the Exchange Act where the statutes themselves and the legislative history have been silent on the issue,²³⁰ and they may do so again. The

223. 15 U.S.C.A. § 78u(d) (Supp. 1979). As discussed earlier, the courts have been willing to use their broad equitable powers to grant various forms of ancillary or other equitable relief in addition to issuing injunctions against violations of the federal securities laws. See notes 165-86 *supra* and accompanying text.

224. "The Commission, of course, will retain all of its existing remedies under the securities laws, and the committee anticipates that the Commission will continue to tailor remedies to fit the circumstances . . ." S. REP. NO. 114, 95th Cong., 1st Sess. 12 (1977). See Timmeny, *supra* note 216, at 40-42 for a discussion of administrative proceedings under section 15(c)(4) of the Exchange Act for violations of the FCPA.

225. Section 32(a) of the Exchange Act, 15 U.S.C. § 78ff (1976), provides that any person who willfully violates any provision of the Exchange Act "shall upon conviction be fined not more than \$10,000, or imprisoned not more than five years, or both." For a discussion of criminal liability under the federal securities laws, see notes 246-324 *infra* and accompanying text.

226. See generally Steinberg, *Implied Rights of Action Under Federal Law*, 55 NOTRE DAME LAW. 33 (1979) [hereinafter cited as Steinberg, *Implied Rights of Action*].

227. *But see* H.R. REP. NO. 640, 95th Cong., 1st Sess. 10 (1977) (suggesting that there may be an implied private right of action).

228. See Steinberg, *supra* note 97; Steinberg, *Implied Rights of Action*, *supra* note 226, at 47.

229. See Steinberg, *Implied Rights of Action*, *supra* note 226, at 42, 51.

230. See, e.g., *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971) (implied private right of action under section 10(b) of the Exchange Act); *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964) (implied private right of action under section 14(a) of the Exchange Act).

SEC, moreover, has clearly espoused the view that an implied private right of action for violations of the FCPA exists.²³¹ It can be expected that if such a private right of action is implied, accountants will be subject to civil liability, particularly for violations of section 13(b)(2).

One of the more difficult questions the accounting profession faces as a result of the FCPA is whether all deviations by a subject company from the requirements of section 13(b)(2) or transgressions of section 30(A), which prohibits "corrupt" payments, constitute violations of the respective provisions and therefore must be disclosed. Neither section speaks of materiality,²³² and indeed, the legislative history of the FCPA supports the argument that materiality is not a prerequisite to a violation.²³³ If that were the case, one could argue that the deviation itself, regardless of its materiality, constitutes a violation of the law and must be disclosed. Although not a panacea, it may be argued that, particularly under section 13(b)(2), a violation in and of itself is not *ipso facto* material, and therefore disclosure of a violation resulting from an immaterial deviation may not necessarily be required.²³⁴ Nonetheless, the absence of a materiality requirement will require greater scrutiny by accountants of their clients' compliance with the provisions of the FCPA.²³⁵

231. *Notification of Enactment of Foreign Corrupt Practices Act of 1977*, ASR No. 242 (1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,264, at 62,701. The Commission apparently has also adopted the view that a negligence standard will govern civil injunctive suits to enforce the FCPA. *Id.* Different culpability requirements for violations may exist under the various provisions of the FCPA. For example, nothing in the language of section 13(b)(2) suggests that any form of evil intent is necessary to establish a violation. The section simply imposes affirmative obligations on public companies as does section 13(a) of the Exchange Act (requiring reports by public companies). Indeed, at least one court has suggested that section 13(a) imposes strict liability and there is not even a need to show negligence to establish a violation. *SEC v. Wills*, 472 F. Supp. 1250 (D.D.C. 1978). The same logic could surely apply to section 13(b)(2). Section 30A of the Exchange Act, which prohibits bribes, may be another matter altogether. The legislative history of the FCPA apparently indicates that the term "corruptly" as used in section 30A of the Exchange Act connotes an evil intent or purpose. *Senate Comm. on Banking, House and Urban Affairs, Corrupt Overseas Payments by U.S. Business Enterprises*, S. REP. No. 131, 94th Cong., 2d Sess. 7 (1976). If that is the case, scienter may be required to establish a violation.

232. See Timmeny, *supra* note 216, at 33-36; *Guide to New Section 13(b)(2)*, *supra* note 214, at 314-24.

233. H. R. REP. No. 831, 95th Cong., 1st Sess. 10 (1977); Securities Exchange Act Release No. 15570 (1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,959, at 81,394.

234. *Notification of Enactment of Foreign Corrupt Practices Act of 1977*, ASR No. 242 (1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,264, at 62,701 ("Although the legality or illegality of a particular transaction is one of the factors that must be assessed in determining its materiality, other factors must also be considered."). See *Report on Questionable and Illegal Corporate Payments and Practices*, submitted by the SEC to the Senate Committee on Banking, Housing and Urban Affairs on May 12, 1976, at 16-32.

235. In Securities Exchange Act Release No. 34-15570, [1979 Transfer Binder] FED. SEC.

The FCPA certainly raises several new questions as to the responsibilities and liabilities of accountants. These questions will no doubt find their way into the courtroom at a future date and will, in all likelihood, result in the tailoring of new duties and responsibilities for accountants.

F. Recent Regulatory Developments and Oversight of the Accounting Profession

The 1970's ended and the 1980's began with several new and significant regulatory developments that can be expected to have a direct impact on accountants. For example, as the 1970's came to a close the Commission adopted new regulation 13B-2, dealing with record-keeping requirements, accountability over assets and financial statement preparation.²³⁶ The Commission also proposed new rules which, had they been adopted, would have required a public company's management to give its opinion on the effectiveness of the company's internal accounting controls, and would also have required the company's independent accountants to examine and report on management's opinion.²³⁷ In addition, the Commission adopted new rules dealing with accountants' liability for filed quarterly financial statements containing limited review reports.²³⁸ Finally, the Commission continued its close oversight of the accounting profession's ability to adequately regulate itself.²³⁹

L. REP. (CCH) ¶ 81,959 (Feb. 15, 1979), the Commission adopted final rules to promote the reliability of financial information and to prevent the concealment of questionable or illegal corporate payments and practices. The Release stated that "[i]t bears emphasis . . . that the new requirements [of section 13(b)(2)(A)] are qualified by the phrase 'in reasonable detail' rather than the concept of 'materiality.'" *Id.* at 81,396. Later in the Release, the Commission stated that "[t]he statute does not require perfection but only that books, records and accounts 'in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer.'" *Id.* at 81,398.

236. Securities Exchange Act Release No. 15570, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,959 (Feb. 15, 1979) (questionable payments rules).

New Rule 13B2-1 provides that no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act. In addition, New Rule 13B2-2 prohibits officers and directors of an issuer from making materially false, misleading or incomplete statements to an accountant in connection with any audit or examination of the financial statements of the issuer or the filing of required reports.

Id. (citations omitted).

237. Securities Exchange Act Release No. 15772, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,063 (Apr. 30, 1979). The Commission declined to adopt the proposed rules.

238. Securities Act Release No. 6173 (Dec. 28, 1979), 6 FED. SEC. L. REP. (CCH) ¶ 72,296.

239. *Securities and Exchange Commission (Second) Report to Congress on the Accounting*

Each of these developments raises several significant questions about the responsibility and liability of accountants. For example, the adoption of regulation 13B-2 may well expand the responsibilities of accountants by virtue of a perceived need to examine the conformity of a company's internal systems to the dictates of the regulation. Similarly, the proposed rules dealing with management's statement on internal accounting controls, if they had been adopted, would have expanded the responsibilities of accountants to include an examination of and report on internal accounting controls and management's statement thereon. This would have generated claims of liability when management's statement was found deficient.²⁴⁰ In the same vein, the Commission's adoption of rules designed to exclude accountants from potential liability for limited review reports on quarterly financial statements may lull accountants into a false sense of security with respect to these reports.²⁴¹

Profession and the Commission's Oversight Role, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,120 (June 28, 1979); *Report of the Securities and Exchange Commission on the Accounting Profession and the Commission's Oversight Role*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,634 (July 1, 1978). For a discussion of the SEC's third annual report to Congress, see 569 SEC. REG. & L. REP. (BNA) D-1 (Sept. 10, 1980).

240. See generally *Statement of Management on Internal Accounting Control—Comments on the SEC Rule Proposals* (Release No. 34-15772), 35 BUS. LAW. 311 (1979).

241. On September 20, 1979, the SEC published rule proposals for public comment dealing with accountants' liability under section 11(a) of the Securities Act for reports rendered on interim financial statements which are included in filed registration statements. *Accountant Liability for Reports on Unaudited Interim Financial Information Under Securities Act of 1933*, Securities Act Release No. 6127 (Sept. 20, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,308. The Commission expressed the desirability of encouraging the inclusion of such reports in filed registration statements, reasoning that: "the involvement of independent accountants will add the expertise of professional accountants with wide experience in reporting problems. . . . This should improve individual company reporting and direct greater professional attention to the general problems of interim reporting." *Id.* at 82,334 (citations omitted).

The Commission's Release, however, went on to point out that reluctance on the part of accountants to issue such reports, based on limited review procedures rather than full-blown audits, had been expressed because of potential liability under section 11(a) of the Securities Act. *Id.* at 82,336. See notes 22-40 *supra* and accompanying text for a discussion of liability of accountants under section 11. Consequently, the Commission, in an effort to diminish this reluctance, proposed and adopted rules designed to exclude accountants from section 11 liability for such reports.

The method utilized by the Commission was to exclude accountants' reports on interim financial statements from the definition of "report" as used under section 11. See *id.* at 82,338-39; Securities Act Release No. 6173 (Dec. 28, 1979), 6 FED. SEC. L. REP. (CCH) ¶ 72,296. While the ingenious means utilized by the Commission may well have its intended effect, there is always the risk that a court may disagree with the Commission's interpretation and conclude that such a report is a "report" within the meaning of section 11. It seems clear that the interim financial statement report would, except for the Commission's rule, come within the express language of section 11. Thus, while the Commission may have the

Finally, and perhaps most importantly, the Commission continues with its commitment to monitor the ability of the accounting profession to effectively regulate itself and to achieve the goal of promoting confidence in financial reporting.²⁴² In the words of the Commission:

During the past several years, public and Congressional attention has been focused to an unprecedented degree on the accounting profession and on its role in promoting public confidence in the integrity of financial reporting. The Federal securities laws, since their enactment in the aftermath of the economic crisis of the early 1930's, have authorized the Commission to require that independent accountants audit the financial statements of publicly-held corporations. Thus, those laws have placed upon the accountant unique and important responsibilities in facilitating the proper functioning of this nation's capital formation processes and, more broadly, of our economic system as a whole.²⁴³

The primary focus of the Commission's monitoring of the accounting profession has been in the areas of independence, the encouragement of corporate audit committees, management advisory services, self-regulation and oversight.²⁴⁴ The accounting profession has re-

authority to promulgate the rule, there is always the possibility that a court could take the position that the Commission's rule goes beyond the language of the statute and therefore it cannot be interpreted as urged by the Commission. Similar reasoning led the Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), to conclude that despite the language of rule 10b-5, which could be read not to require scienter, the language of section 10(b), which rule 10b-5 was designed to implement, was controlling and required scienter.

In 1980, the Commission published proposed amendments to a rule which would exclude accountants' reports on unaudited supplementary information as to the effects of changing prices and as to oil and gas reserves from the definition of "report" under sections 7 and 11 of the Securities Act, and thus would have the intended effect of excluding accountants from section 11(a) liability for such reports. Securities Act Release No. 6208 (Apr. 30, 1980), [Current] FED. SEC. L. REP. (CCH) ¶ 82,499. See AICPA, Financial Accounting Standards Board Statement No. 33.

242. Among other things, the Commission attributed the following recent developments to the heightened attention the accounting profession has received:

Further, the incidence of significant unexpected failures by major corporations and the disclosure of widespread questionable payments and illegal acts in the 1970's, among other events, have raised concerns about the integrity and credibility of financial controls and reporting of publicly-owned companies and, consequently, the role and responsibility of the accounting profession has come under careful scrutiny. A broad examination of the nature and structure of the accounting profession has resulted.

Report of the Securities and Exchange Commission on the Accounting Profession and the Commission's Oversight Role, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,634, at 80,545 (July 1, 1978).

243. *Id.*

244. See *Securities and Exchange Commission Report to Congress on the Accounting Pro-*

sponded by implementing a host of changes in its self-regulatory framework and by promulgating new principles and standards in identified areas of concern. While not entirely satisfied with the profession's progress, as well as some of its conclusions on controversial subjects, the Commission appears, for the present, to be satisfied with the strides that have been made.²⁴⁵

II. CRIMINAL LIABILITY

From a general perspective, the overwhelming number of criminal suits for violations of the federal securities laws have been brought under section 24 of the Securities Act²⁴⁶ and section 32(a) of the Exchange Act.²⁴⁷ These statutes, however, are not the sole sources of accountant criminal liability under federal law. The Federal Mail Fraud Statute,²⁴⁸ the False Statements Section of the Criminal Code,²⁴⁹ the

profession and the Commission's Oversight Role, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,120, at 81,954-74 (June 28, 1979); *Report of the Securities and Exchange Commission on the Accounting Profession and the Commission's Oversight Role*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,634, at 80,545-56 (July 1, 1978).

245. For example, in its concluding remarks to the second report to Congress, the Commission stated:

The Commission believes that progress has been sufficient to merit continued opportunity for the profession to pursue its efforts at self-regulation. Consequently, the Commission is not recommending, at this time, legislation to supersede or control the regulation of accountants.

[1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,120, at 81,973 (June 28, 1979). At another point in its second report, the Commission stated:

[I]n our report last year, the Commission asked the profession to study two specific questions—the need for a professional standard mandating independent audit committees and the scope of auditor management advisory services—which, in the Commission's view, may impact directly on independence and credibility. In both cases, although the profession's responses were thorough and timely, its conclusions were disappointing and indicative of the need for further Commission consideration.

Id. at 81,955.

246. 15 U.S.C. § 77x (1976).

247. 15 U.S.C. § 78ff(a) (1976). See Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901, 905 (1971) [hereinafter cited as Mathews]; Note, *The Securities and Exchange Commission: An Introduction to the Enforcement of the Criminal Provisions of the Federal Securities Laws*, 17 AM. CRIM. L. REV. 121, 133-34 (1979) [hereinafter cited as *Introduction to the Criminal Provisions*].

While the majority of criminal cases have been brought under the Securities Act and the Exchange Act, the other federal acts which come within the penumbra of the "federal securities laws" also contain criminal provisions. See Public Utility Holding Company Act of 1935, § 29, 15 U.S.C. § 79z-3 (1976); Trust Indenture Act of 1939, § 325, 15 U.S.C. § 77yyy (1976); Investment Company Act of 1940, § 49, 15 U.S.C. § 80a-48 (1976); Investment Advisers Act of 1940, § 217, 15 U.S.C. § 80b-17 (1976).

248. 18 U.S.C.A. § 1341 (Supp. 1979).

249. 18 U.S.C. § 1001 (1976).

offenses of conspiracy,²⁵⁰ aiding and abetting,²⁵¹ criminal contempt for willful violation of an injunction²⁵² and willful noncompliance with an administrative subpoena issued by the SEC²⁵³ provide alternative bases for imposing accountant criminal liability. In addition, the Blue Sky Laws of every state, many of which have adopted the Uniform Securities Act's provisions on criminal sanctions, authorize the imposition of fines or imprisonment for willful violations.²⁵⁴ Although accountants can be prosecuted under any of the foregoing provisions, attention has generally focused on accountant liability under the Securities Act, the Exchange Act and the Mail Fraud Statute.²⁵⁵

A. A General Perspective of Criminal Prosecutions

Although a number of provisions under the federal securities laws can be employed to provide a basis for imposing criminal liability,²⁵⁶ the ones most frequently utilized are the antifraud prohibitions contained in section 17(a) of the Securities Act and section 10(b) of the Exchange Act²⁵⁷ and the registration provisions of section 5 of the Securities Act.²⁵⁸ However, the foregoing statutory provisions are not in and of themselves criminal statutes. Instead, section 24 of the Securities Act and section 32 of the Exchange Act generally make willful violations of any provision, rule or regulation of the respective Acts a

250. 18 U.S.C. § 371 (1976).

251. 18 U.S.C. § 2 (1976).

252. *See, e.g.*, Frank v. United States, 395 U.S. 147 (1969); Williams v. United States, 402 F.2d 47 (10th Cir. 1967); United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967). With respect to the requisite state of mind for a criminal contempt conviction, the Fourth Circuit Court of Appeals stated:

The appellants already breached the law and had been enjoined not to do so again; yet they knowingly repeated the selfsame forbidden acts. It is not consonant with reason, in these circumstances, to demand a more explicit demonstration of an evil mind in order to sustain the conviction for criminal contempt.

376 F.2d at 682.

253. Each of the Acts that make up the federal securities laws, except for the Securities Act, contains a provision making willful noncompliance with a subpoena punishable by fine and/or imprisonment.

254. *See* H. SOWARDS & N. HIRSCH, BUSINESS ORGANIZATIONS—BLUE SKY REGULATION § 9.03 (1979).

255. *See, e.g.*, United States v. Natelli, 527 F.2d 311 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976); United States v. Zane, 495 F.2d 683 (2d Cir.), *cert. denied*, 491 U.S. 895 (1974); United States v. Bruce, 488 F.2d 1224 (5th Cir.), *cert. denied*, 419 U.S. 825 (1973); United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970); Getchell v. United States, 282 F.2d 681 (5th Cir. 1960).

256. *See* note 247 *supra*.

257. *See Introduction to the Criminal Provisions, supra* note 247, at 133; Mathews, *supra* note 247, at 907.

258. Section 3 of the Securities Act exempts certain types of securities from the application of section 5, and section 4 of the Act exempts certain transactions.

crime. Hence, criminal violations of the antifraud or registration provisions must be prosecuted under the express authority of sections 24 and 32. Since these two sections are somewhat different, they will be set out in their entirety. Section 24 of the Securities Act provides:

Any person who willfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than \$10,000 or imprisoned not more than five years, or both.²⁵⁹

Section 32 of the Exchange Act provides:

Any person who willfully violates any provision of this title (other than section 30A), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this title, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than \$10,000, or imprisoned not more than five years, or both, except that when such person is an exchange, a fine not exceeding \$500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.²⁶⁰

Before the criminal provisions may be invoked, some nexus with the means or instrumentalities of interstate commerce must be shown.²⁶¹ This jurisdictional nexus, however, is not difficult to establish. Use of the telephone, the mails, the wire services, the facilities of

259. 15 U.S.C. § 77x (1976).

260. 15 U.S.C. § 78ff(a) (1976).

261. One need look only so far as the express language of the statutes to discover this

the national securities exchanges or other means of commerce are commonplace in business transactions. The violation itself need not be committed by means of the jurisdictional nexus, but some part of the scheme or course of conduct must touch the jurisdictional means.²⁶² Therefore, even mailing annual reports to stockholders or to the SEC invokes the jurisdiction of the statutes.²⁶³

Generally, both sections 24 and 32 make a willful violation of any provision, rule or regulation of the respective Acts a crime. However, by virtue of the express language of section 32, violation of a rule or regulation under the Exchange Act is not a crime unless such violation "is made unlawful" or observance of the rule or regulation is required under the terms of the Exchange Act.²⁶⁴ Under section 24, presumably violation of any rule or regulation promulgated by the SEC under the authority of the Securities Act is criminally punishable.

The most evident inconsistency in the language of sections 24 and 32 is the dual use of the terms "willfully" and "willfully and knowingly." Section 24 employs only the term willfully. Section 32, on the other hand, employs both terms. The question is therefore, what significance, if any, has been and should be attached to the different terms.

The "willfulness" and "knowledge" requirements have not been uniformly construed by the courts.²⁶⁵ The Second Circuit, in *United States v. Peltz*,²⁶⁶ construed "willfully" under section 32(a) to signify that there must exist " 'a realization on the defendant's part that he was doing a wrongful act'. . . with the qualifications . . . that the act be wrongful under the securities laws and that the knowingly wrongful act

limitation. See, e.g., sections 5 and 17 of the Securities Act and section 10(b) of the Exchange Act.

262. See Mathews, *supra* note 247, at 920-25. See, e.g., *Woodward v. Metro Bank*, 522 F.2d 84, 93 n.19 (5th Cir. 1975); *Dupuy v. Dupuy*, 511 F.2d 641, 642-44 (5th Cir. 1975), *cert. denied*, 434 U.S. 911 (1977); *United States v. MacKay*, 491 F.2d 616, 629 (10th Cir. 1973), *cert. denied*, 416 U.S. 972 (1974). See generally 5A A. JACOBS, *THE IMPACT OF RULE 10B-5* § 37:01, at 2-7 to 2-12 (1974); 3 L. LOSS, *SECURITIES REGULATION* 1524 (2d ed. 1961) [hereinafter cited as Loss].

263. See, e.g., *United States v. Simon*, 425 F.2d 796, 805 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

264. This distinction has gone unnoticed by commentators. See, e.g., Mathews, *supra* note 247, at 904-06; *Introduction to the Criminal Provisions*, *supra* note 247, at 126-27.

265. "[W]illful" is a word 'of many meanings, its construction often being influenced by its context.' *Screws v. United States*, 325 U.S. 91, 101 (1945) (quoting *Spies v. United States*, 317 U.S. 492, 497 (1943)). See *United States v. Benjamin*, 328 F.2d 854, 860-61 (2d Cir.), *cert. denied sub nom. Howard v. United States*, 377 U.S. 953 (1964). See Mathews, *supra* note 247, at 950-51; Note, *Federal Criminal and Administrative Controls for Auditors: The Need for a Consistent Standard*, 1969 WASH. U.L.Q. 187, 189-90.

266. 433 F.2d 48 (2d Cir. 1970), *cert. denied*, 401 U.S. 955 (1971).

involve a significant risk of effecting the violation that has occurred."²⁶⁷ Also relevant is the Supreme Court's language in *United States v. Murdock*,²⁶⁸ an income tax evasion case:

The word [willfully] often denotes an act which is intentional, or knowing, or voluntary, as distinguished from accidental. But when used in a criminal statute it generally means an act done with a bad purpose; without justifiable excuse; stubbornly, obstinately, perversely. The word is also employed to characterize a thing done without ground for believing it is lawful, or conduct marked by careless disregard whether or not one has the right so to act.²⁶⁹

Based on a literal reading of *Murdock*, it could be argued that the terms "willfully" and "knowingly" are synonymous. Indeed, Professor Loss has suggested that "knowingly" as contained in section 32(a) is redundant and that "willfully" alone is controlling.²⁷⁰ Judge Friendly, on the other hand, has concluded that Congress deliberately inserted the "knowingly" requirement in the second clause of section 32(a) to ensure the inclusion of a term which has "typically [been] associated with prosecution for acts grounded in fraudulent intent."²⁷¹ The debate on whether or not a real distinction exists between the terms "willful" and "knowingly" continues.²⁷²

Even if "knowingly" is read separately, it seems clear that the government need not show, in a prosecution under either section 24 or section 32, a specific intent on the defendant's part to violate the law.²⁷³ It does appear, however, that while the "willfulness" requirement as interpreted by some courts may be satisfied by the prosecution without showing an evil purpose by the defendant,²⁷⁴ such a showing will be required when a defendant is criminally charged with a "willful and

267. *Id.* at 54 (quoting Herlands, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 VA. L. REV. 139, 149 (1934)). For a discussion of *Peltz*, see *United States v. Dixon*, 536 F.2d 1388, 1395 (2d Cir. 1976).

268. 290 U.S. 389 (1933).

269. *Id.* at 394-95 (citations omitted).

270. 3 Loss, *supra* note 262, at 1986-87.

271. *United States v. Dixon*, 536 F.2d 1388, 1396 (2d Cir. 1976).

272. See *Introduction to the Criminal Provisions*, *supra* note 147, at 128, 132.

273. *United States v. Dixon*, 536 F.2d at 1397; *United States v. Schwartz*, 464 F.2d 499, 509 (2d Cir.), *cert. denied*, 409 U.S. 1009 (1972). In *Schwartz*, the court stated that: "Proof of a specific intent to violate the law is not necessary to uphold a conviction under § 32(a) of the Act, provided that satisfactory proof is established that the defendant intended to commit the act prohibited." *Id.* at 509.

274. See H. SOWARDS, BUSINESS ORGANIZATIONS—THE FEDERAL SECURITIES ACT § 10.04[1] (1978) [hereinafter cited as SOWARDS].

knowing" violation under section 32(a).²⁷⁵

Because of the different constructions the courts have placed on the term "willfully" as used in the different Acts, and on the term "willfully and knowingly" as used in the Exchange Act, it is difficult to draw clear distinctions between them. The use of "willfully and knowingly" in the second clause of section 32, coupled with the mitigating effect of the last clause in the section, which precludes imprisonment (but not imposition of a fine) for a violation if the defendant proves that he lacked knowledge of the rule or regulation, has led some courts to adopt a less strict definition of willfully as used in the first clause of section 32 than that ordinarily given to the term.²⁷⁶ As implicitly noted by the Ninth Circuit, it follows that the term "willfully" as used in section 24 of the Securities Act, which does not contain any mitigating language for lack of knowledge on the defendant's part, may well be more difficult to prove than "willfully" as used in section 32.²⁷⁷

Even though *specific* intent to defraud is not required to establish a criminal violation of either section 17(a) of the Securities Act or section 10(b) of the Exchange Act when prosecuted *vis-a-vis* sections 24 and 32, an intent to defraud must be shown.²⁷⁸ This intent may be evidenced through conduct designed to deceive, defraud or mislead.²⁷⁹ There is no requirement, however, that the defendant know that he is violating a specific statute.²⁸⁰ On the other hand, a showing of "good faith," but not blind faith,²⁸¹ by the defendant will provide a viable defense to criminal charges.²⁸²

275. See *United States v. Dixon*, 536 F.2d at 1395-98; SOWARDS, *supra* note 274 § 10.04[1], at 10-33 to 10-34.

276. *United States v. Dixon*, 536 F.2d at 1397. See *United States v. Brown*, 578 F.2d 1280, 1284-85 (9th Cir. 1978), *cert. denied*, 440 U.S. 975 (1979); *United States v. Peltz*, 433 F.2d 48, 54-55 (2d Cir. 1970), *cert. denied*, 401 U.S. 955 (1971); *United States v. Charnay*, 537 F.2d 341, 351-52 (9th Cir.), *cert. denied sub nom. Davis v. United States*, 429 U.S. 1000 (1976).

277. *United States v. Brown*, 578 F.2d at 1284-85.

278. See note 273 *supra*; *United States v. Brown*, 578 F.2d at 1284-85. See also *United States v. Amick*, 439 F.2d 351, 369 (7th Cir.), *cert. denied sub nom. Irving v. United States*, 403 U.S. 918 (1971).

279. *United States v. Charnay*, 537 F.2d at 351-52; *United States v. Piepgrass*, 425 F.2d 194, 198 (9th Cir. 1970). See *Introduction to the Criminal Provisions, supra* note 247, at 128-31.

280. See note 273 *supra* and accompanying text.

281. Closing one's eyes to what can plainly be seen, or believing the unbelievable, will not suffice as a defense. See *Wall v. United States*, 384 F.2d 758, 762 (10th Cir. 1967); *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964). Blind faith can constitute criminal, not to mention civil, recklessness sufficient to sustain a charge of violations of the antifraud provisions of the Securities Acts. See *id.*

282. See Mathews, *supra* note 247, at 954.

The various culpability standards in criminal cases charging violations of the antifraud prohibitions of the Securities Acts appear to have remained intact after the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*.²⁸³ In *Hochfelder*, the Court reasoned that the "manipulative," "deceptive" and "device or contrivance" language as used in section 10(b) of the Exchange Act, connotes intentional or willful conduct.²⁸⁴ While the prior formulations of the state of mind requirements may have been affected by *Hochfelder*, it would appear that they were not;²⁸⁵ the question, however, has not been definitively decided.

In addition to the federal securities laws, the Mail Fraud Statute²⁸⁶ has frequently been employed in criminal prosecutions involving accountants.²⁸⁷ The statute prohibits the use of the mails in furtherance of a scheme or artifice to defraud.²⁸⁸ Allegations of mail fraud and securities law violations are often joined in a single indictment.²⁸⁹ Because the Mail Fraud Statute, like certain provisions of the securities laws,²⁹⁰ reaches schemes to defraud, "it is not essential that the Government allege or prove that purchasers were in fact defrauded."²⁹¹ Moreover, "reckless disregard for the truth of a statement is sufficient

283. 425 U.S. 185 (1976). The same conclusion appears to be true after the Supreme Court's recent decision in *Aaron v. SEC*, 100 S. Ct. 1945 (1980).

284. 425 U.S. at 199.

285. *Introduction to the Criminal Provisions*, *supra* note 247, at 130-31.

286. 18 U.S.C.A. § 1341 (Supp. 1979).

287. *See, e.g.*, *United States v. Bruce*, 488 F.2d 1224, 1225 (5th Cir. 1973), *cert. denied*, 419 U.S. 825 (1974); *United States v. Benjamin*, 328 F.2d 854, 856 (2d Cir. 1964); *United States v. White*, 124 F.2d 181, 182 (2d Cir. 1941).

288. 18 U.S.C.A. § 1341 (Supp. 1979) provides:

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than \$1000 or imprisoned not more than five years, or both.

289. *United States v. Dixon*, 536 F.2d 1388, 1399 (2d Cir. 1976). *See United States v. Brien*, 617 F.2d 299, 310 (1st Cir. 1980).

290. *E.g.*, section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976). In *Bruce*, the Fifth Circuit commented on the similarities between the Mail Fraud Statute and section 17(a). 488 F.2d at 1229-30.

291. *United States v. Dixon*, 536 F.2d at 1399 n.11 (quoting *United States v. Andreadis*, 366 F.2d 423, 431 (2d Cir. 1966), *cert. denied*, 385 U.S. 1001 (1967)). Note, however, that although the government need not show that purchasers were defrauded, "this does not mean that the government can escape the burden of showing that some actual harm or

to sustain a conviction for securities or mail fraud."²⁹²

B. Criminal Case Law

With the foregoing principles in mind, the following discussion will analyze the more significant cases involving accountants' criminal liability. The first such case is *United States v. White*,²⁹³ where the defendant, a public accountant, was charged with preparing false financial statements that were contained in prospectuses mailed to investors. The prosecution was unable to prove directly that the defendant knew the statements were false but instead relied on the inference that an accountant of the defendant's experience and intelligence could not have permitted such gross irregularities to pass without becoming aware of the underlying fraud.²⁹⁴ In affirming the defendant's conviction for mail and securities fraud, Judge Learned Hand observed:

It is true that all these instances, taken singly, do not prove beyond question that [the defendant] knew that the statements which he prepared were padded with false entries; but logically the sum is often greater than the aggregate of the parts, and the cumulation of instances, each explicable only by extreme credulity or professional inexpertness, may have a probative force immensely greater than any one of them alone.²⁹⁵

Implicit in Judge Hand's statement is the idea that an accountant cannot close his eyes to the presence of fraud.²⁹⁶ The accountant in *White* argued in defense that he committed no act knowingly, but rather took information from the books of the company and from those who managed the company, and placed such information in the financial statements.²⁹⁷ To this Judge Hand responded: "[F]aced with the choice of finding him a knave or a fool, we cannot say that the jury was bound to acquit him; fair men might have had no compunction in refusing to believe that he was so credulous or so ill acquainted with his

injury was contemplated." 536 F.2d at 1399 n.11 (quoting *United States v. Regent Office Supply Co.*, 421 F.2d 1174, 1180 (2d Cir. 1970)).

292. *Nelson v. Serwold*, 576 F.2d 1332, 1336-37 (9th Cir.), cert. denied, 439 U.S. 970 (1978) (securities fraud); *United States v. McDonald*, 576 F.2d 1350, 1358-59 (9th Cir.), cert. denied, 439 U.S. 830 (1978) (mail fraud).

293. 124 F.2d 181 (2d Cir. 1941).

294. *Id.* at 182.

295. *Id.* at 185.

296. See Note, *Criminal Liability of Public Accountants: A Lurking Nightmare?* 67 J. CRIM. L. AND CRIMINOLOGY 32, 36-37 (1976) [hereinafter cited as *Lurking Nightmare*]; text accompanying note 302 *infra*.

297. 124 F.2d at 182.

calling as a finding of innocence demanded."²⁹⁸

Judge Hand's suggestion that an accountant may not legally ignore the presence of fraud became explicit in *United States v. Benjamin*,²⁹⁹ in which a certified public accountant, who prepared pro forma statements relating to the financial structure of his client, rendered false reports stating that certain auditing work had been performed and certain assets existed when, in reality, no examination or verification procedures had been used.³⁰⁰ Rejecting the defendant's contention that the evidence against him was insufficient to prove the state of mind necessary for a criminal conviction, Judge Friendly responded that the government could "meet its burden by proving that a defendant closed his eyes to facts he had a duty to see, . . . or recklessly stated as facts things of which he was ignorant."³⁰¹ Of particular relevance, Judge Friendly reflected:

In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar. Of course, Congress did not mean that any mistake of law or misstatement of fact should subject an attorney or an accountant to criminal liability simply because more skillful practitioners would not have made them. But Congress equally could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.³⁰²

298. *Id.* at 185.

299. 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964).

300. *Id.* at 856-60.

301. *Id.* at 862 (citations omitted).

302. *Id.* at 863. In upholding the accountant's conviction, the court also enunciated the following principle regarding the requisite state of mind:

It is true that the Government had not merely to show that the statements were false but to present evidence from which the judge could be convinced beyond reasonable doubt of [the accountant's] culpable state of mind. But, as Judge Hough said for this court years ago, "when that state of mind is a knowledge of false statements, while there is no allowable inference of knowledge from the mere fact of falsity, there are many cases where from the actor's special situation and continuity of conduct an inference that he *did* know the untruth of what he said or wrote may legitimately be drawn." . . . Any accountant must know that his obligations in certifying "pro forma" statements are not satisfied by any such arithmetical exercise as [the defendant accountant] performed. But, as our description of the reports has indicated, there were further false assertions, some of them clearly known to [defendant] to be such; these constituted a basis for holding him that was independent of the falsity of the total report, as well as for discrediting his assertions of ignorance as to what was required of him.

One question that remained unanswered after *White* and *Benjamin* was whether compliance with generally accepted accounting principles or generally accepted auditing standards immunized an auditor from criminal liability. In *United States v. Simon*,³⁰³ this question was addressed. As stated earlier,³⁰⁴ *Simon* involved the conviction of three accountants of an internationally known firm for designing and certifying misleading and false financial statements. Specifically, the accountants were accused of drawing up a footnote to their client's financial statements which concealed looting of the corporation by its president.³⁰⁵ At their trial, eight expert independent accountants testified that, with the exception of one error, the footnote was not inconsistent with either GAAP or GAAS.³⁰⁶

The defendants requested a jury instruction that would make proof of compliance with GAAP a valid defense so that if the financial statements as a whole did not fairly reflect the corporation's financial condition, a guilty verdict could be returned only if such deviation from accepted standards "was due to willful disregard of those standards with knowledge of the falsity of the statements and an intent to deceive."³⁰⁷ The trial judge refused to give the requested instruction but rather instructed the jury that the "critical test" was whether the financial statements as a whole fairly and accurately presented the corporation's condition, and, if not, whether the defendants had acted in good faith. Proof of compliance with generally accepted standards, the trial judge instructed, should be "evidence which may be very persuasive but not necessarily conclusive that he acted in good faith" ³⁰⁸

On appeal, the Second Circuit upheld the propriety of the trial judge's instruction, noting, however, that proof of compliance with generally accepted standards may be a valid defense as to questions of overall fair presentation in those instances where the auditor can point to specific GAAP rules or prohibitions.³⁰⁹ Writing for the court, Judge Friendly expanded upon the relationship of GAAP to an auditor's responsibilities once he discovers or has reason to believe that there is fraud afoot:

Id. at 861-62 (citations omitted).

303. 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

304. See notes 82-87 *supra* and accompanying text.

305. 425 F.2d at 799-804.

306. *Id.* at 805.

307. *Id.*

308. *Id.* See *United States v. Weiner*, 578 F.2d 757, 785-86 (9th Cir. 1978), *cert. denied*, 99 S. Ct. 568 (1979) (citing *Simon* as authority for particular jury instructions).

309. 425 F.2d at 806.

Generally accepted accounting principles instruct an accountant what to do in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe that this basic assumption is false, an entirely different situation confronts him. Then, . . . he must "extend his procedures to determine whether or not such suspicions are justified." If . . . his suspicions [are] confirmed, full disclosure must be the rule, unless he has made sure the wrong has been righted and procedures to avoid a repetition have been established³¹⁰

In *United States v. Weiner*,³¹¹ a more recent case involving an issue akin to that presented in *Simon*, three accountants employed as auditors for Equity Funding Corporation argued that they approved of and concurred in the grossly misleading financial statements in the good faith belief that such statements were accurate representations of the actual financial condition of the company.³¹² One issue raised in connection with this defense was whether the defendants, in auditing Equity Funding's financial statements, complied with both GAAS and GAAP. Relying on *Simon*, the Ninth Circuit held that, although not conclusive, evidence regarding compliance with GAAS and GAAP was a relevant consideration in the jury's determination of whether the defendants acted with knowledge and willfulness as required by section 32(a) of the 1934 Act with respect to reports or other documents filed with the Commission.³¹³

310. *Id.* at 806-07. Also relevant is the following statement by the *Simon* court:

We join defendants' counsel in assuming that the mere fact that a company has made advances to an affiliate does not ordinarily impose a duty on an accountant to investigate what the affiliate has done with them or even to disclose that the affiliate has made a loan to a common officer if this has come to his attention. But it simply cannot be true that an accountant is under no duty to disclose what he knows when he has reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders but for the private benefit of its president. For a court to say that all this is immaterial as a matter of law if only such loans are thought to be collectible would be to say that independent accountants have no responsibility to reveal known dishonesty by a high corporate officer. If certification does not at least imply that the corporation has not been looted by insiders so far as the accountants know, or, if it has been, that the diversion has been made good beyond peradventure (or adequately reserved against) and effective steps taken to prevent a recurrence, it would mean nothing, and the reliance placed on it by the public would be a snare and a delusion.

Id. at 806.

311. 578 F.2d 757 (9th Cir. 1978).

312. *Id.* at 784.

313. *Id.* at 785-86. Commenting on the defendants' state of mind, the Ninth Circuit stated:

The overwhelming scope of the fraud, its often complex but sometimes very simple

The Second Circuit's decision in *United States v. Natelli*,³¹⁴ in which the court affirmed the conviction of a partner in a major international accounting firm for violating section 32(a) of the 1934 Act, is also significant. In *Natelli*, the violations arose out of a proxy statement issued by National Student Marketing Corporation (Marketing) and filed with the SEC. The indictment charged that the partner and an audit supervisor, whose conviction was reversed by the court of appeals,³¹⁵ created a materially false and misleading explanatory footnote in the proxy statement by attempting to reconcile certain income statement accounts. The indictment also charged the accountants with knowledge of Marketing's materially overstated net sales and earnings as they were reflected in the nine-month interim financial statements included in the proxy statement.³¹⁶

On appeal, the Second Circuit rejected the partner's contention that there was insufficient evidence to support the jury's finding that he knowingly committed the acts charged in the indictment. As to the false footnote, the court noted that the footnote was the only place in the proxy statement where an interested investor could compare Marketing's performance, as evidenced in its previous 1968 Annual Report, with its 1969 performance, as retroactively adjusted, separate and apart from the sales and earnings of the companies that Marketing had acquired in fiscal 1969. Under such circumstances, the accountant partner had a duty to correct the earlier financial statement. Knowing that the 1968 audited statement was being relied upon and used continuously, he nevertheless concealed the fact that Marketing had taken substantial write-offs after the 1968 statement had been disseminated, to reflect a loss for the year.³¹⁷

Regarding the unaudited interim financial statement, the court of appeals noted that the partner failed to verify a significant transaction that had occurred under very suspicious circumstances and that had been entered in Marketing's books and reflected in the financial state-

mechanisms, and the failure of the auditors to find in any of the suspicious procedures cause to dig further into Equity Funding's financial records system all lead to the inescapable conclusion that defendants were involved. Even if they did not initially know or indeed learn the step-by-step fictitious entries and improper manipulations, their consistent failure to apply GAAS and GAAP after they knew some kind of a major fraud was afoot provided a basis from which the jury could reasonably infer defendants' knowing and willful participation in the fraud.

Id. at 784-85.

314. 527 F.2d 311 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976).

315. *Id.* at 325.

316. 527 F.2d at 314.

317. *Id.* at 317, 319.

ments just prior to the printing of the proxy statement.³¹⁸ On appeal, the partner argued that he had no duty to verify the earnings statement within which the last minute transaction was included because it was unaudited. Rejecting this argument, the Second Circuit observed that he was "associated" with the unaudited statement and was required to object to any matter that he knew was materially false.³¹⁹ While noting that in the ordinary case an auditor would not be liable because he neglected to uncover the invalidity of booked accounts receivable, the court observed that, in the case at bar, the partner "knew" about Marketing's dismal history of reporting inaccurate earnings. The court therefore concluded:

We do not think this means, in terms of professional standards, that the accountant may shut his eyes in reckless disregard of his knowledge that highly suspicious figures, known to him to be suspicious, were being included in the unaudited earnings figures with which he was "associated" in the proxy statement.³²⁰

Natelli's significance and possible impact must be underscored. At the time it was decided, it was perhaps the first criminal case under the federal securities laws where liability was imposed upon a certified public accountant with respect to an "unaudited" financial statement.³²¹ A subsequent state civil case has extended *Natelli's* reasoning

318. As the court remarked:

The Eastern contract was a matter for deep suspicion because it was substituted so rapidly for the Pontiac contract to which [the partner] had objected, and which had, itself, been produced after the end of the fiscal period, though dated earlier. It was still another unbilled commitment produced by Marketing long after the close of the fiscal period. Its spectacular appearance, as [the partner] himself noted at the time, made its replacement of the Pontiac contract "wiedr." The Eastern "commitment" was not only in substitution for the challenged Pontiac "commitment" but strangely close enough in amount to leave the projected earnings figures for the proxy statement relatively intact. Marketing had only time logs of a salesman relating to the making of the proposals but no record of expenditures on the Eastern "commitment," no record of having ever billed Eastern for services on this "sale," and not one scrap of paper from Eastern other than the suddenly-produced letter. Nevertheless, it was booked as if more than \$500,000 of it had already been earned.

Id. at 320.

319. *Id.* An auditor is "associated" with unaudited financial statements "when he has consented to the use of his name in a report, document or written communication setting forth or containing statements." AICPA, Professional Standards No. 1 § 516.03 (1977).

320. 527 F.2d at 320. See *Lurking Nightmare*, *supra* note 296, at 40-42.

321. See *Bonhiver v. Graff*, 311 Minn. 111, 117, 248 N.W.2d 291, 297 (1976) (citations omitted):

All accountant malpractice cases called to our attention have involved accountants who prepare or certify completed financial statements. No case cited by the parties passes on the liability of a certified public accountant when his work product is not a completed financial statement but is rather a set of unfinished workpapers and

to impose liability for the preparation of erroneous workpapers and the making of erroneous adjusting entries intended for an insurance company's books and records.³²² The Minnesota State Commissioner of Insurance and his examiners had relied on a private accountant's workpapers and entries to conclude that the insurance company under scrutiny was solvent. After the company collapsed, it was discovered that the accountant's workpapers and entries were erroneous. In affirming a finding of malpractice against the accounting firm and the individual accountant, the Minnesota Supreme Court premised its holding on the fact that "the defendants personally displayed their workpapers to the state examiners and knew that the examiners were relying upon them."³²³ Based on *Natelli's* reasoning, there can be little question that if the accountant had intentionally falsified his workpapers and the adjusting entries with the expectation that others would rely upon them to their detriment, criminal liability would be imposed. Such liability, depending on different factual circumstances, could rest on such statutes as section 17(a) of the Securities Act, section 10(b) of the Exchange Act, the Mail Fraud Statute, and the antifraud provisions of the state Blue Sky Laws.

The foregoing discussion suggests that the scope of accountants' criminal liability is expanding. *Simon* and *Weiner* define compliance with GAAP as a relevant, but not determinative, criterion in assessing a defendant's liability.³²⁴ *Natelli* and recent state court decisions have ramifications of imposing criminal liability upon accountants for preparing workpapers, making adjusting entries and being associated with unaudited financial statements. In light of these decisions, accountants

adjusting entries. Only one case passes on the liability of a certified public accountant with respect to an "unaudited" financial statement [*i.e.*, *Natelli*].

322. *Bonhiver v. Graff*, 311 Minn. 111, 248 N.W.2d 291 (1976). See *Seedkem, Inc. v. Safranek*, 466 F. Supp. 340 (D. Neb. 1979).

323. 311 Minn. at 119, 248 N.W.2d at 299. The court further remarked: "Defendants not only had actual knowledge of the fact that representations were being made by use of the workpapers and adjusting entries, but they made those representations themselves—by personally handing over the workpapers and adjusting entries." *Id.* Query whether liability would have been imposed if the insurance company had transmitted the workpapers to the state examiners without the accountant's knowledge. In an accompanying footnote, the court asserted that, in such a situation, perhaps liability should not be imposed. *Id.* at 119 n.4, 248 N.W.2d at 299 n.4. Yet, it is arguable that when an accountant prepares workpapers and sets forth adjusting entries for the company's books and records, foreseeable reliance by others could be *ipso facto* presumed in some circumstances.

324. Note that *Simon* dealt principally with compliance with GAAP, while *Weiner* considered the relevancy of compliance with both GAAP and GAAS. See notes 77-94 *supra* and accompanying text; Liebhafsky, *Accountants Liability—Recent Developments*, N.Y.L.J., July 24, 1979, at 2, col. 1.

must engage in their professional practice in a most prudent and circumspect manner.

III. COMMON LAW LIABILITY

Because a wealth of material has been written on accountants' liability under the common law,³²⁵ the following discussion will provide an overview of accountants' common law liability to clients and to third parties when either negligence or fraud is alleged.

A. Liability to Clients

As a general proposition, accountants, as members of a skilled professional class,³²⁶ must exercise that degree of care and competence reasonably expected of persons in their profession in the community.³²⁷ Although an accountant is liable to his client for "negligence, bad faith, or dishonesty,"³²⁸ he is not a guarantor of correct judgment but merely must perform with reasonable competence.³²⁹ If an accountant fails to perform in accordance with these standards, he may be liable to his

325. See, e.g., Fiflis, *supra* note 71; Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797 (1959) [hereinafter cited as Hawkins]; Kurland, *Accountant's Legal Liability Ultrameres to Barchris*, 25 BUS. LAW. 155 (1969); Marinelli, *The Expanding Scope of Accountants' Liability to Third Parties*, 23 CASE W. RES. L. REV. 113 (1971) [hereinafter cited as Marinelli]; Mess, *Accountants and the Common Law: Liability to Third Parties*, 52 NOTRE DAME LAW. 838 (1977) [hereinafter cited as Mess]; Note, *Accountants' Liabilities For False And Misleading Financial Statements*, 67 COLUM. L. REV. 1437 (1967); Note, *Accountants' Liability for Negligence—A Contemporary Approach for a Modern Profession*, 48 FORDHAM L. REV. 401 (1979).

326. "At least since 1905, accountants, in this country, have been accepted as a 'skilled professional class . . . subject generally to the same rules of liability for negligence in the practice of their profession as are members of other skilled professions.'" Stanley L. Bloch, Inc. v. Klein, 45 Misc. 2d 1054, 1057, 258 N.Y.S.2d 501, 505 (1965) (quoting Smith v. London Assur. Corp., 109 App. Div. 882, 883, 96 N.Y.S. 820, 820 (1905)). See Gammel v. Ernst & Ernst, 245 Minn. 249, 72 N.W.2d 364 (1955).

327. See, e.g., Bancroft v. Indemnity Ins. Co., 203 F. Supp. 49, 53 (W.D. La.), *aff'd*, 309 F.2d 959 (5th Cir. 1962). Referring to attorney professional liability, the Supreme Court, in an 1880 case, stated:

When a person adopts the legal profession, and assures to exercise its duties in behalf of another for hire, he must be understood as promising to employ a reasonable degree of care and skill in the performance of such duties; and if injury results to the client from a want of such degree of reasonable care and skill, the attorney may be held to respond in damages to the extent of the injury sustained.

National Sav. Bank v. Ward, 100 U.S. 195, 198 (1880).

328. 3 T. COOLEY, TORTS 335 (4th ed. 1932).

329. See Stanley L. Bloch, Inc. v. Klein, 45 Misc. 2d 1054, 1057, 258 N.Y.S.2d 501, 505 (1965). See generally *In re Kingston Cotton Mill Co.*, 2 Ch. Div. 279 (1896), in which the court said that accountants cannot be obligated to "track out ingenious and carefully laid schemes of fraud where there is nothing to arouse their suspicion . . ." *Id.* at 290. The court concluded that the accountant "is a watchdog, but not a bloodhound." *Id.* at 288.

client either for breach of contract,³³⁰ or alternatively, in tort for failure to exercise due care.³³¹

B. Negligence Liability to Third Parties

The starting point from which to examine accountant common law liability to third parties based on negligence is *Ultramares Corp. v. Touche*.³³² In that case, Justice Cardozo, writing for the court, refused to extend the rationale of his prior decision in *Glanzer v. Shepard*³³³ to encompass liability for economic damages caused by the negligent rendering of services by an accounting firm in favor of a third party not in privity.³³⁴ Unlike *Glanzer* where reliance by the third party was the "end and aim of the transaction,"³³⁵ the case at bar, Justice Cardozo concluded, involved an indeterminate class of persons who, currently or in the future, might foreseeably rely on the negligently audited financial statements.³³⁶ Accordingly, in denying recovery based on negligence to the third party, Justice Cardozo observed:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these

330. See, e.g., *L.B. Laboratories, Inc. v. Mitchell*, 39 Cal. 2d 56, 244 P.2d 385 (1952); 1136 Tenants' Corp. v. Max Rothenberg & Co., 27 A.D.2d 830, 277 N.Y.S.2d 996 (App. Div. 1967); *Stanley L. Bloch, Inc. v. Klein*, 45 Misc. 2d 1054, 258 N.Y.S.2d 501 (1965).

331. As stated by one commentator:

Like other professionals, the accountant usually gets into the position where he must exercise his professional skill as the result of a contract. The contract says what he undertakes to do, but the law says he must do it with reasonable care, by professional standards. If he fails, he may be liable either for breach of his contract, in tort, for breach of the general duty to exercise due care, arising out of the contract relationship.

Hawkins, *supra* note 325, at 797. Whether the case is pleaded in tort or in contract may be critical to its outcome. For example, an action stated in tort may be barred by the running of the usually shorter statute of limitations. See, e.g., *Carr v. Lipshie*, 9 N.Y.2d 983, 218 N.Y.S.2d 62 (1961); *American Indem. Co. v. Ernst & Ernst*, 106 S.W.2d 763 (Tex. Civ. App. 1937). Problems may also arise as to the issues of contributory negligence and the remoteness of damages. See Hawkins, *supra* note 325, at 800-01, 809-12.

332. 255 N.Y. 170, 174 N.E. 441 (1931).

333. 233 N.Y. 236, 135 N.E. 275 (1922). In *Glanzer*, the third party plaintiffs were permitted to recover from the defendant, a public weigher, with whom the seller contracted to certify the correct weight of the beans which the plaintiff purchased. Because the weigher knew that the plaintiffs were relying on his certification, the court held that he was liable to the plaintiffs for negligently overstating the weight. See *id.* at 239, 135 N.E. at 276.

334. 255 N.Y. at 181-85, 174 N.E. at 444-48.

335. *Id.* at 182, 174 N.E. at 445.

336. *Id.* at 183, 174 N.E. at 445-46.

terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.³³⁷

As the Seventh Circuit noted in *Hochfelder v. Ernst & Ernst*,³³⁸ *Ultramares* set the outer boundary in defining an accountant's common law liability to third parties "for it establishes that there was no duty owing to all who might foreseeably rely on the accountant's negligent misrepresentations."³³⁹ Based on the *Glanzer* rationale, however, *Ultramares* left open the possibility that lack of privity would not preclude recovery when it was specifically foreseeable that the third party would rely on the accountant's representations. A number of courts, however, have refused to follow this rationale. Strictly adhering to *Ultramares*, these courts have held that privity is essential to imposing liability for an accountant's negligence, even when the accountant knew, or should have known, that the third party was relying on his representations.³⁴⁰

An increasing number of courts, however, have declined to employ a strict privity rule to bar a third party from recovery.³⁴¹ These courts have diminished the impact of *Ultramares*, not only by permitting recovery by a foreseen plaintiff, but also by extending an "accountant's liability for negligence to those who, although not themselves foreseen, are members of a limited class whose reliance on the representation is specifically foreseen."³⁴²

337. *Id.* at 179-80, 174 N.E. at 444.

338. 503 F.2d 1100 (7th Cir. 1974), *rev'd on other grounds*, 425 U.S. 185 (1976).

339. *Id.* at 1107.

340. *See, e.g.,* *Stephens Indus., Inc. v. Haskins & Sells*, 438 F.2d 357, 359-60 (10th Cir. 1971); *Western Sur. Co. v. Loy*, 3 Kan. App. 2d 310, 312, 594 P.2d 257, 260 (1979); *Investors Tax Sheltered Real Estate, Ltd. v. Laventhol, Krekstein, Horwath & Horwath*, 370 So. 2d 815, 817 (Fla. App. 1979) (*per curiam*); *Investment Corp. of Fla. v. Buchman*, 208 So. 2d 291, 293-96 (Fla. App. 1968). As stated by the Tenth Circuit in *Stephens*: "[A]s to third parties—even those who the accountant knew or should have known were relying on his audit—liability can be founded only upon fraudulent conduct, and proof of mere negligence will not suffice." 438 F.2d at 359.

341. *See, e.g.,* *Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs*, 455 F.2d 847, 851 (4th Cir. 1972); *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 90-93 (D.R.I. 1968); *Milliner v. Elmer Fox & Co.*, 529 P.2d 806, 808 (Utah 1974); *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378, 381-83 (Mo. App. 1973); *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873, 876-80 (Tex. Civ. App. 1971); *Canaveral Capital Corp. v. Bruce*, 214 So. 2d 505 (Fla. App. 1968). *See also* *Kittilson v. Ford*, 93 Wash. 2d 203, 608 P.2d 264 (1980) (*Hochfelder* held inapplicable to state securities statute on the basis that "manipulative or deceptive" language of section 10(b) not included in Washington statute and also no analogous or similar legislative history between the Exchange Act and the state statute).

342. *Bonhiver v. Graff*, 311 Minn. 111, 128, 248 N.W.2d 291, 301-02 (1976). *Accord*, *White v. Guarente*, 43 N.Y.2d 356, 362, 372 N.E.2d 315, 319 (1977); *Hochfelder v. Ernst &*

Indeed, the demise of a strict construction of *Ultramares* was fortified by the New York Court of Appeals in *White v. Guarente*.³⁴³ In *White*, the court that decided *Ultramares* characterized that case as holding that "an accountant need not respond in negligence to those in the extensive and indeterminable investing public-at-large."³⁴⁴ Citing the Seventh Circuit's decision in *Hochfelder* for the proposition that recent cases have extended accountant liability based on negligence,³⁴⁵ the *White* court, in reversing the lower court's granting of a motion to dismiss, asserted that the third party "was a member of a limited class whose reliance on the audit and returns was, or at least should have been, specifically foreseen."³⁴⁶

Recent decisions have extended this rationale to encompass accountants' liability based on negligence when unaudited financial statements and work papers were relied on by third parties.³⁴⁷ The extent to

Ernst, 503 F.2d 1100, 1107 (7th Cir. 1974), *rev'd on other grounds*, 425 U.S. 185 (1976). See cases cited in note 341 *supra*. Note that a Missouri appellate court has adopted a balancing test for determining whether a third party can recover in an action against an allegedly negligent accountant:

The determination of whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of several factors: (1) the extent to which the transaction was intended to affect the plaintiff; (2) the foreseeability of harm to him; (3) the degree of certainty that the plaintiff suffered injury; and (4) the closeness of the connection between the defendant's conduct and the injury suffered.

Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378, 383 (Mo. App. 1973). This balancing test is similar to the one that the California courts have applied in cases involving allegations of attorney negligence when the plaintiff is not in privity with the defendant attorney. If presented with the proper case, it appears that the California courts would apply this balancing test to accountants' liability. See *Goodman v. Kennedy*, 18 Cal. 3d 335, 342, 556 P.2d 737, 742, 134 Cal. Rptr. 375, 380 (1976); *Biakanja v. Irving*, 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (1958); *Roberts v. Ball, Hunt, Hart, Brown & Baerwitz*, 57 Cal. App. 3d 104, 110, 128 Cal. Rptr. 901, 905-06 (1976).

343. 43 N.Y.2d 356, 372 N.E.2d 315 (1977).

344. *Id.* at 361, 372 N.E.2d at 318.

345. *Id.* at 362, 372 N.E.2d at 319 (citing *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1107 (7th Cir. 1974), *rev'd on other grounds*, 425 U.S. 185 (1976)).

346. 43 N.Y.2d at 362, 372 N.E.2d at 319. In concluding, the court stated:

While *Ultramares* made it clear that accountants were not to be liable in negligence on the generalized basis that a contract for professional services creates liability in favor of the general populace, this plaintiff seeks redress, not as a mere member of the public, but as one of a settled and particularized class among the members of which the report would be circulated for the specific purpose of fulfilling the limited partnership agreed upon arrangement.

Id. at 363, 372 N.E.2d at 320.

347. See, e.g., *Seedkem, Inc. v. Safranek*, 466 F. Supp. 340 (D. Neb. 1979); *Bonhiver v. Graff*, 311 Minn. 111, 248 N.W.2d 291 (1976). See generally *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969) where the court stated:

Although in this profession a distinction is made between certified audits where greater time and effort are expended to verify book items, and uncertified audits where greater reliance is placed on book items, it is clear to us that accountants, or

which this erosion of *Ultramares* will continue is uncertain. Although some courts continue to adhere to strict privity,³⁴⁸ there is a growing number of courts that view a strict application of *Ultramares* as unfair to the innocent reliant third party who should be viewed as a "foreseeable plaintiff."³⁴⁹

C. Liability for Fraud

Ultramares provides the focal point from which to examine an accountant's liability to a third party based on fraud. In holding that the trial court had erred in not submitting the question of fraud to the jury, Justice Cardozo concluded that "negligence or blindness, even when not equivalent to fraud, is nonetheless evidence to sustain an inference of fraud. At least this is so if the negligence is gross."³⁵⁰ Thus, under a literal reading of *Ultramares*, although negligence is not a substitute for fraud, recklessness or gross negligence, depending on the circumstances of a particular case, may be evidence from which the trier of fact may draw an inference of fraud.³⁵¹

In a later decision, *State Street Trust Co. v. Ernst*,³⁵² the New York Court of Appeals, relying on its reasoning in *Ultramares*, held that gross negligence and "even blindness to the obvious" may constitute sufficient evidence to sustain an inference of fraud.³⁵³ In reversing the trial court's directed verdict for the defendant and remanding for a new trial, the high court reflected:

Accountants . . . may be liable to third parties, even where there is lacking deliberate or active fraud. 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

any other professional persons, must perform those acts that they have agreed to do under the contract and which they claim have been done in order to make the determination set forth and presented in their report. Their liability must be dependent upon their undertaking, not their rejection of dependability. They cannot escape liability for negligence by a general statement that they disclaim its reliability.

170 N.W.2d at 404.

348. See cases cited in note 340 *supra*.

349. See cases cited in notes 305, 341-42 *supra*.

350. 255 N.Y. at 190-91, 174 N.E. at 449.

351. *Id.* at 186, 190-91, 174 N.E. at 447, 449. As an example, Justice Cardozo stated that "[e]ven an opinion, especially an opinion by an expert, may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it." *Id.* at 186, 174 N.E. at 447. See *Derry v. Peek*, 14 App. Cas. 337, 374 (1889).

352. 278 N.Y. 104, 15 N.E.2d 416 (1938).

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

that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.³⁵⁴

A subsequent New York Supreme Court case, *Duro Sportswear, Inc. v. Cogen*,³⁵⁵ arguably expands the holdings of *Ultramares* and *State Street* to make a finding of gross negligence actionable in itself by a third party, rather than merely providing an inference of fraud.³⁵⁶ Although the opinion contains language that supports this construction,³⁵⁷ that language must be read in the context of the entire holding. While expressly relying on *Ultramares* and *State Street* in its decision, the court at no point sought to distinguish those holdings or to expand their principles. At most, it appears that if the court did hold that gross negligence was a separate cause of action, it did so on the basis of erroneously applying the New York high court decisions.³⁵⁸

The possibility of liability for fraud to a third party, arising not from affirmative misrepresentation but from nondisclosure is seen in *Fischer v. Kletz*.³⁵⁹ In *Fischer*, the court denied a motion to dismiss a complaint which alleged that the defendant accountants had a duty to disclose after-acquired information that the audited and certified figures in financial statements previously filed with the SEC were grossly inaccurate. As a general proposition, the court asserted that it saw "no reason why this duty to disclose should not be imposed upon an accounting firm which makes a representation it knows will be re-

354. *Id.* at 112, 15 N.E.2d at 418-19. For later decisions adopting or commenting on *State Street*, see, e.g., *Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, 46 n.13 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112, 131-32 (S.D.N.Y. 1974), *rev'd in part and aff'd in part*, 540 F.2d 27 (2d Cir. 1976); *Rich v. Touche Ross & Co.*, 69 A.D.2d 778, 415 N.Y.S.2d 23 (1979).

355. 131 N.Y.S.2d 20, 25 (Sup. Ct. 1954), *aff'd*, 285 A.D. 867, 137 N.Y.S.2d 829 (App. Div. 1955).

356. See *Mess*, *supra* note 325, at 846-47. See also *C.I.T. Financial Corp. v. Glover*, 224 F.2d 44 (2d Cir. 1955).

357. 131 N.Y.S.2d at 25: "In order for Schwartz to recover damages, it would be necessary for the court to find that Cogan was guilty of gross negligence rather than mere faulty judgment." *Id.*

358. See *id.* at 24-25 (citing *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 112, 15 N.E.2d 416, 418 (1938) and *Ultramares Corp. v. Touche*, 255 N.Y. 170, 190, 174 N.E. 441, 449 (1931)).

359. 266 F. Supp. 180 (S.D.N.Y. 1967).

lied upon by investors.”³⁶⁰ The court, however, did not enunciate a precise rule of liability for nondisclosure, asserting that the weighing of the potentially significant impact of such a rule upon accountants, lawyers, and business entities *vis-a-vis* the strong interest of investor protection should be undertaken only after a full development of the facts of the case.³⁶¹

In summary, *Ultramares* and its progeny permit third party recovery for deceit, even when “deliberate or active fraud” is lacking.³⁶² Although not a substitute for fraud, gross negligence may furnish evidence that leads to an inference of fraud. And, as a final caveat, nondisclosure of after-acquired information which makes the previous representation false or misleading may result in the imposition of liability under certain circumstances.

CONCLUSION

The accounting profession presently is engulfed in a dynamic state of affairs. The days of simple “ticking and footing” have long since passed. The demands placed on the profession today require acute sensitivity and rapid responses to the needs of our changing and complex society. From both within and without the profession, rules and regulations are emerging and will continue to emerge and alter the role of the accountant. Concomitantly, the profession will experience changes in its responsibilities and, no doubt, an increasing number of liability claims.

360. *Id.* at 186. In denying the defendant's motion to dismiss, the court stated:

The common law has long required that a person who has made a representation must correct that representation if it becomes false and if he knows people are relying on it. This duty to disclose is imposed regardless of the interest of defendant in the representation and subsequent nondisclosure. Plaintiffs have sufficiently alleged the elements of nondisclosure on the part of this “disinterested” defendant. Accordingly, they must be given an opportunity to prove these allegations.

Id. at 188.

361. *Id.* at 189. See also 1136 *Tenants' Corp. v. Max Rothenberg & Co.*, 36 A.D.2d 804, 804, 319 N.Y.S.2d 1007, 1008 (1971), *aff'd*, 30 N.Y.2d 585, 330 N.Y.S.2d 800 (1972).

362. *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 112, 15 N.E.2d 416, 419 (1938).