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RECKLESSNESS AND THE RULE 10b-5 SCIENTER STANDARD AFTER *HOCHFELDER*

INTRODUCTION

In *Ernst & Ernst v. Hochfelder*,¹ the Supreme Court held that to maintain a private damage action based on a violation of the Securities and Exchange Commission's rule 10b-5,² the plaintiff must prove that the defendant acted with scienter. The Court thereby excluded liability for "negligent conduct alone,"³ defining scienter as "a mental state embracing intent to deceive,

1. 425 U.S. 185 (1976). *Hochfelder* followed a long period of expansion of the scope of securities legislation. In recognition of the need to construe the securities laws broadly and flexibly, the Court expanded the concept of fraud under the Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (1976), *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963), recognized a private right of action for violations of § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(n)(a) (1976) (1934 Act), *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964), and liberalized the causation requirement for material misstatements or omissions in proxy statements, *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384-85 (1970). The expansion of the private damage action under § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976), however, was perhaps the most significant in that time period. The Court extended the protections of § 10(b) to corporations, *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10-14 (1971), determined that no securities exchange or organized over-the-counter market need be involved to make a transaction actionable, *id.*, recognized an implied private right to damages, *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 156-57 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 (1971), and ruled that in a case of nondisclosure, "positive proof of reliance is not a prerequisite to recovery." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972). These Supreme Court decisions, together with the lower federal courts' interpretations of them, expanded the scope of the securities laws to such an extent that commentators have described the expansion as a "revolution in securities regulation." Whitaker & Rotch, *The Supreme Court And The Counter-Revolution In Securities Regulation*, 30 Ala. L. Rev. 335, 336 (1979). It has been commented that "[t]he continued expansion of rule 10b-5, under the rationale of promoting its intended remedial purpose, has been greeted with a rending of garments and a gnashing of teeth by the brokerage industry. Promised elucidation of rule 10b-5 . . . has not been forthcoming." Solomon & Wilke, *Securities Professionals And Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines And Proposals For Reform*, 43 Fordham L. Rev. 505, 505 (1975) (footnote omitted).

2. 17 C.F.R. § 240.10b-5 (1979) provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." Rule 10b-5 was promulgated under § 10(b) of the 1934 Act which provides that it is unlawful "[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b) (1976). Throughout this Note, "rule 10b-5" will be used to refer to either the rule or to § 10(b).

3. 425 U.S. at 201. The Court expressed a desire to exclude "wholly faultless" conduct from the scope of rule 10b-5, *id.* at 198, and conduct which is the product of an "entirely innocent mistake." *Id.* at 207. The Court noted: "As we find the language and history of § 10(b) dispositive

manipulate, or defraud."⁴ Although the Court noted that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct,"⁵ it declined both to define recklessness and to state whether it satisfies the scienter requirement.⁶ The federal Courts of Appeal now generally agree that

of the appropriate standard of liability, there is no occasion to examine the additional considerations of 'policy.' . . ." *Id.* at 214 n.33. The Court, however, went on to discuss the ramifications of a negligence standard on securities professionals. "Acceptance of [a negligence standard] would extend to new frontiers the 'hazards' of rendering expert advice under the Acts, raising serious policy questions not yet addressed by Congress." *Id.* See also 5 A. Jacobs, *The Impact of Rule 10b-5* (rev. ed. 1979). The author reported that eight policies underly rule 10b-5: "(1) maintaining free securities markets; (2) equalizing access to information; (3) insuring equal bargaining strength; (4) providing for disclosure; (5) protecting investors; (6) assuring fairness; (7) building investor confidence; and (8) deterring violations while compensating victims." *Id.* § 6.01, at 1-125. For a discussion of the crucial role of securities professionals such as accountants, lawyers, and broker-dealers in maintaining the efficient functioning of the securities market, see 3A H. Bloomenthal, *Securities and Federal Corporate Law* §§ 7.06, 9.09 (rev. ed. 1979); Metzger & Heintz, *Hochfelder's Progeny: Implications for the Auditor*, 63 Minn. L. Rev. 79 (1978). While it has been recognized that "many large securities transactions require the mechanical aid of a number of [securities professionals]," *Cumis Ins. Soc'y, Inc. v. E. F. Hutton & Co.*, 457 F. Supp. 1380, 1387 n.9 (S.D.N.Y. 1978), it has also been asserted that "[i]n 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." *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964); *accord*, *SEC v. Frank*, 388 F.2d 486, 489 (2d Cir. 1968). See generally *SEC v. Coven*, 581 F.2d 1020 (2d Cir. 1978), *cert. denied*, 440 U.S. 950 (1979); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976); Messer, *Roles and Reasonable Expectations of the Underwriter, Lawyer and Independent Securities Auditor in the Efficient Provision of Verified Information: 'Truth in Securities' Reinforced*, 52 Neb. L. Rev. 429 (1973); Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597 (1972); Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 Colum. L. Rev. 1437 (1967); Note, *Recklessness Under Section 10(b): Weathering the Hochfelder Storm*, 8 Rut.-Cam. L.J. 325 (1977) [hereinafter cited as *Weathering the Hochfelder Storm*]; Note, *Rule 10b-5: Liability for Aiding and Abetting after Ernst & Ernst v. Hochfelder*, 28 U. Fla. L. Rev. 999 (1976).

4. 425 U.S. at 193 n.12.

5. *Id.*

6. *Id.* The Court stated: "We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." *Id.* The Court also reserved the question whether scienter was a necessary element in an injunctive suit brought under § 10(b) and rule 10b-5, by either the Securities and Exchange Commission (SEC) or a private individual. *Id.* This article deals only with scienter in private damage actions. The courts that have dealt with the issue of scienter in injunctive suits, however, have reached varied results. See, e.g., *SEC v. Blatt*, 583 F.2d 1325, 1333-34 (5th Cir. 1978) (knowing or intentional conduct is necessary); *SEC v. Koracorp Indus., Inc.*, 575 F.2d 692, 701 (9th Cir.), *cert. denied*, 439 U.S. 953 (1978) (assumed negligence is sufficient); *SEC v. Bausch & Lomb Inc.*, 565 F.2d 8, 18-19 (2d Cir. 1977) (negligence is sufficient); *SEC v. Everest Mgt. Corp.*, 466 F. Supp. 167, 175-76 (S.D.N.Y. 1979) (required knowingly willful conduct). See generally Whitaker & Rotch, *supra* note 1, at 372-73 (1979); Calhoun, *Divining the Implications of Ernst & Ernst v. Hochfelder*, 1 Corp. L. Rev. 99, 102-07 (1978); 90 Harv. L. Rev. 1018, 1024-28 (1977); 22 Vill. L. Rev. 1238, 1247-53 (1977); see also Comment, *Scienter and SEC Injunctive Actions Under Securities Act Section 17(a)*, 63 Iowa L. Rev. 1248 (1978). The Supreme Court will soon decide whether the SEC is required to establish scienter in enforcement actions to enjoin violations of

recklessness suffices as a form of scienter to support rule 10b-5 liability.⁷ The courts, however, have neither adopted nor applied a uniform definition of recklessness.⁸

Most of the uncertainty in defining recklessness as a form of scienter under rule 10b-5 stems from the ambiguity of the *Hochfelder* decision.⁹ Although the

§ 10(b) and rule 10b-5. *SEC v. Aaron*, 605 F.2d 612 (2d Cir.), *cert. granted*, 100 S. Ct. 227 (1979).

7. See, e.g., *McLean v. Alexander*, 599 F.2d 1190, 1197-98 (3d Cir. 1979); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023 (6th Cir. 1979); *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 596 (10th Cir. 1979); *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 516 (1st Cir. 1978); *Nelson v. Serwold*, 576 F.2d 1332, 1336-37 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44-47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978); *Bosser v. Magazine*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,304, at 93,022 (D.C. Cir. 1977); *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir. 1977), *cert. denied*, 439 U.S. 830 (1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). The Fourth Circuit has not decided the issue. The Eighth Circuit has failed to define the *Hochfelder* scienter requirement. *Shull v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152, 156 (8th Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978). In *Berdahl v. SEC*, 572 F.2d 643 (8th Cir. 1978), however, the Eighth Circuit accepted a recklessness standard in an SEC enforcement action citing cases in the other circuits that have adopted recklessness in private damage actions. *Id.* at 647 n.6.

8. E.g., *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir.) (fiduciary duty standard), *cert. denied*, 439 U.S. 1039 (1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir.) (must have known), *cert. denied*, 434 U.S. 875 (1977); *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974) (flexible duty standard); *Stern v. American Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977) (should have known); see Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5*: Ernst & Ernst v. *Hochfelder*, 29 Stan. L. Rev. 213, 233-35 (1977); Jacobs, *Rule 10b-5 Developments—Who Can Sue and Who Is Liable*, in Tenth Ann. Inst. on Sec. Reg. 457, 466-69 (A. Fleischer, M. Lipton & R. Stevenson, eds. 1979). The Court's definition of scienter added little to the "glib generalizations and unthinking abstractions" already characteristic of securities jurisprudence. *SEC v. National Sec., Inc.*, 393 U.S. 453, 465 (1969); see Goldwasser, Ernst & Ernst v. *Hochfelder: An Anti-Landmark Decision*, 22 N.Y.L.S.L. Rev. 29, 40-62 (1976); 2 J. Corp. Law. 389, 403-04 (1977); notes 65-69 *infra* and accompanying text.

9. Although the *Hochfelder* Court stated that the scienter requirement was "intent to deceive, manipulate, or defraud," 425 U.S. at 193 n.12, its analysis contained various other formulations. For example, the Court found that the language of the statute "was intended to proscribe knowing or intentional misconduct." *Id.* at 197. Similarly, the Court interpreted the statute "to proscribe a type of conduct quite different from negligence." *Id.* at 199 (footnote omitted). Finally, the Court stated that "the language of § 10(b) . . . clearly connotes intentional misconduct." *Id.* at 201. "The phrase 'mental state embracing intent to deceive, manipulate, or defraud' has frequently been quoted, but few courts have attempted the difficult task of applying the standard to the specific facts before them. Those courts that have attempted to reconcile an expansive interpretation of the scienter standard . . . have often done so in spite of the Court's language, rather than because of it." Note, *The Supreme Court's Trimming of the Section 10(b) Tree: The Cultivation of a New Securities Law Perspective*, 3 J. Corp. Law 112, 115 (1977) (footnote omitted) [hereinafter cited as *Trimming of the Section 10(b) Tree*]. Furthermore, the legislative history of § 10(b) does little to clarify the elements of a private cause of action, because the federal courts implied the action from § 10(b) and rule 10b-5 using a statutory tort theory. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), see *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

Court held that negligence is not actionable, it did not decide whether proof that defendants acted with any form of scienter more culpable than "innocent mistake" will suffice.¹⁰ Yet, because the Court also stated that proof of "intentional or willful conduct" is required for liability,¹¹ it implied that a form of mental culpability approaching purpose or intent is necessary to sustain a cause of action under rule 10b-5.¹²

In an attempt to resolve the ambiguities of *Hochfelder*, two different definitions of recklessness have been developed by the federal courts. Certain courts have defined a reckless defendant as one who "should have known" that his conduct was fraudulent.¹³ Others have stated that a reckless defendant is one who "must have known" of the risk of harm to plaintiffs that would result from his conduct.¹⁴ Although the distinction may appear purely semantic, it is submitted that the first definition of recklessness is indistinguishable from negligence, which *Hochfelder* rejected as a standard for rule 10b-5 liability. The latter definition, however, is equivalent to the form of willful or conscious deception required by *Hochfelder*, and has recently been adopted and correctly applied by the Seventh Circuit in *Sundstrand Corp. v. Sun Chemical Corp.*¹⁵

The Seventh Circuit definition of recklessness properly restricts liability under rule 10b-5 to conduct performed with an element of mental culpabil-

10. 425 U.S. at 207; see *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978); *SEC v. World Radio Mission, Inc.*, 544 F.2d 535, 540-41 (1st Cir. 1976); *Rich v. Touche Ross & Co.*, 415 F. Supp. 95, 101 (S.D.N.Y. 1976).

11. 425 U.S. at 199.

12. See Liggio, *The 'Ernst' Ruling—Expansion of a Trend*, N.Y.L.J., Apr. 14, 1976, at 1, col. 2 (Part I); *Trimming of the Section 10(b) Tree*, *supra* note 9, at 116. It has been argued that a strict scienter standard is necessary to limit the scope of rule 10b-5 liability. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 n.33 (1976). The concern expressed in *Hochfelder* is based on policy considerations present at common law. In *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), the New York Court of Appeals excluded negligence as the basis for an action against accountants for fraudulent misrepresentation. Judge Cardozo noted that to allow accountants' liability to be based on negligence would "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class." *Id.* at 179, 174 N.E. at 444. Thus, the court concluded that "if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract." *Id.* at 189, 174 N.E. at 448; see Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability To The Public*, 18 De Paul L. Rev. 56 (1968); Note, *Accountants' Liability For Negligence—A Contemporary Approach For A Modern Profession*, 48 Fordham L. Rev. 401 (1979).

13. See, e.g., *SEC v. Coven*, 581 F.2d 1020, 1028 (2d Cir. 1978), *cert. denied*, 440 U.S. 950 (1979); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973); *Stern v. American Bankshares Corp.*, 429 F. Supp. 818, 826 (E.D. Wis. 1977). The validity of such an interpretation is to be seriously questioned because "the Supreme Court [in *Hochfelder*] revers[ed] the [lower court's] decision, which was premised on a 'should have known' or simple negligence standard." 9 Creighton L. Rev. 775, 792-93 (1976) (footnote omitted); see notes 114-23 *infra* and accompanying text.

14. E.g., *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979); *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977); see notes 71-90 *infra* and accompanying text.

15. 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 375 (1977); see notes 79-93 *infra* and accompanying text.

ity.¹⁶ Furthermore, it provides an objective standard that may be satisfied by circumstantial evidence that the risk of fraudulently misleading the plaintiff was obvious to the defendant. Most important, the definition comports with the congressional intent and the *Hochfelder* decision.¹⁷ Accordingly,

16. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 211 n.31 (1976). The legislative history of the 1934 Act evidences a congressional intent to exclude from liability conduct which is useful to the market system, but is negligently performed. See S. Rep. No. 792, 73d Cong., 2d Sess. 7, 12 (1934). The reason for this concern is that non-culpable conduct such as negligence cannot be specifically deterred. The fear of potential liability, however, could deter professionals from undertaking the performance of their functions which would have a deleterious effect on the market as a whole. See 425 U.S. at 211 n.31; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 747-48 (1975). In *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), Judge Friendly argued in a concurring opinion that recklessness "equivalent to willful fraud," *id.* at 868 (Friendly, J., concurring), should be the scienter standard in rule 10b-5 actions to reduce the potential for the unduly "expansive liability" inherent in a negligence standard. *Id.* Judge Friendly stated, "[t]he consequences of holding that negligence in the drafting of a press release . . . may impose civil liability . . . are frightening." *Id.* at 866. He also noted that inordinate liability would deter the future disclosure of information to the general public by forcing corporations to choose between remaining silent, or to issue releases "at the risk that a slip of the pen or failure properly to amass or weigh the facts [would] lead to large judgments." *Id.* at 867. See also Cohen, "Truth in Securities" Revisited, 79 Harv. L. Rev. 1340, 1370 (1966). Although the scienter standard may not include negligence, it need not be limited to a strict intent to defraud. *E.g.*, *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023-25 (6th Cir. 1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 45-47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 792-93 (7th Cir. 1977); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1043-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); see Bucklo, *supra* note 8, at 227-40; *Weathering the Hochfelder Storm*, *supra* note 3, at 343-45. The support for limiting scienter to a strict intent to defraud is based on a narrow interpretation of the Supreme Court cases that were decided in the same period as *Hochfelder*, that limit the scope of the securities laws. *E.g.*, *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). These cases, however, emphasize the equitable balance between investor protection and the facilitation of the role of the professional and the ethical businessman. See, *e.g.*, *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448 (1976) ("The potential liability for a Rule 14a-9 violation can be great indeed, and if the standard of materiality is unnecessarily low . . . the corporation and its management [may] be subjected to liability for insignificant omissions or misstatements. . ."); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58-59 (1975) ("Indeed, the Act's draftsmen commented upon the 'extreme care' which was taken 'to avoid tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid.'"); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975) ("The very pendency of the lawsuit may frustrate or delay normal business activity. . ."). The strict intent to defraud standard does not strike an equitable balance because it overly limits the private cause of action in derogation of the legislative intent to interpret the laws broadly and flexibly. See *United States v. Naftalin*, 99 S. Ct. 2077, 2082-83 (1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194-95 (1963).

17. The *Hochfelder* Court examined the words of § 10(b) and concluded that they proscribed conduct of a "knowing" or "intentional" nature. 425 U.S. at 197. Moreover, the legislative reports indicate that the word "manipulative" was not meant to encompass only intentional acts. The statutory words "manipulative," "deceptive," and "contrivance," necessitate proof that the defendant had either actual or constructive knowledge of the facts and circumstances surrounding

"[b]ecause securities litigation can be complex and expensive," and "should be avoided to the maximum extent by early clarification of the ground rules,"¹⁸ this Note contends that the courts should resolve the existing uncertainty as to the proper scienter standard after *Hochfelder* by adopting and appropriately applying the Seventh Circuit's definition of recklessness.¹⁹

I. RECKLESSNESS AT COMMON LAW

In general, the purpose of requiring some form of scienter as an element of a cause of action is to limit the scope of liability and to guide the application of sanctions.²⁰ These concerns are present, for example, in common law accountants' liability for fraud,²¹ defamation of public officials,²² and in criminal law manslaughter cases.²³ In these contexts, courts have been

the allegedly fraudulent securities transactions. See 425 U.S. at 199-201. For example, in describing the manipulative practices that were specifically envisioned to be covered by the securities laws, Senator Fletcher reported the following occurrence: "[T]estimony before the committee has shown that a broker, while operating a syndicate account in a copper stock, caused the sale of 35,000 shares by the syndicate and the purchase of 35,000 shares by an individual member of the syndicate on the same day. Although any intention to accomplish a 'wash' sale was disclaimed, nevertheless the result of the transaction was to bring about an immediate rise in the market value of the stock" S. Rep. No. 792, 73d Cong., 2d Sess. 8 (1934). This scenario indicates that Congress envisioned that professedly unintentional actions would be covered by the sections prohibiting manipulations, such as § 10(b). Specifically, this report illustrates that a conscious decision to disregard the risk can be imputed to the broker, in light of the obvious circumstances surrounding the transaction. See 3 A. Bromberg & L. Lowenfels, *Securities Fraud & Commodities Fraud* § 8.4 (1977) (advocating a constructive knowledge standard).

18. *Dupuy v. Dupuy*, 434 U.S. 911, 912 (1977) (White, J., dissenting). The disputed issue in *Dupuy* was the correct standard of care for plaintiffs in 10b-5 private damage actions. See *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); Note, *The Due Diligence Defense in Rule 10b-5: The Hochfelder Aftershocks*, 11 Ind. L. Rev. 727 (1978); Note, *Plaintiff's Standard of Care After Hochfelder: Toward A Theory of Causation*, 31 Vand. L. Rev. 1225 (1978); 9 Rut.-Cam. L.J. 598 (1978).

19. The scienter issue has become a deciding factor in many cases not only due to the *Hochfelder* decision, but because the materiality and reliance elements of the private damage action under rule 10b-5 have become less debatable. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). "The disappearance of privity and the relaxations of materiality, reliance and causation leave *scienter* as the principal 'swing' element in many cases." 3 A. Bromberg, *supra* note 17, § 8.4, at 514 (1977).

20. See generally 1 F. Harper & F. James, *The Law of Torts* § 7.3 (1956); W. Prosser, *Handbook of the Law of Torts* §§ 75, 76, 107, 128, at 492-94, 501, 700-04, 920-22 (4th ed. 1971); Haimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 Bus. Law. 147, 151-52 (1976).

21. See generally Keeton, *Professional Malpractice*, 17 Washburn L.J. 445 (1978); 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).

22. See *Garrison v. Louisiana*, 379 U.S. 64, 73-75 (1964); *New York Times Co. v. Sullivan*, 376 U.S. 254, 279-80 (1964). See generally Eaton, *The American Law of Defamation Through Gertz v. Robert Welch, Inc. and Beyond: An Analytical Primer*, 61 Va. L. Rev. 1349 (1975); Wade, *Defamation, the First Amendment and the Torts Restatement*, 11 Forum 3 (1975).

23. See generally S. Kadish & M. Paulsen, *Criminal Law & Its Processes* 192-93 (3d ed. 1976); W. La Fave & A. Scott, *Criminal Law* §§ 73-78 (1972); Edwards, *The Criminal Degrees of*

successful in drawing clear distinctions between various mental states, particularly in distinguishing recklessness from other forms of scienter. Thus, although these areas of the law are not identical to securities law,²⁴ "[i]t is unquestionable that the common law has served as an interpretive source of securities law concepts."²⁵

At common law, recklessness is viewed as occupying a place on a continuum of conduct: intentional conduct is at one extreme, negligence is at the other, and in between, are knowing conduct and recklessness.²⁶ Each of these forms of conduct differ in mental culpability according to the degree of intentionality, risk, and resulting harm.²⁷

Recklessness and intentional conduct are comparatively easy to discern. The intentional actor is substantially certain that harm will result from his conduct, and acts specifically to cause that harm.²⁸ In contrast, from the vantage point of the reckless actor, it is strongly probable that harm will result from his act, yet he acts in disregard of that risk.²⁹ Because of this

Knowledge, 17 Mod. L. Rev. 294 (1954). The general principle of proportionality in criminal law is that "liability ought to match culpability." H. Gross, *A Theory of Criminal Justice* 436 (1979). Once culpability is determined, greater or lesser punishment is administered "according to greater or lesser culpability" and penalties are assigned "on a scale that reflects relative culpability among crimes, both for different kinds of crimes and for different instances of the same kind of crime." *Id.* at 438; see Mulligan, *Cruel And Unusual Punishments: The Proportionality Rule*, 47 Fordham L. Rev. 639, 645-48 (1979).

24. A review of the recklessness standard in torts and criminal law is instructive because their underlying goals—compensation and deterrence—are similar to those underlying the securities laws. See, e.g., *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 104-07 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946); Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 Bus. Law. 991, 1001 (1976); Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 Mich. L. Rev. 1398, 1429 (1974); 1977 Utah L. Rev. 150, 152 n.17.

25. *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 45 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1979); see *Holdsworth v. Strong*, 545 F.2d 687, 693-94 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Nickels v. Koehler Mgt. Corp.*, 541 F.2d 611, 618 (6th Cir. 1976). The elements of the common law action for fraud or deceit are: a misrepresentation of a material fact, scienter of the defendant, an intent to induce reliance, the plaintiff's justifiable reliance and subsequent injury. Restatement (Second) of Torts § 525 (1977); W. Prosser, *supra* note 20, § 105, at 685-86. The elements of the private damage action under rule 10b-5 closely parallel these elements. 3 H. Bloomenthal, *supra* note 3, at 9-106 to 9-164; 4 A. Bromberg & L. Lowenfels, *supra* note 17, at 195-223. See generally 3 L. Loss, *Securities Regulation 1445-1473* (2d ed. 1961); Note, *Plaintiff's Standard of Care After Hochfelder: Towards A Theory of Causation*, 31 Vand. L. Rev. 1225, 1225 (1978).

26. E.g., *Bucklo*, *supra* note 8, at 214 n.8; accord, *Trimming of the Section 10(b) Tree*, *supra* note 9, at 118-22. See generally Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 U.C.L.A. L. Rev. 583 (1965).

27. H. Gross, *supra* note 23, at 77-82.

28. Restatement (Second) of Torts § 500, Comment f at 590 (1977); see, e.g., *United States v. Benjamin*, 328 F.2d 854, 861-63 (2d Cir. 1964); *Bentel v. United States*, 13 F.2d 327, 329 (2d Cir.), *cert. denied*, 273 U.S. 713 (1926).

29. See *Western Constr., Inc. v. Southern Pac. Co.*, 381 F.2d 573, 576 (9th Cir. 1967); *Ellis v. Ferguson*, 238 Ark. 776, 778-79, 385 S.W.2d 154, 155 (1964); *Mathes v. Robinson*, 205 Kan. 402, 406-07, 469 P.2d 259, 263 (1970); Restatement (Second) of Torts § 500 (1977).

probability of harm, recklessness is usually viewed as a form of knowing conduct.³⁰ The knowledge that is possessed by the reckless actor is imputed from the objective circumstances of his conduct.³¹ Actual knowledge, however, is "consciousness of the existence of a fact" that is proven by subjective evidence.³² The difference between the two mental states may be expressed as: "the reckless actor must have known" and "the knowing actor knew."

Although the manner of proof is different, courts have generally recognized that the willfulness inhering in knowledgeable conduct is also present in reckless conduct.³³ For example, in *United States v. Benjamin*,³⁴ an accountant participated in a conspiracy to sell unregistered securities fraudulently by preparing a pro forma financial statement without factual basis.³⁵ Specifically, the defendant failed to examine or inspect the issuing corporation's accounts, and included assets which did not exist.³⁶ In determining whether the evidence was sufficient to prove that the defendant had the requisite degree of mental culpability,³⁷ the court noted the distinction between actual and imputed knowledge and concluded that the willfulness involved is the same.³⁸ The court stated that "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*

30. See *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 407 & n.6 (3d Cir. 1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1305 (2d Cir. 1973); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112, 126 (S.D.N.Y. 1974), *modified*, 540 F.2d 27 (2d Cir. 1976). See also *United States v. Jewell*, 532 F.2d 697, 702 (9th Cir.), *cert. denied*, 426 U.S. 951 (1976) ("[K]nowingly in criminal statutes is not limited to positive knowledge, but includes the state of mind of one who does not possess positive knowledge only because he consciously avoided it.") (footnote omitted).

31. W. Prosser, *supra* note 20, § 107, at 701; *accord*, *United States v. Benjamin*, 328 F.2d 854, 861 (2d Cir. 1964); *Bentel v. United States*, 13 F.2d 327, 329 (2d Cir.), *cert. denied*, 273 U.S. 713 (1926). An objective standard is an external standard that does not depend on the psychological awareness of the individual. H. Gross, *supra* note 23 at 90-103; O. Holmes, *The Common Law* 39-76 (1881).

32. 2 F. Harper & F. James, *supra* note 20, § 16.5, at 907-08 (footnote omitted). See generally Seavey, *Negligence—Subjective or Objective?*, 41 Harv. L. Rev. 1, 17 (1927). Subjective intent requires a "psychological elemen[t]" which requires that defendants actually "have in their minds" the elements of foresight or knowledge. H.L.A. Hart, *Punishment and Responsibility Essays in the Philosophy of the Law* 152 (1975). See generally W. La Fave & A. Scott, *supra* note 23, at 216.

33. See *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979); *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 595-96 (10th Cir. 1979); *Berdahl v. SEC*, 572 F.2d 643, 647 & n.6 (8th Cir. 1978).

34. 328 F.2d 854 (2d Cir. 1964).

35. *Id.* at 859-60. The court characterized the scheme as "another of those sickening financial frauds which so sadly memorialize the rapacity of the perpetrators and the gullibility, and perhaps also the cupidity, of the victims." *Id.* at 856. The scheme involved selling shares of worthless stock to innocent investors. *Id.* at 862.

36. *Id.*

37. *Id.* at 861-63. The case was brought under the Securities Act of 1933 §§ 17(a), 24, 15 U.S.C. §§ 77e (a, c), 77q(a), 77x (1976). The court proscribed knowing and deliberate conspiracy to defraud investors.

38. 328 F.2d at 862-63.

know the [falsity] of what he said or wrote may legitimately be drawn.'"³⁹ In this situation, the actor is reckless because he "deliberately closed his eyes to facts he had a duty to see"⁴⁰ and is, therefore, deemed guilty of conscious deception.⁴¹

Recklessness differs from negligence in several respects, although breach of duty is implicit in both concepts.⁴² Negligence is comprised of the actor's failure to perceive a risk that the reasonable man "should have known" in light of community standards.⁴³ Recklessness, however, involves the actor's disregard of a risk that he "must have known" in light of the actual circumstances.⁴⁴ This distinction was the focal issue in *Ultramares Corp. v. Touche*,⁴⁵ a case involving accountants' liability for fraud and negligent misrepresentation.⁴⁶ The defendant accounting firm prepared financial statements by relying on representations made by an employee of the audited company and failed to verify independently the existence of assets later

39. *Id.* at 861-62 (quoting *Bentel v. United States*, 13 F.2d 327, 329 (2d Cir.), *cert. denied*, 273 U.S. 713 (1926)).

40. 328 F.2d at 862. The court did not specifically refer to the defendant's conduct as reckless. The *Benjamin* case has, however, been cited for the proposition that recklessness is a form of knowing conduct. *E.g.*, *United States v. Brawer*, 482 F.2d 117, 127 (2d Cir. 1973); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1097 (2d Cir. 1972); *Tarvestad v. United States*, 418 F.2d 1043, 1047 (8th Cir.), *cert. denied*, 397 U.S. 935 (1970).

41. *See Spies v. United States*, 317 U.S. 492, 497 (1943); *United States v. Murdock*, 290 U.S. 389, 394-96 (1933); *Bentel v. United States*, 13 F.2d 327, 329 (2d Cir.), *cert. denied*, 273 U.S. 713 (1926).

42. The distinction is often academic, but recklessness should also be compared with gross negligence to define the scienter standard under rule 10b-5. The difference between negligence and gross negligence is one of degree. 2 F. Harper & F. James, *supra* note 20, § 16.1, at 896-902; W. Prosser, *supra* note 20, § 34, at 183-84; *see* *McTavish v. Chesapeake & O. R.R.*, 485 F.2d 510, 512 (6th Cir. 1973); *Frankel v. Kurtz*, 239 F. Supp. 713, 718 (W.D.S.C. 1965); *Montellier v. United States*, 202 F. Supp. 384, 400 nn.9 & 10 (E.D.N.Y. 1962), *aff'd*, 315 F.2d 180 (2d Cir. 1963). The difficulty in distinguishing gross negligence from recklessness arises when courts attempt to determine the actor's mental state by focusing on the egregiousness of the result of the conduct, rather than by examining the attendant circumstances of the conduct. The distinguishing factor, therefore, is not what the actor should have done to comport with community standards, but the actions that should have been taken in light of the attendant circumstances. *See* Restatement (Second) of Torts § 500, Comment g at 590 (1977). A federal district court has recently explained its perception of the difference between gross negligence and recklessness: "[w]hereas the former implies an irrational failure to perceive a danger, the latter connotes persisting in a course of action in the face of a perceived danger, although the specific harm resulting may not be intended." *Berman v. Richmond Indus., Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,518, at 94,015 n.17 (S.D.N.Y. 1978).

43. *See* Restatement (Second) of Torts § 12 (rev. ed. 1965). "The words 'should know' are used throughout the Restatement . . . to denote . . . that a person of reasonable prudence and intelligence or of the superior intelligence of the actor would ascertain the fact in question in the performance of his duty to another, or would govern his conduct upon the assumption that such fact exists." *Id.*

44. Restatement (Second) of Torts § 500, Comment g at 590 (1977); *see* *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 792 (7th Cir. 1977).

45. 255 N.Y. 170, 174 N.E. 441 (1931).

46. *Id.* at 173, 174 N.E. at 442.

disclosed to be fictitious.⁴⁷ Judge Cardozo, writing for the New York Court of Appeals, noted that "accountants . . . by the very nature of their calling profess to speak with knowledge when certifying to an agreement between the audit and the entries."⁴⁸ Accordingly, a defendant is merely negligent when he has failed to conduct the necessary inquiries, yet prepares a financial statement because he "believed the representation made by him to be true . . . without reasonable cause for such belief."⁴⁹ In contrast, a defendant is reckless if he failed to inquire even though he was "put on [his] guard by the circumstances . . . to scrutinize with special care."⁵⁰ In such a case, "[a] jury might find that with suspicions thus awakened, [he] closed [his] eyes to the obvious, and blindly gave assent."⁵¹ Thus, recklessness is more than the omission of ordinary care; unlike a negligent act, a reckless act is performed in such disregard of the deleterious consequences as to evince bad faith.⁵²

The bad faith that distinguishes negligence from recklessness supports the imposition of liability for defamation of public officials. The balance between the public official's reputation and the publisher's first amendment rights could not be maintained if publishers were held to the same negligence standard of ordinary care that governs a reasonably prudent person in the conduct of his daily activities.⁵³ Thus, a public official cannot recover damages for libel unless the defamatory statement was published with actual malice; that is, knowledge that it was false, or with reckless disregard for its truth or falsity.⁵⁴ In *St. Amant v. Thompson*,⁵⁵ the Court held that a

47. *Id.* at 192, 174 N.E. at 443-44. The defendants used a random choice of accounts to determine whether the books of the company were regular. The court found this system of verification inadequate. The defendants admitted that none of the invoices supporting the fictitious sales were selected for inspection or investigation. Although the court noted that independent verification usually involves "the exercise of judgment and discretion," such is not the case where the inquiry is "whether the entries certified as there, are there in very truth, there in the form and in the places where men of business training would expect them to be." *Id.* at 192, 174 N.E. at 449.

48. *Id.* at 191, 174 N.E. at 449.

49. *Id.*

50. *Id.* at 192, 174 N.E. at 449.

51. *Id.* In *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938), the New York Court of Appeals adopted the idea that recklessness involves a deliberate disregard of an obvious risk. The court described recklessness on the part of accountants as "a . . . misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, . . . [a] refusal to see the obvious, a failure to investigate the doubtful." *Id.* at 112, 15 N.E.2d at 418-19.

52. 1 F. Harper & F. James, *supra* note 20, § 7.3, at 537; see *United States v. Amrep. Corp.*, 560 F.2d 539, 544 (2d Cir. 1977), *cert. denied*, 434 U.S. 1015 (1978); *Whittle v. United States*, 328 F. Supp. 1361, 1363 (M.D. Ala. 1971); *Noel v. United Aircraft Corp.*, 204 F. Supp. 929, 932-34 (D. Del. 1962).

53. See *Wolston v. Reader's Digest Ass'n, Inc.*, 99 S. Ct. 2701, 2706 (1979); *Curtis Publishing Co. v. Butts*, 388 U.S. 130, 152-54 (1967); *Maheu v. Hughes Tool Co.*, 384 F. Supp. 166, 170 (C.D. Cal. 1974), *modified*, 569 F.2d 459 (9th Cir. 1978). The public interest in compensating injured plaintiffs who are not public figures is greater because they have less opportunity for rebuttal, and have not voluntarily cast themselves in the public light. See *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 339-48 (1974).

54. *New York Times Co. v. Sullivan*, 376 U.S. 254 (1964). Accordingly, the Court held that

publisher's failure to investigate the truth or falsity of a statement prior to its publication is not in itself reckless.⁵⁶ Rather, "[t]here must be sufficient evidence to permit the conclusion that the defendant in fact entertained serious doubts as to the truth of [its] publication. Publishing with such doubts shows reckless disregard for truth or falsity and demonstrates actual malice."⁵⁷ Admittedly, an analogy to the scienter requirement in defamation cases is not dispositive of the issue under rule 10b-5. It does serve, however, to illustrate that the Supreme Court has recognized the validity of using an objective scienter standard, such as recklessness, as a substitute for subjective or conscious fault.⁵⁸

Similarly, a distinction between recklessness and negligence is used in criminal law to determine the severity of a crime.⁵⁹ For example, the Model Penal Code converts homicide to manslaughter when a death is caused by the defendant's recklessness.⁶⁰ The Code defines recklessness as a conscious disregard of a risk "of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct [a person] would observe in the actor's situation."⁶¹ In comparison, an actor's conduct is negligent when the actor "should be aware of a substantial and unjustifiable risk . . . of such a nature and degree that the actor's failure to perceive it . . . involves a gross deviation from the standard of care that a reasonable person would observe in the actor's situation."⁶² The primary difference between the two definitions is that while the reckless actor consciously disregards a risk ascertainable from the actual circumstances, the negligent actor unconsciously disregards a risk of which he should be aware in light of the community

the defendant newspaper did not act recklessly and hence, was not liable for defamation, even though it failed to investigate the claims of an advertisement it had published. *Id.* at 287-88.

55. 390 U.S. 727 (1968).

56. *Id.* at 730-33.

57. *Id.* at 731.

58. See *id.* at 731-32. The Court stated that a "[f]ailure to investigate does not in itself establish bad faith," *id.* at 733, yet, "[p]rofessions of good faith will be unlikely to prove persuasive . . . when the publisher's allegations are so inherently improbable that only a reckless man would have put them in circulation. . . . [R]ecklessness may be found where there are obvious reasons to doubt the veracity of the [statement]." *Id.* at 732. Thus, obviousness of harm may substitute for guilty knowledge. See, e.g., *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979); *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 595-96 (10th Cir. 1979); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 102 (2d Cir. 1978); *Berdahl v. SEC*, 572 F.2d 643, 647 (8th Cir. 1978); *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682, 711-12 (D.D.C. 1978).

59. See S. Kadish & M. Paulsen, *supra* note 23, at 97, 187-90; W. La Fave & A. Scott, *supra* note 23, at 208.

60. Model Penal Code § 210.3 (Proposed Official Draft 1962); accord, N.Y. Penal Law §§ 125.10, 125.15 (McKinney 1975); Tex. Penal Code Ann. tit. 5, §§ 19.05, 19.07 (Vernon 1974). Compare Model Penal Code § 210.3 (Proposed Official Draft 1962) (criminal homicide is classified as manslaughter, a second degree felony, when it is committed recklessly) with Model Penal Code § 210.4 (1974) (criminal homicide is classified as negligent homicide, a third degree felony, when it is committed negligently).

61. Model Penal Code § 2.02(c) (Proposed Official Draft 1962).

62. *Id.* at § 2.02(d).

standards. Although both definitions take into consideration the reasonableness of the conduct, the knowledge of actual circumstances is tantamount to awareness of a danger, imputing a purposeful state of mind to the reckless defendant; his disregard of the risk and indifference to the danger are deemed deliberate, and, therefore, culpable.⁶³

In sum, in various contexts courts have been successful in making the distinctions between recklessness and other mental states necessary to circumscribe the scope of liability and to determine the proportionality of sanctions. The Supreme Court sought to achieve similar goals in *Hochfelder* by mandating proof of scienter for rule 10b-5 liability.⁶⁴ Therefore, when applying a recklessness standard in rule 10b-5 cases, the federal courts should adopt a definition that encompasses culpable conduct, yet is capable of objective proof.

II. RECKLESSNESS IN RULE 10b-5 ACTIONS

The inability of most courts to define the recklessness standard for rule 10b-5 actions is consistent with the Seventh Circuit's observation that "the difficult problems presented [in securities litigation] have been in the formulation of the governing principles of law rather than the more common legal problem of application of settled principles . . . to particular facts."⁶⁵ Thus, some courts avoid the issue by deftly stating that it is unnecessary to define precisely the nature of reckless behavior.⁶⁶ Other courts use definitions that require evidence that the defendant actually knew of the danger of misleading plaintiffs, and thus pose the obstacle of subjective proof.⁶⁷ In addition, some definitions of recklessness are broad enough to

63. The Comments to the Model Penal Code state that "negligence [is] distinguished from acting purposely, knowingly or recklessly in that it does not involve a state of awareness." Model Penal Code § 2.02(3), Comment (Tent. Draft No. 4, 1955).

64. See notes 1-19 *supra* and accompanying text.

65. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 n.15 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *accord*, *Stern v. American Bankshares Corp.*, 429 F. Supp. 818, 826 (E.D. Wis. 1977).

66. *E.g.*, *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir. 1977), *cert. denied*, 439 U.S. 830 (1978). The Third Circuit stated that in private damage actions "a party must prove injury resulting . . . from a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception." 567 F.2d at 574. This formulation is completely circular in reasoning, see *Trimming of the Section 10(b) Tree*, *supra* note 9, at 126, because some mental culpability must be present in order to determine the degree of scienter. See also *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879, 889 (E.D. Pa. 1978) (refused to use *Coleco* definition for jury instruction). Another court stated that it found "no reason to indulge in semantic definitional games, for in this case it is clear that under any sensible standard of scienter [the defendant] cannot be held liable." *Cumis Ins. Soc'y, Inc. v. E.F. Hutton & Co.*, 457 F. Supp. 1380, 1387 (S.D.N.Y. 1978); *accord*, *Berdahl v. SEC*, 572 F.2d 643, 647 n.6 (8th Cir. 1978) (defendant's conduct "sufficiently purposive").

67. See, *e.g.*, *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 37 (2d Cir. 1976); *Thomas v. Duralite Co.*, 524 F.2d 577, 584 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976); *Roches Bros., Inc. v. Rhoades*, 491 F.2d 402, 407-08 (3d Cir. 1974); notes 94-105 *infra* and accompanying text.

encompass negligence.⁶⁸ Finally, even when an accurate definition is adopted, some courts fail to apply it properly.⁶⁹

A. *The Franke Definition*

Perhaps in recognition of the "variety, disparity and confusion" of judicial definitions of the "requisite but elusive mental element"⁷⁰ in rule 10b-5 actions, the federal district court in *Franke v. Midwestern Oklahoma Development Authority*,⁷¹ set forth an explicit definition of recklessness which is sufficiently narrow to exclude liability for negligence and which may be satisfied by objective proof. In *Franke*, an investor in industrial revenue bonds sued the bond counsel alleging that counsel recklessly omitted communication of material facts and misrepresented the financial worth of the bond offering.⁷² In the context of these facts, the court stated:

[R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.⁷³

The court held that the defendants were not liable because they "possessed neither authority nor responsibility . . . to participate in either the formulation or the review of . . . official [financial] statement[s]."⁷⁴ Under such circum-

68. See, e.g., *SEC v. Paro*, 468 F. Supp. 635, 649 (N.D.N.Y. 1979); *Upton v. Trinidad Petro. Corp.*, 468 F. Supp. 330, 337 (N.D. Ala. 1979); *Stern v. American Bankshares Corp.*, 429 F. Supp. 818, 827 (E.D. Wis. 1977); *Whitaker & Rotch*, *supra* note 1, at 372; notes 114-23 *infra* and accompanying text.

69. See *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 516-17 (1st Cir. 1978); *SEC v. Coven*, 581 F.2d 1020, 1025 (2d Cir. 1978), *cert. denied*, 440 U.S. 950 (1979); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 33, 47-48 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Arthur Young & Co. v. United States Dist. Ct.*, 549 F.2d 686, 695 (9th Cir.), *cert. denied*, 434 U.S. 829 (1977); *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. 528, 536-57 (D. Md. 1978). The basis for a majority of these decisions appears to be no more than a judicial recognition that reckless conduct is more than negligent, but less than intentional. See, e.g., *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 595-96 (10th Cir. 1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); *Berdahl v. SEC*, 572 F.2d 643, 647 (8th Cir. 1978); *Upton v. Trinidad Petro. Corp.*, 468 F. Supp. 330, 337 (N.D. Ala. 1979). See generally *Jacobs*, *supra* note 8, at 474-76; *Metzger & Heintz*, *supra* note 3, at 90-112.

70. *Morissette v. United States*, 342 U.S. 246, 252 (1952).

71. 428 F. Supp. 719 (W.D. Okla. 1976).

72. *Id.* at 722.

73. *Id.* at 725 (emphasis added).

74. *Id.* at 724. The defendants' involvement in the transaction was limited to the preparation of an opinion concerning the legality of the bond sale and the verification of the tax exempt status of the interest payments accruing to the bond-holders. *Id.* at 722. The court noted that if "obviousness of risk of harm can be a substitute for guilty knowledge, it is sufficient to note that there is no evidence here of such a state of facts." *Id.* at 725. The court stated that "it would be inappropriate . . . to arbitrarily expand bond counsel liability beyond expressly understood limits and clearly beyond [the defendants'] acknowledged and professed area of expertise." *Id.* at 722. This is particularly valid in aiding and abetting cases. "Since many large securities transactions require the mechanical aid of a number of collateral participants" the proper scienter standard becomes the determinative factor in differentiating between those fraudulently involved and those

stances, the function of the bond counsel was not "to warrant the over-all economic soundness of the issue."⁷⁵ Not only was there a lack of evidence that the defendants had actual knowledge,⁷⁶ but the extent of their professional duty and the scope of their particular obligations did not place them in circumstances which must have informed them of the risk to the plaintiffs.⁷⁷ Accordingly, the defendants' failure to disclose certain adverse facts relating to the capitalization of the bond offering was not an extreme departure from the standards of ordinary care, and thus, the defendants were not reckless.⁷⁸

In *Sundstrand Corp. v. Sun Chemical Corp.*,⁷⁹ the Seventh Circuit adopted the *Franke* definition and provided a practical mode of analysis for courts applying a recklessness standard. The plaintiff in *Sundstrand* had been involved in negotiating a merger with Standard Kollsman Industries (SKI). Although the merger was never consummated, the plaintiff purchased a substantial amount of stock in reliance upon representations made by the defendant, a SKI director and merger broker, concerning the financial performance and condition of SKI.⁸⁰ Specifically, the defendant had given the plaintiff an earnings projection based partially on an accounting policy that deferred reporting preproduction costs. This projection yielded a higher earnings potential than would have been revealed had preproduction costs been included.⁸¹

The *Sundstrand* court developed a two-pronged analysis using the *Franke* definition of recklessness as a base. First, the court employed an objective test requiring that "the danger of misleading buyers must be . . . so obvious that any reasonable man would be legally bound as knowing."⁸² The court then used a subjective component requiring that "the danger of misleading buyers must be actually known . . . and the omission must derive from something

"who were guilty only of engaging in the usual and customary business activities." *Cumis Ins. Soc'y, Inc. v. E.F. Hutton & Co.*, 457 F. Supp. 1380, 1387 n.9 (S.D.N.Y. 1978); see Note, *Rule 10b-5: Liability for Aiding and Abetting after Ernst & Ernst v. Hochfelder*, 28 U. Fla. L. Rev. 999 (1976).

75. 428 F. Supp. at 722.

76. *Id.* at 724-25.

77. *Id.* at 725.

78. *Id.*

79. 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). The *Franke* definition "will not significantly broaden the class of plaintiffs who may seek to impose liability upon experts who perform services or express opinions with regard to matters under the Securities Exchange Act of 1934." *Id.* at 1045 n.21. (citation omitted).

80. *Id.* at 1037. The merger between the two companies was cancelled because of certain aspects of SKI's operation, such as increased labor costs, unfavorable labor practices, the unexpected incompatibility of the two companies' products, and an overly optimistic earnings projection. *Id.* at 1038. The plaintiff had previously purchased shares of SKI stock in anticipation of the merger and suffered financial loss due to its cancellation. *Id.* at 1037.

81. *Id.* at 1038-39.

82. *Id.* at 1045. (footnote omitted) This component of the *Sundstrand* analysis obviates any inclusion of negligence in the recklessness standard. The knowledge is imputed from circumstances that must have been evident to the actor. Hence, the "grey area in which negligence merges into recklessness," *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 516-17 (1st Cir. 1978) (footnote omitted), is clearly delineated into black and white. The standard is objective because of the importance of the actual circumstances at the time of the transaction.

more egregious than even 'white heart/empty head' good faith."⁸³ Furthermore, the court stated that even if the subjective test is not satisfied by evidence that the defendant disregarded "actual knowledge," liability for recklessness can be based on proof of "constructive knowledge," or support of the objective component only.⁸⁴ Applying this analysis to the factual circumstances, the court found that the defendant was reckless as a matter of law and therefore liable under rule 10b-5.⁸⁵

Under the objective test, the court considered several circumstances surrounding the defendant's conduct relevant to the obviousness of the potential fraud. First, the defendant's role as both a director and merger broker situated him " 'on both sides and in the middle of the transaction.' "⁸⁶ Second, another director, officer, and large shareholder of SKI had submitted a formal inquiry to SKI's board of directors concerning the impropriety of deferring the accounting of preproduction costs. Third, a major public accounting firm concluded that this accounting practice seemed questionable, and the firm's report was discussed at numerous board meetings at which the defendant was present.⁸⁷ Finally, the accounting policy caused shareholders to lodge a formal complaint with the SEC and prompted two SKI directors to refuse to sign an SEC registration statement.⁸⁸

Given these attendant circumstances, the *Sundstrand* court concluded that the obviousness of the risk of misleading the plaintiffs was sufficient to infer that the defendant must have known of the potential harm.⁸⁹ "When measured against this external standard, it may be said that . . . a reckless man has 'use[d] or employ[ed] [a] deceptive device' " in contravention of rule 10b-5.⁹⁰

Under the subjective test, the Seventh Circuit concluded that the defendant actually appreciated the significance of the omitted material.⁹¹ The court based this finding on the defendant's negative response when specifically asked whether the plaintiff had been informed of the faulty accounting practices.⁹² The defendant did not "genuinely forg[e]t about these facts . . .

83. 553 F.2d at 1045. Under this aspect of the *Sundstrand* analysis, the actual appreciation by the defendant of the significance of the alleged omission or misrepresentation is considered. Even "inexcusable negligence" would not be included under this test. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 190 n.5 (1976). To illustrate this aspect of the definition, the *Sundstrand* court hypothesized a defendant who genuinely forgot to disclose information. This actor would not be liable "even though the proverbial 'reasonable man' would never have forgotten." 553 F.2d at 1045 n.20. See also *SEC v. National Student Mktg., Corp.*, 457 F. Supp. 682, 711-12 n.68 (D.D.C. 1978).

84. 553 F.2d at 1047. The *Sundstrand* case illustrates that although the *Franke* definition may not be "the conceptual equivalent of intent as a matter of general philosophy, it does serve as a proper legally functional equivalent for intent, because it measures conduct against . . . an external standard." *Id.* at 1045.

85. *Id.* at 1048.

86. *Id.* at 1043.

87. *Id.* at 1046.

88. *Id.* at 1047.

89. *Id.*

90. *Id.* at 1045.

91. *Id.* at 1046.

92. *Id.* at 1047.

[b]ut consciously decided not to disclose" the danger of the accounting practices to the plaintiff.⁹³ Therefore, the defendant was reckless under either the objective or subjective test, and hence, could not escape liability under rule 10b-5.

B. *Analysis of the Seventh Circuit Application*

There are several benefits of the Seventh Circuit's application of the *Franke* definition of recklessness. First, the plaintiff need not necessarily prove that the defendant had subjective knowledge of the risk of harm. Second, even if a plaintiff cannot prove that the defendant had subjective knowledge, objective evidence of the circumstances existing at the time of the defendant's conduct may impute constructive knowledge of the risk of harm. Third, consideration of the obviousness of the actual circumstances to support an inference that the defendant "must have known" of the risk, provides a distinction from negligence because a defendant will not be held liable solely because he "should have known" of the risk. Finally, the Seventh Circuit's application of the *Franke* definition provides a framework for practical analysis of the complex factors inherent in securities litigation.

First, the Seventh Circuit's use of a subjective test as an alternative basis on which to find recklessness has certain merits. Certainly, if there is unequivocal evidence, by an admission, for example, that the defendant knew he was fraudulently misleading the plaintiff, the inquiry into the defendant's scienter is ended;⁹⁴ the *Hochfelder* requirement of conscious deception would be satisfied.⁹⁵ If such subjective proof is not accessible to the plaintiff, however, a court applying the Seventh Circuit approach, could still use the objective standard.⁹⁶ Failure to do so may not only preclude many injured plaintiffs from properly recovering,⁹⁷ but may result in the court's use of attenuated reasoning to support a defendant's mental culpability.⁹⁸ For

93. *Id.* (citation omitted).

94. See *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 33 (2d Cir. 1976); *In re Transocean Tender Offer Sec. Lit.*, 455 F. Supp. 999, 1010 (N.D. Ill. 1978); *Aldrich v. New York Stock Exch., Inc.*, 446 F. Supp. 348, 355 (S.D.N.Y. 1977).

95. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197-98 (1976).

96. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1046 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); see notes 86-90 *supra* and accompanying text.

97. See *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). Section 10(b) was enacted, in part, due to the inadequate redress available to investors under state law. See S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934). There were many state "blue sky" laws that had provisions regulating fraud prior to the enactment of the federal securities acts. These state laws were characterized as "hastily drafted by well-intentioned men with little or no appreciation of the world of finance. . . . [F]ew of the statutory schemes were sufficiently sophisticated to achieve the avowed purpose of preventing fraud." L. Loss & E. Cowett, *Blue Sky Law* 11 (1958). See generally 3 L. Loss, *supra* note 25, at 1623-83; Note, *The Future of the Reliance Requirement in Private Actions Under SEC Rule 10b-5: A Proposal*, 9 Cum. L. Rev. 721, 724 (1979).

98. One commentator has observed that the courts "have feigned consistent standards while broadly deciding each case on its individual facts depending on the result they believe is dictated by their own particular construction of the purposes of Section 10(b)." Mann, *Rule 10b-5*:

example, in *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*,⁹⁹ the Second Circuit recognized the elements of recklessness,¹⁰⁰ but sought to predicate the defendant's liability on actual awareness that he had fraudulently misled the plaintiff.¹⁰¹ The plaintiff, however, did not demonstrate that the defendant actually knew that audits he had prepared falsely would be used for a final financial statement upon which the plaintiff would rely in making securities investments.¹⁰² Moreover, the plaintiff did not allege that the defendant had participated in or had responsibility for the final report.¹⁰³ Nevertheless, by considering the materiality of the omissions and misrepresentations, and the plaintiff's reliance, the court found that the defendant possessed the requisite "intent to deceive, manipulate, or defraud."¹⁰⁴ This reasoning improperly blurs the distinctions between the separate elements of the rule 10b-5 offense.¹⁰⁵

Lacking the necessary evidence to satisfy the subjective test, the *Herzfeld* court might have used an objective standard to determine the presence of recklessness.¹⁰⁶ Under that second test, *Sunstrand* directs a court to examine the actual circumstances existing at the time of the transaction, rather than attempt to discern the defendant's state of mind "in the blazing light of hindsight."¹⁰⁷ The Third Circuit recently employed this approach in *McLean*

Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter, 45 N.Y.U. L. Rev. 1206, 1207 (1970). See also Keeton, *supra* note 26, at 583.

99. 540 F.2d 27 (2d Cir. 1976). The defendant Laventhol prepared financial statements that were used in formulating a report to advise the plaintiff of the profitability of a corporation in which the plaintiff was planning to invest. Laventhol used an accounting method that immediately recognized profits from a "fictitious or proposed or artificial transaction," *id.* at 30 (citations omitted), that, had it been consummated, would have been the largest transaction in the corporation's history. *Id.* The plaintiffs relied on the financial report and suffered financial loss. *Id.* at 34.

100. *Id.* at 35-36. Although the *Herzfeld* court did not expressly use the term, the decision has been cited for the proposition that recklessness sustains a private action under rule 10b-5. See, e.g., *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 n.6 (3d Cir. 1977), *cert. denied*, 439 U.S. 830 (1978); *Aldrich v. New York Stock Exch., Inc.*, 446 F. Supp. 348, 355-56 (S.D.N.Y. 1977). The *Herzfeld* court noted that the defendant acted in total disregard of facts which were known to him and "dictated precisely the contrary course." 540 F.2d at 35.

101. 540 F.2d at 32-34.

102. *Id.* at 32.

103. *Id.*

104. *Id.* at 37. For example, the court acknowledged that the defendants were "not being cast in damages for negligenc[ce]," but for "their active participation in the preparation and issuance of false and materially misleading accounting reports upon which [the plaintiff] relied to his damage." *Id.* Yet, the court did not delineate the relationship between scienter and materiality or reliance, and never expressly described the nature of the defendant's scienter.

105. 3 A. Bromberg & L. Lowenfels, *supra* note 17, at 193-223; 5 A. Jacobs, *supra* note 3, § 36, at 2-2 to 2-6; Note, *The Future of the Reliance Requirement in Private Actions Under SEC Rule 10b-5: A Proposal*, 9 Cum. L. Rev. 721, 721 (1979). See generally Note, *The Due Diligence Defense in Rule 10b-5: The Hochfelder Aftershocks*, 11 Ind. L. Rev. 727, 730-33 (1978); see also *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 63 (1975).

106. Concededly, the court's finding of liability was justified given the egregious conduct of the defendant. See 540 F.2d at 36.

107. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 n.19 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). "As in all lawsuits, we deal in the sometimes unreal certainties of

v. Alexander,¹⁰⁸ in which the plaintiff purchased stock in reliance on representations in the defendant public accounting firm's report that was based on an audit which erroneously included unconsummated consignment sales in current assets.¹⁰⁹ The court found no evidence that the defendant, a partner in the firm, had "actual knowledge of the consignment arrangement" or that he "was aware of the risk" that the financial statements were misleading.¹¹⁰ But applying the *Sundstrand* objective standard, the court stated that the accountant could be held to have the necessary scienter if the evidence "give[s] rise to an inference that it 'must have been aware' of the risk that the [statement] was misleading."¹¹¹ Holding that the defendant was not reckless, the court determined that he was not privy to the purchasing negotiations, that he would not have been put on notice of the consignment nature of the sales by inconsistencies in the audit, and that he received confirmations indicating that several accounts receivable were genuine.¹¹² The court concluded that although the defendant had reason to believe that the investigation into the sales was inadequate,¹¹³ there was no evidence to support

hindsight. . . . [The defendant] may think he 'knows' things contrary to what he is told by the management upon which he must perforce rely. He may be wrong. . . . How and when he must—or may—run off to 'warn' or advise outsiders . . . could suggest questions of great refinement." *Lanza v. Drexel & Co.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,826, at 90,105 n.18 (S.D.N.Y. 1970), *aff'd*, 479 F.2d 1277 (2d Cir. 1973) (en banc).

108. 599 F.2d 1190 (3d Cir. 1979).

109. *Id.* at 1194-96. The plaintiff, a sophisticated investor, sought to invest in a company with a good future growth potential. *Id.* at 1195. The plaintiff chose to purchase stock in Technidyne based on his own knowledge of the company's future sales potential and the report of the defendants—a public accounting firm—which indicated that Technidyne had "hard" sales consummated of the Model V Techitool. *Id.* at 1195-96. These sales were, in fact, not consummated and the plaintiff, therefore, suffered a loss as a result of his investment. *Id.* at 1196.

110. *Id.* at 1199.

111. *Id.* The *McLean* court extended the use of the Seventh Circuit's definition of recklessness to misrepresentations as well as omissions. *Id.* at 1197; *accord*, *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47-48 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976).

112. 599 F.2d at 1199. The defendants relied on certain telegram messages which confirmed purchase orders, but did not indicate confirmation of amounts due and owing. These telegrams had been fraudulently sent by employees of Technidyne, rather than the customers. *McLean v. Alexander*, 420 F. Supp. 1057, 1070 (D. Del. 1976), *rev'd*, 599 F.2d 1190 (3d Cir. 1979). The accountants never personally verified the telegrams, and therefore, did not discover the fraud. 599 F.2d at 1199. "Thus, without having received positive confirmations from three of four accounts representing nearly 90% of the dealer receivables and having no personal knowledge about any of the dealers since they were all new accounts, [the defendant] issued a certified audit indicating that the accounts were genuine." 420 F. Supp. at 1070. Additionally, there was a one month discrepancy between the invoices of the sales and the purported purchase orders. This discrepancy, coupled with the fact that some of the merchandise was still in the Technidyne warehouse, might have put the defendants on notice of a possible fraud. *Id.* at 1199.

113. *Id.* at 1199-1200. The court noted that if it applied a negligence standard it "could affirm a finding that given the one month discrepancy in the due dates between the invoice and purchase order, the late issuance of the invoice, and the ambiguity in the telegraphic confirmation [of accounts receivable], [the accountant] should have made further inquiry of management . . .

liability for recklessness. The court's analysis suggests that insufficiency of subjective evidence should not foreclose further inquiry into the objective circumstances of the defendant's conduct to discover the potential for recklessness.

The third benefit of the Seventh Circuit analysis is that knowledge is imputed because of the obviousness of the attendant circumstances: thus, a defendant is reckless only if he "must have known" of the risk, and is not liable when he is merely negligent because he "should have known" of the risk.¹¹⁴ The Second Circuit failed to draw this distinction in *Rolf v. Blyth, Eastman Dillon & Co.*,¹¹⁵ in which it purported to use the *Franke* definition, but did not employ the Seventh Circuit's analytical framework.¹¹⁶ In *Rolf*, the plaintiff had entrusted his stock portfolio to the defendant broker who had delegated management of the portfolio to another investment advisor who the court characterized as "one of the 'new breed' of young money-managers with supposed expertise in research and 'special situations.'"¹¹⁷ The defendant made repeated assurances concerning the advisor's capabilities to manage the account profitably, when in fact, the court found that the defendant considered some of the investments made for plaintiff to be "junk"—or securities of very low quality.¹¹⁸ The court held that the defendant was reckless because he had failed to investigate the stock purchases and to supervise the investment decisions adequately, yet represented to the plaintiff the soundness of his

before concluding that the account receivable was genuine." *Id.* Furthermore, the court recognized that those factors did not evidence that the accountant "was aware that it was without sufficient knowledge to form that opinion. Such a holding would obliterate the distinction between tortious conduct requiring scienter, which the *Hochfelder* construction of § 10(b) demands, and negligence, which *Hochfelder* found insufficient." *Id.* at 1200

114. See notes 42-63 *supra* and accompanying text.

115. 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). Similarly, in *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (en banc), the Second Circuit formulated a recklessness standard which encompassed 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." *Id.* at 1306 n.98. This standard amounts to little more than a description of the skeletal fact situation that would normally give rise to a 10b-5 suit. The difficult issue concerning the defendant's duty of inquiry and the facts that would give notice are merely stated without more. Thus, knowledge may be imputed to the defendant by determining what he "should have known" based on the reasonable community standard. Such a result would include negligence within the scope of rule 10b-5 liability. Substantially similar formulations have been used both before and after the *Hochfelder* decision. See, e.g., *Nelson v. Serwold*, 576 F.2d 1332, 1137-38 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); *Cohen v. Franchard Corp.*, 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 357 (1973); *Steinberg v. Carey*, 439 F. Supp. 1233, 1239 (S.D.N.Y. 1977); *Little v. First Cal. Co.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,225, at 92,555 (D Ariz. 1977).

116. 570 F.2d at 45-47.

117. *Id.* at 41-42. The plaintiff sought to combine the investment advisor's "youth and zeal with [the defendant's] reliability and supervision." *Id.* at 42.

118. *Id.* at 43. The plaintiff's portfolio included 21 good quality listed securities and the warrants of two companies, and had an estimated value of \$1,423,000 at the time the defendant assumed responsibility. *Id.* at 42. Shortly before the plaintiff brought suit, its value had dropped to \$446,000.

portfolio.¹¹⁹ Judge Mansfield dissented arguing that the plaintiff's allegations supported only a finding that the defendant failed to conduct an investigation necessary to make these assertions, and that the danger to the plaintiff was neither known to the defendant nor would it "have been readily apparent upon exercise of due diligence."¹²⁰

After *Hochfelder*, "[a] failure to perform such an investigation without more does not . . . establish" that the defendant "deliberately shu[t] his eyes to facts that would have revealed the 'fraud.'"¹²¹ It is arguable, therefore, that the *Rolf* court improperly imposed liability for recklessness without finding that the defendant had either subjective or constructive knowledge of fraud. Liability seems to have been based solely on breach of the duty of inquiry¹²² pursuant to which the defendant "should have known" of the risk to the plaintiff.¹²³ Thus, the Second Circuit's decision in *Rolf* complies neither with the Seventh Circuit's analysis of recklessness nor with the scienter requirement of *Hochfelder*.

CONCLUSION

The Seventh Circuit's analysis of the *Franke* definition of recklessness provides functional guidelines for courts to apply to determine the scienter of

119. *Id.* at 47-48, citing *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 112, 15 N.E.2d 416, 418-19 (1938); see note 51 *supra*. The *Rolf* court determined that the defendant was liable as an aider and abettor because of his continual assurances concerning the advisor's fraudulent mismanagement of the account, 570 F.2d at 44, stating that the *Hochfelder* scienter requirement applies to aiding and abetting liability. *Id.* The *Rolf* decision has been subsequently cited to support the proposition that the recklessness standard is limited to fiduciary relationships in aiding and abetting cases. See *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 484 (2d Cir. 1979); *Bartels v. Algonquin Props. Ltd.*, 471 F. Supp. 1132, 1147 (D. Vt. 1979); *Schulman v. Weil*, 466 F. Supp. 432, 434 (S.D.N.Y. 1979); *Cumis Ins. Soc'y, Inc. v. E.F. Hutton & Co.*, 457 F. Supp. 1380, 1387 & n.10 (S.D.N.Y. 1978).

120. 570 F.2d at 50 (Mansfield, J., dissenting). Judge Mansfield pointed out that "at all pertinent times [the investment advisor's] reputation . . . was excellent and his successful accomplishments in the trade were well known." *Id.* Indeed, the plaintiff testified "that he 'wanted somebody other than [the defendant] to handle his account. In short, he *wanted* to gamble on some 'high fliers.'" *Id.* at 53 (emphasis in original).

121. *Id.* at 52 (Mansfield, J., dissenting).

122. *Id.* at 47. "The standard of care applicable to the determination of whether an independent accountant has exercised due care in his conduct . . . is similar to the standard applied to doctors, lawyers and other professional experts, in that their conduct is not measured in terms of the customary 'reasonable man' test of negligence but rather in terms of a 'reasonable CPA' test." Solomon, *supra* note 12, at 57-58; see *Gammel v. Ernst & Ernst*, 245 Minn. 249, 72 N.W.2d 364 (1955); *Rassieur v. Charles*, 354 Mo. 117, 188 S.W.2d 817 (1945).

123. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 192 (1976). *Hochfelder* involved an accounting firm that had failed to investigate a corporation president's "mail rule" under which only he could open mail addressed to him. This practice aided him in embezzling investors' funds. The failure to fulfill a duty of inquiry, even if mandated by a fiduciary position, cannot alone support an action under rule 10b-5. *Id.* Furthermore, to impose such liability on a broker who is essentially little more than a supervisor of an account disregards an established market practice under which "thousands of business ventures" are traded in the United States markets and it would be "impossible for any one investment advisor . . . to follow all traded business ventures closely." *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 54 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978) (Mansfield, J., dissenting).

securities personnel in private 10b-5 actions. In contrast to the somewhat amorphous and contradictory scienter standards developed to construe *Hochfelder*, the Seventh Circuit's analysis strikes an equitable balance between the goals of protecting investors and insuring the efficient functioning of the securities market. It is submitted that the federal courts should uniformly adopt and apply the Seventh Circuit's analysis to achieve the just resolution of private damage actions under rule 10b-5.

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