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Fredric J. Klink

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The Scienter Standard of Liability Under the Proposed Federal Securities Code

FREDRIC J. KLINK*

I. Introduction

In discussing scienter, I will rely principally on Professor Loss's discussion in the Comments to the Proposed Federal Securities Code¹ and on relevant case law, principally the Supreme Court's opinion in *Ernst & Ernst v. Hochfelder*.²

I will first outline the general fraud and civil liability scheme of the Code and discuss some of the Code's definitions which bear on the issue of scienter. Next, I will trace the evolution of the scienter concept in the various drafts of the Code and then compare the Code's treatment with present law.

II. The Fraud and Civil Liability Scheme of the Code

Fraud and civil liability are dealt with in Parts XVI and XVII of the Code.³ In his introduction to the Code, Professor Loss states that these parts of the Code are of the broadest public interest. The Code provisions, however, can only be assessed

* LL.B., 1960, Columbia Law School; A.B., 1955, Columbia University; Member, Schreiber, Klink, Schreiber, Lenhardt & Carney, P.C., New York.

1. ALI FED. SEC. CODE (1978) (Proposed Official Draft). References in this speech are to the 1978 draft. Comparison will be made with the ALI FED. SEC. CODE (1980) (Official Draft) where the changes in the 1980 draft are significant. On Sept. 30, 1980, the Securities and Exchange Commission published, in an agency release, changes to the 1980 draft which were agreed upon by Professor Loss and the Commission. SEC Sec. Act Release No. 33-6242, 20 SEC Docket 1483 (1980) [hereinafter referred to and cited as CODE RECOMMENDATION].

2. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Petitioner, an accounting firm, was found not liable under rule 10b-5 for failing to discover an unusual procedure established by a brokerage firm's president, who had induced respondents to invest in non-existent escrow accounts. The Supreme Court held that a private cause of action for damages will not lie under § 10(b) of the Securities Act of 1934 and rule 10b-5 in the absence of any allegation of scienter, i.e. "intent to deceive, manipulate, or defraud." *Id.* at 193, 194 n. 12. See note 20 and accompanying text *infra*.

3. ALI FED. SEC. CODE §§ 1601-1614, 1701-1728 (1978).

in the light of the difficulties encountered under current law. In Professor Loss's view, these difficulties are due, in part, to the sparseness of present legislation and to the fact that this area of the law has been frequently litigated and, as a result, is mostly judge-made.⁴

A. *Definitions in the Code*

"Fraudulent acts" and "misrepresentations" are defined in Part XVI, sections 262 and 297.⁵ A fraudulent act, as defined, includes an "act, device, scheme, practice, or course of conduct that (1) is fraudulent or (2) operates or would operate as a fraud."⁶ This includes inaction or silence when there is a duty to act or speak. A person must, however, act with knowledge that his action will result in fraud, or in reckless disregard of such a possibility, if his act is to be considered fraudulent under the Code.⁷

"Misrepresentation" is defined as "(1) an untrue statement of a material fact, or (2) an omission to state a material fact necessary to prevent the statements made from being misleading in the light of the circumstances under which they are made."⁸ If, however, a statement of fact has a reasonable basis and is made in good faith, it is not a misrepresentation.⁹

Section 262(a), which contains the definition of fraud, is derived from the language of rule 10b-5 which, in turn, is derived

4. ALI FED. SEC. CODE at xlix (1978).

Professor Loss lists the most serious difficulties under current law as follows: (a) currently, the fraud provisions are scattered in several statutes and overlap; (b) the increased reliance on rule 10b-5 and the resultant decreased use of §§ 9(e) and 18 of the 1934 Act and § 12(2) of the 1933 Act have led to difficult questions with respect to express and implied liabilities for wrongful acts in connection with all securities transactions; (c) the growth of a "federal corporation law" has created problems; (d) the 1934 Act's provision on insider's short-term trading profits, § 16(b), has presented difficult questions; (e) the judicial practice of developing civil liability for rule violations of stock exchange rules has created uncertainties; and (f) the scattered statutes presently relied upon are often internally inconsistent. ALI FED. SEC. CODE at xlix - lii (1978).

5. *Id.* §§ 262, 297. The 1980 draft makes no change in § 297 but adds a cross reference to § 1602(b)(2) which contains a duty to correct. ALI FED. SEC. CODE § 297 (1980).

6. ALI FED. SEC. CODE § 262(a) (1978).

7. *Id.* §§ 262(b), 262(c).

8. *Id.* § 297(a).

9. *Id.* § 297(b).

from section 17 of the Securities Act of 1933.¹⁰ These definitions, together with the definitions of "fact"¹¹ and "material,"¹² make it possible, according to Professor Loss, to consolidate the proscription of fraudulent acts with respect to securities into one

10. For the text of section 262(a), see text accompanying note 6 *supra*. Rule 10b-5 states:

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.

17 C.F.R. § 240.10b-5 (1980). Section 17 of the Securities Act of 1933 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 or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, 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.

Securities Act of 1933, § 17, 15 U.S.C. § 77g (1976).

11. The 1978 draft broadly defines "fact" as "(a) a promise, prediction, estimate, projection, or forecast, or (b) a statement of intention, motive, opinion, or law." ALI FED. SEC. CODE § 256 (1978).

12. "A fact is 'material' if there is a substantial likelihood that a reasonable person would consider it important under the circumstances in determining his course of action," ALI FED. SEC. CODE § 293(a) (1978). This definition incorporates the "substantial likelihood" phrase from *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). This case involved an action brought by Northway, a TSC shareholder, against Aetna National claiming that the ATSC-Aetna National joint proxy statement was incomplete and materially misleading in violation of section 14(a) of the Securities Exchange Act of 1934 and rules 14a-3 and 14a-9. Northway also alleged that Aetna National pursued a fraudulent plan to acquire TSC in violation of section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5. The court held that

[a]n omitted fact is material if there is a *substantial likelihood* that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. . . . [T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Id. at 449 (emphasis added).

short section, section 1602. Section 1602 makes it unlawful for anyone to make a misrepresentation or to commit a fraudulent act with respect to purchases, sales, tender offers and investment advice.¹³

B. *The Code's Liability Provisions*

Part XVII of the Code, which contains the sections dealing with liability, includes all of today's express civil liabilities and, in addition, expressly includes those liabilities presently most often implied. Furthermore, section 1722 of the Code authorizes the courts to imply private causes of actions if, among other things, such actions are consistent with the conditions and restrictions applicable to the private causes of action expressly provided in the Code and if the plaintiff demonstrates that the remedy sought is not disproportionate to the violation.¹⁴

III. *Scienter*

A. *Evolution of the Definition of Scienter in the Proposed Code*

The comments accompanying section 287 of the Code trace the evolution of the knowledge and the scienter concepts in the various drafts of the Code. Originally the Code defined the term

13. ALI FED. SEC. CODE § 1602(a) (1978). This section provides:

(a) [General.] It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with (1) a sale or purchase of a security, an offer to sell or buy a security, or an inducement not to buy or sell a security, (2) a proxy solicitation or other circularization of security holders in respect of a security of a registrant, (3) a tender offer or a recommendation to security holders in favor of or opposition to a tender offer, or (4) activity or proposed activity as an investment adviser.

The 1980 draft rephrases § 1602(a)(4) as follows: "any activity or proposed activity by an investment adviser with respect to a client or a prospective client." ALI FED. SEC. CODE § 1602(a)(4) (1980). For the Code's definition of misrepresentation, see note 8 and accompanying text *supra*.

14. ALI FED. SEC. CODE § 1722(a) (1978). Judicial implication of a private right of action was dealt with by the Supreme Court in *Cort v. Ash*, 422 U.S. 66 (1975). In this case, the Court formulated a four part test for implying a private right of action in federal legislation. *Id.* at 78. The implied liability provisions of section 1722(a) were modified by the Commission and Professor Loss to conform to the standards for implying a private right of action set forth in *Cort*. CODE RECOMMENDATION, *supra* note 1, at 1500-01. See 571 SEC. REG. & L. REP. (BNA) A-1 (1980).

“knowledge,”¹⁵ but did not define “scienter.” Subsequently, a definition of scienter was added to the Code and the definition of knowledge restricted to one specific provision. In the next draft of the Code, the definition of scienter was refined, following the concept of the ALI *Model Penal Code*,¹⁶ in terms of “intentionally” and the term knowledge was included as part of the term scienter.¹⁷

Currently, scienter is defined in section 299.50 of the Code as follows:

A person makes . . . a misrepresentation with “scienter” if he knows that he is making a misrepresentation (or a misrepresentation is being made) or acts in reckless disregard of whether that is so.¹⁸

Knowledge, however, is not defined in the Code. Under the present scheme of the Code, with no definition of knowledge, courts and the Commission are directed to interpret the term in context.¹⁹ Scienter is defined in terms of “reckless disregard” rather than in terms of the “intent to deceive” language of the *Ernst & Ernst v. Hochfelder* case.²⁰ This approach was adopted because

15. The 1978 draft originally adopted a definition of knowledge that was similar to the definition found in RESTATEMENT OF TORTS § 526 (1976). Section 526 of the Restatement provides:

A misrepresentation is fraudulent if the maker

(a) knows or believes that the matter is not as he represents it to be,

(b) does not have the confidence in the accuracy of his representation that he states or implies or

(c) knows that he does not have the basis for his representation that he states or implies.

16. ALI MODEL PENAL CODE § 2.02(2)(b) 1980. This section provides:

A person acts knowingly with respect to a material element of an offense when:

(i) if the element involves the nature of his conduct or the attendant circumstances, he is aware that his conduct is of that nature or that such circumstances exist; and

(ii) if the element involves a result of his conduct, he is aware that it is practically certain that his conduct will cause such a result.

17. ALI FED. SEC. CODE § 287, Comments (2) - (8) (1978).

18. *Id.* § 299.50.

19. *Id.* § 287, Comment 7(d)(i).

20. *Id.* § 299.50. The Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), defined scienter as “a mental state embracing intent to deceive, manipulate, or defraud.” The Court also recognized that recklessness is considered intentional conduct for some areas of law and thus refused to address whether “reckless behavior is sufficient for civil liability under § 10(b) or rule 10b-5.” *Id.* at 194 n. 12.

Professor Loss believes that knowledge should only mean actual knowledge in the ordinary sense and that use of the Latinism, "scienter," makes it clear that the Code intends something other than ordinary knowledge.²¹ Scienter, then, is defined in terms of whether the person knows that he is making a misrepresentation or acts in reckless disregard of the accuracy of his statement.²² Scienter in the proposed Code is confined to civil and Securities and Exchange Commission administrative proceedings.²³

B. *Comparison of the Code with Present Law.*

Professor Loss has indicated that the Code's definition of scienter is different from the *Hochfelder* test of "a mental state embracing intent to deceive, manipulate or defraud."²⁴ Professor Loss indicates that he has always felt that clause B of rule 10b-5 does not carry out the statutory mandate of section 10(b) of the 1934 Act unless scienter is implied.²⁵ He claims, however, that there is no reason to believe that section 10(b) of the Act requires a measure of scienter stricter than that required by common-law deceit.²⁶

After *Hochfelder*, a number of circuit courts have defined rule 10b-5 intentional behavior to include reckless disregard as

21. ALI FED. SEC. CODE § 287, Comment 7 (1978). But, according to Black's Law Dictionary, "scienter" is the Latin equivalent for "knowingly."

The term is used in pleading to signify an allegation (or that part of the declaration or indictment which contains it) setting out the defendant's previous knowledge of the cause which led to the injury complained of, or rather his previous knowledge of a state of facts which it was his duty to guard against, and his omission to do which has led to the injury complained of. The term is frequently used to signify the defendant's guilty knowledge.

BLACK'S LAW DICTIONARY 1207 (5th ed. 1979).

22. ALI FED. SEC. CODE § 299.50 (1978).

23. *Id.* § 287, Comment 7(d)(iii).

24. *Id.* § 287, Comment 8(a).

25. *Id.* § 287, Comment 8(b).

26. The comment further states that common law deceit does not require intent to cause injury but only to induce action in reliance on the misrepresentation. "[I]ntent to cause harm is of no importance at common law except with respect to the issue of punitive damages. . . ." ALI FED. SEC. CODE § 287, Comment (8)(b) (1978). See also *Arthur Lipper Corp. v. SEC*, 547 F.2d 171 (2d Cir. 1976), cert. denied, 434 U.S. 1009 (1978). The court held that proof of intention to deceive, manipulate or defraud is sufficient to show a rule 10b-5 violation; intention to act in knowing violation of the law is not necessary. *Id.* at 180-81. The common-law background of deceit, as used in *Hochfelder*, is discussed in *Aimoff, Holmes Looks at Hochfelder and 10b-5*, 32 BUS. LAW 147 (1976).

to falsity and have attempted to give meaning to the term reckless. In *Sundstrand Corp. v. Sun Chemical Corp.*,²⁷ the seventh circuit stated that reckless behavior is actionable under rule 10b-5 for acts of commission or omission, which are "highly unreasonable" and reflect "an extreme departure from the standards of ordinary care."²⁸ The seventh circuit held in a subsequent case that reckless behavior should not be so liberally construed as to blur the distinction between scienter and negligence.²⁹ The second circuit, in *Rolf v. Blyth, Eastman Dillon & Co.*, stated that reckless behavior meant highly unreasonable behavior or extreme departure from ordinary care.³⁰

This seems to me to bring us back to something equivalent to gross negligence. Mere negligence would not be actionable under the Code and is not now actionable under rule 10b-5.³¹ Reckless behavior — whatever that will be found to mean — would clearly be actionable under the Code and is actionable under the circuit court cases discussed above. Whether the Supreme Court will ultimately adopt the standard of recklessness articulated by the circuit courts is open to question. Recklessness would seem to be a much more liberal concept than the "intent to deceive" test of *Hochfelder*.³² Whether the Code's definition of scienter, which included reckless disregard, would prove more liberal than the Supreme Court's test will ultimately

27. *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir.), cert. denied, 434 U.S. 875 (1977).

28. *Id.* at 1045 (quoting *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976)).

29. *Sanders v. John Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977). The defendant, underwriter of short-term notes on which the issuer defaulted, was, at first, held liable under rule 10b-5 for failing to make reasonable inquiries that would have led to the discovery of the issuer's fraud. After granting *certiorari*, the Supreme Court remanded the case for reconsideration in light of *Hochfelder*. The Seventh Circuit, on remand, reversed, finding the record void of intent to deceive, since the defendant had relied upon financial statements prepared by certified public accountants. Though the court noted that reckless behavior can constitute scienter for rule 10b-5 purposes, it warned that "the definition of 'reckless behavior' should not be a liberal one, lest any discernible distinction between 'scienter' and 'negligence' be obliterated. . . ." *Id.* at 793.

30. *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir.), cert. denied, 439 U.S. 1039 (1978).

31. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). *But see* *Aaron v. SEC*, 446 U.S. 680 (1980). In *Aaron* the Court held that the Commission, in an injunctive action brought for violations of 10b-5, must also show scienter.

32. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). *See* notes 2 & 20 *supra*.

depend on whether the Supreme Court will extend the *Hochfelder* standard to include reckless behavior. Even if the Supreme Court does find reckless behavior sufficient to trigger rule 10b-5 liability, the issue will not be settled. A line will still have to be drawn between reckless behavior and negligent behavior. Subsequent courts will have to draw this line.

C. Aider and Abettor Liability

It is difficult to focus on a particular provision of the Code without discussing collateral issues. For example, in discussing the role or position of accountants, most of the case law under rule 10b-5, including the *Hochfelder* case, has involved so-called aider and abettor liability.³³ This is covered in section 1724 of the Code which provides:

An agent or other person who knowingly causes or gives substantial assistance to conduct by another person (herein a "principal") giving rise to liability under this Code (as defined in section 225 and except for section 1714) with knowledge that the conduct is unlawful or a breach of duty, or involves a fraudulent act, a misrepresentation, or nondisclosure of a fact of special significance by an insider (as defined in section 1603(b)), is liable as a principal.³⁴

In the notes to this section, Professor Loss indicates that one who "knowingly" gives substantial assistance to the person primarily liable is himself liable.³⁵ The problem again is that the term knowingly is not defined in the Code. As indicated above,

33. See, e.g., *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478 (2d Cir. 1979); *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588 (10th Cir. 1979); *Hirsch v. duPont*, 553 F.2d 750 (2d Cir. 1977); *Murphy v. McDonnell & Co.*, 553 F.2d 292 (2d Cir. 1977); *Verace v. New York Stock Exch.*, 478 F. Supp. 1061 (S.D.N.Y. 1979).

34. ALI FED. SEC. CODE § 1724(a) (1978). The 1980 Code changes "conduct" to "fraudulent or manipulative act." ALI FED. SEC. CODE § 1724 (1980). A major modification of § 1603(a) insider trading resulted from negotiations between the Commission and Professor Loss and his advisers. See 571 SEC. REG. & L. REP. (BNA) A-1 (1980); CODE RECOMMENDATION, *supra* note 1, at 1485. Under these changes, the Commission, in any Commission injunctive or administrative actions involving insider trading or tippees, would only be required to demonstrate "materiality." Private actions, however, would be governed under the Code's test of "fact of special significance." The plaintiff would have to show that the omitted or misrepresented fact was material, with the defendant bearing the burden of showing that this material fact was not of special significance. *Id.*

35. ALI FED. SEC. CODE § 1724(b), Comment (1978).

Professor Loss has stated that when he uses the term knowledge in the Code, he means actual knowledge. The question becomes, actual knowledge of what? Knowledge of a violation of law is not required; knowledge that one is breaching a duty would seem to be sufficient. Note that there is no reference here to reckless behavior; apparently reckless behavior by an aider and abettor is not sufficient to give rise to liability.

D. *Status of the Defendant*

The meaning of the term reckless, which has been left undefined in the Code, will vary, and will depend, in Professor Loss's view, "to some extent on the particular person's position — whether, for example, he is a director, a securities professional, or some species of fiduciary."³⁶ As Professor Loss seems to suggest, one of the principal factors in determining whether certain behavior would be actionable would be the status of the defendant or defendants. Accountants, securities professionals, and inside officers and directors (particularly those with operational responsibilities in the problem area) will probably be held to a stricter standard of responsibility than outside directors.³⁷

It is probably also relevant, when considering what behavior can be classed as reckless, first, to look at the practical steps a defendant, given his role in the transaction, could have taken to ferret out the fraud and, second, to see what the defendant gained by the allegedly fraudulent transaction. For example, if it is the financial statements which are alleged to be misleading, an accounting firm which has derived substantial fees from its client for preparing those statements should be required to demonstrate that extraordinary due diligence has been used to ferret out inaccuracies.³⁸ A harder case is presented if the alleged

36. *Id.* § 287, Comment (8)(d). See generally Note, *Recklessness and Rule 10b-5 Scienter Standard After Hochfelder*, 48 *FORDHAM L. REV.* 817 (1979-80).

37. See Steinberg & Gruenbaum, *Variations of 'Recklessness' After Hochfelder and Aaron*, 8 *SEC. REG. L.J.* 179, 203-07 (1980).

38. See generally 5 A. JACOBS, *THE IMPACT OF RULE 10B-5* § 66.01[d] at 3-303 (1980). But see *Adams v. Standard Knitting Mills*, 623 F.2d 422 (6th Cir. 1980). This case involved a private action against an outside accounting firm brought by a shareholder under §§ 10(b) and 14(a) of the Securities Exchange Act of 1934. The firm was held not liable for misleading errors in the proxy statement which were due to the firm's negligence in preparing the statement. The deficiencies were not caused by failure to follow

fraudulent document is a registration statement. The law is still evolving as to the extent of securities lawyers' responsibilities for inaccuracies in a registration statement or other disclosure document. Typically, when securities lawyers give opinions on a securities issue, they, unlike accountants, do not specifically opine on text portions of a registration statement other than those that pertain to litigation and other specialized areas. It seems fair, however, for a securities lawyer who, for substantial compensation, prepares disclosure documents to have to prove that he used reasonable due diligence in checking the accuracy of the registration statement. At the other end of the spectrum, it seems that an outside director or officer should not be held to the standards just stated if he does not have direct responsibility in the area of the misstatement, realizes no special benefit from the fraud, and has only limited practical ways of ferreting out the fraud.³⁹

IV. Conclusion

In conclusion, it seems to me that since the terms "knowledge" and "reckless," which are the two principal ingredients within the definition of scienter, are deliberately not defined in the Code, the same case-by-case evaluation of the standards of liability, which has occurred, and will continue to occur, under rule 10b-5, would continue under the Code.

V. Discussion

Mr. Jacobs: I wonder if I could add two comments. Even if we had a definition of knowledge in the Code, we would still have to face the following issue, extremely troublesome under present law: if you talk about actual knowledge within an inanimate body, what exactly do you mean? For example, if the chief executive officer of a corporation has actual knowledge of an event, does that mean that the corporation has actual

appropriate accounting procedures. *Id.* at 428-31.

39. For further analysis of the role of securities professionals in the securities market, see Hamil, *Attorney Liability in Securities Transactions*, 9 COLO. LAW 516 (1980); Metzger & Heintz, *Hochfelder's Progeny: Implications for the Auditor*, 63 MINN. L. REV. 79 (1978); 3A H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATION LAW*, §§ 7.06, 9.09 (rev. ed. 1979).

knowledge? If the answer to that is yes, what if the knowledge is that of the geologist up in Timmons, Ontario, who is not an officer, but a \$10,000-a-year employee? Is his actual knowledge imputed to the corporation?

My second comment is on a much broader scale. I think that while scienter is one of the key issues in the entire Code, juries and judges in their role as fact finders are going to do what they please, without being bound by rigorous definitions. The definition in the Code is not going to make any difference because as long as you convince the trier of fact that this conduct is wrongful, it's very likely that the finder of fact is going to find the level of conduct necessary to impose liability.