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AUDITORS WHISTLE AN UNHAPPY TUNE

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INTRODUCTION

The Private Securities Litigation Reform Act of 1995 (Reform Act)[1] contains a provision which requires auditors to detect fraudulent financial reporting and illegal acts and to report such illegal acts in their audit procedures.[2] Auditors now seemingly have an obligation to whistle blow on their clients. This represents a significant departure from existing judicial and professional auditing standards in terms of auditors' potential fraud liability.

Before the adoption of the Reform Act, auditors' responsibilities in this area were governed by Generally Accepted Auditing Standards (GAAS) issued by the American Institute of Certified Public Accountants (AICPA) and judicial decisions under section 10(b) of the Securities and Exchange Act of 1934 (Exchange Act).[3]

Two auditing standards issued prior to the passage of the Reform Act are critical: (1) Statement on Auditing Standards (SAS) No. 53 entitled "The Auditors' Responsibility to Detect and Report Errors and Irregularities"[4] and (2) SAS No. 54 entitled "Illegal Acts by Clients."[5]

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1. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as additions and amendments to 15 U.S.C. §§ 77-78 and 18 U.S.C. § 1964 (Supp. I 1995)) [hereinafter Reform Act].

2. Reform Act sec. 301(a), § 10A, 15 U.S.C. § 78j-1 (Supp. I 1995) (amending the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (1994)).

3. Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)(1994). The full text of section 10(b) makes it unlawful for any person:

> [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).

4. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), CODIFICATION OF STATEMENTS ON AUDITING STANDARDS § 316.03 (1995) (codifying AUDITING STANDARDS BOARD, STATEMENT ON AUDITING STANDARDS NO. 53 (1988)) [hereinafter SAS NO. 53]. The STATEMENT ON AUDITING STANDARDS consists of standards promulgated by the AICPA's Auditing Standards Board for future assimilation into the CODIFICATION OF STATEMENTS ON AUDITING STANDARDS.

Shortly after the enactment of the Reform Act, in SAS No. 82 entitled "Consideration of Fraud in a Financial Statement Audit,"[6] the AICPA promulgated new guidance on auditors' responsibilities to detect fraud in conducting a financial statement audit.[7]

Unlike the Reform Act's whistle blower provision, neither SAS No. 54 nor SAS No. 82 requires the auditor to make a public disclosure of a client's wrongdoing, although SAS No. 82 refers to the Reform Act's disclosure requirement as a circumstance in which public disclosure of illegal acts by the auditor may be required.[8] Although the Accounting Standards Board (ASB) formed its fraud task force to develop SAS No. 82 long before the Reform Act was enacted[9] and does not consider SAS No. 82 to be a response to the Reform Act,[10] there appears to be an unmistakable relationship between the legislation and these professional auditing standards.

Furthermore, auditors' whistle blower responsibilities have been defined and developed in a growing body of judicial decisions adjudicating securities fraud claims under section 10(b) of the Exchange Act.[11] Securities fraud litigation has proven to be quite costly to the accounting profession which was one of the Reform Act's earliest and strongest advocates.[12] The accounting profession heavily lobbied for such provisions of the Reform Act as the safe harbor for forward-looking information,[13] the heightened pleading requirements for alleging securities fraud,[14] the

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5. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS § 317.08 (1995) [hereinafter AU].

6. AUDITING STANDARDS BOARD, STATEMENT ON AUDITING STANDARDS NO. 82, CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT (1997) (superseding SAS NO. 53, effective for audits of financial statements for periods ending on or after December 15, 1997) [hereinafter SAS NO. 82].

7. *Id.*

8. *Id.* at ¶ 40; *see infra* Part II B.

9. Jane Mancino, *The Auditor and Fraud*, J. OF ACCOUNTANCY, Apr. 1997, at 32 (noting the AICPA board of directors, in its June 1993 report, supported the recommendation of the Public Oversight Board (POB) of the AICPA division for CPA firms, SEC practice section, to undertake initiatives to detect and prevent fraud, particularly in financial statements).

10. *See* PUBLIC OVERSIGHT BOARD OF THE SEC PRACTICE SECTION OF THE AICPA, IN THE PUBLIC INTEREST (Mar. 5, 1993) (special report); Board of Directors of the AICPA, *Meeting the Financial Reporting Needs of the Future: A Public Commitment from the Public Accounting Profession*, J. OF ACCOUNTING, Aug. 1993, at 17; Mancino, *supra* note 9, at 32.

11. *See generally* Robert A. Prentice, *Locating that "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691 (1997) (providing extensive analysis of court treatment of section 10(b)).

12. Harvey L. Pitt & David B. Hardison, *For Outside Accountants, the New Obligations Imposed by the Securities Litigation Reform Act Go Way Beyond Classical GAAS*, NAT'L L.J., Mar. 25, 1996, at B4 (discussing the accounting profession's active role in lobbying for the Reform Act).

13. *See* Reform Act sec. 102(a), § 27A, 15 U.S.C. § 77z-2 (Supp. I 1995) (adding a safe harbor provision to the Securities Act of 1933); Reform Act sec. 102(b), § 21E, 15 U.S.C. § 78u-5 (adding a safe harbor provision to the Exchange Act).

14. Reform Act sec. 101(b), § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2).

elimination of joint and several liability[15] and the adoption of a modified system of proportionate liability for securities fraud cases.[16]

In 1992, securities fraud litigation costs for the six largest accounting firms accounted for $783 million or more than 14% of their audit revenues, and today these firms face billions of dollars in securities fraud claims.[17] The Big Six accounting firms[18] are more aggressively protecting themselves by dumping audit clients that they deem to be a high risk for generating costly securities fraud litigation over allegedly faulty audits.[19] According to Dan Guy, vice president of professional standards and services at the AICPA, "[m]ore than ever, accounting firms don't want to expose themselves to clients who will harm their reputations or generate costly litigation."[20]

This may be especially true in light of a recent empirical study conducted by Stanford University Law School Professors Grundfest and Perino (Grundfest study) of class action securities fraud litigation which were filed during calendar year 1996, the first year that the Reform Act took effect.[21] It concluded that "allegations of accounting irregularities or trading by insiders now explain the lion's share of federal class action litigation."[22] According to the Grundfest study, the frequency of accounting-driven allegations in post-Reform Act complaints has decidedly increased.[23] This increase may be attributed to the Reform Act's height-

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15. Reform Act sec. 201(a), 15 U.S.C. § 78u-4(g)(2)(A) (adding § 21D(g) to the Reform Act's amendments established by the addition of section 101).

16. Reform Act sec. 201(a), 15 U.S.C. § 78u-4(g)(2)(B).

17. George B. Yankwitt & Susan A. Moldovan, *Reform Act: Panacea or Paper Tiger for Accountants and Auditors?*, N.Y. L.J., June 27, 1996, at 1, 1 n.2 (citing *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, 103d Cong., 1st Sess. No. 103-431 (1993) (statement of Jake L. Netterville), *reprinted in* Fed. Sec. L. Rep. (CCH) No. 1696, § 407 (Jan. 10, 1996)).

18. The "Big Six" accounting firms consist of Arthur Andersen, Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Price Waterhouse. Elizabeth MacDonald, *More Accounting Firms Are Dumping Risky Clients*, WALL ST. J., Apr. 25, 1997, at A2.

19. *Id.* (recognizing that the Big Six accounting firms have dropped 30 publicly traded companies as audit clients from January through April, 1997, 92 such clients in 1996, 68 clients in 1995, and 85 clients in 1994).

20. *Id.*

21. Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience*, *in* SECURITIES LITIGATION 1997, at 955 (PLI Corp. Law & Practice Course Handbook Series No. 1015, 1997).

22. *Id.* at 959.

23. The Grundfest study stated:

> [O]ne of the most common forms of fraud alleged in the sixty-five [Post-Reform Act federal] complaints analyzed are misrepresentations or omissions in financial statements which appear in 58.5% of the complaints. Thirty complaints (or 79% of those alleging false and misleading financial statements) allege a violation of Generally Accepted Accounting Principles (GAAP). Of the thirty-eight complaints alleging misrepresentations or omissions in financial statements, thirty-six (or 95%) allege improperly recorded sales, revenues, or earnings. Allegations of misstated financials account for 67.4% of the forty-six complaints that are based solely on alleged section 10(b) violations.

Grundfest & Perino, *supra* note 21, at 973.

ened pleading requirement that plaintiffs "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[24] Plaintiffs may believe that by making particular allegations involving misrepresentations or omissions in financial statements or violations of Generally Accepted Accounting Principles (GAAP), courts will more likely find that they have met their pleading requirements for fraud.[25]

Two new studies indicate that the number of securities fraud class action suits filed in federal court during 1997 have reached the high levels of the early 1990s despite the Reform Act's efforts to curb such lawsuits.[26] Plaintiff's lawyers have also returned to federal court after making adjustments to the higher pleading standards and other barriers, such as the new safe harbor provision for forward-looking statements,[27] created by the Reform Act. The number of shareholder lawsuits filed in state courts, previously viewed as a more amenable forum for such lawsuits, was down sharply in 1997.[28]

This article discusses the current legal issues pertaining to the auditors' duty to detect fraud and illegal acts and disclose such illegal acts under the Reform Act, professional auditing standards and court decisions. Part I provides the judicial framework for auditors' duty to whistle blow on their client's illegal activities. Part II describes auditors' statutorily prescribed duty to detect fraudulent and illegal acts and report illegal acts pursuant to the Reform Act and auditing standards promulgated by the accounting profession. Part III delineates the legal standards plaintiffs must meet to properly plead that auditors have committed securities fraud. Part IV assesses the current legal environment that auditors are working within and suggests a future course for auditors facing fraud liability.

I. JUDICIAL BASIS FOR AUDITORS' DUTY TO DISCLOSE

An auditor's whistle blowing duty was recognized by the Supreme Court in *United States v. Arthur Young & Co.*,[29] where the Court, while denying a federal law privilege for independent auditors' workpapers, stated:

> An independent certified public accountant performs a different role [than an attorney whose job is to serve the client]. By certifying the

24. Reform Act sec. 101(b), § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2) (Supp. I 1995).
25. Grundfest & Perino, *supra* note 21, at 974.
26. Dean Starkman, *Securities Class-Action Lawsuits Make Comeback in Federal Court*, WALL ST. J., July 9, 1997, at B4 (discussing two studies performed by the National Economic Research Associates Inc., a White Plains, N.Y., consulting firm, and the Securities Class Action Clearinghouse, a research project run by Stanford University Law School).
27. Reform Act sec. 101(b), § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2).
28. Starkman, *supra* note 26, at B4.
29. 465 U.S. 805 (1984).

> public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[30]

The Securities and Exchange Commission (SEC) has reiterated this duty[31] enunciated by the Supreme Court. Congress codified this approach by enacting the Reform Act's whistle blower provision.

Shareholder securities fraud actions are generally brought under section 10(b)[32] of the Exchange Act which makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance . . . ."[33] The SEC promulgated Rule 10b-5,[34] commonly known as the general anti-fraud provision prohibiting fraudulent activity in connection with the purchase or sale of any security,[35] in order to implement section 10(b). Most shareholder lawsuits also allege section 10(b) and Rule 10b-5 violations since federal law implicitly, but not expressly, recognizes a private civil cause of action under these sections.[36] As will be discussed below, however, under the Reform Act auditors are specifically protected from private causes of action for any reports of illegal acts by management that are reported to the SEC.[37]

To maintain a securities fraud cause of action under Rule 10b-5, the plaintiff must prove five elements: (a) the defendant made a false state-

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30. *Arthur Young & Co.*, 465 U.S. at 817-18.

31. *In re* American Finance Co., 40 S.E.C. 1043, 1049 (1962).

32. Grundfest & Perino, *supra* note 21, at 973 (stating that review of sixty-five post-Reform Act federal court complaints alleging fraud found that forty-six of the complaints were based solely on section 10(b) violations).

33. 15 U.S.C. § 78j(b) (1994).

34. 17 C.F.R. § 240.10b-5 (1997).

35. Rule 10b-5 states in part:

> It shall be unlawful for any person, directly or indirectly . . . (b) [t]o 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 . . . in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

36. In *Ernst & Ernst v. Hochfelder*, the Court stated:

> Although sec. 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress or the Commission when adopting Rule 10b-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established.

425 U.S. 185, 196 (1976) (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975)); *see also* R. Douglas Martin, Basic Inc. v. Levinson*: The Supreme Court's Analysis of Fraud on the Market and Its Impact on the Reliance Requirement of SEC Rule 10b-5*, 78 KY. L.J. 403, 405-407 (1990).

37. Reform Act sec. 301(a), § 10A(c), 15 U.S.C. § 78j-1(c).

ment or omission; (b) of a material fact; (c) with scienter; (d) in connection with the purchase or sale of securities; (e) upon which the plaintiff reasonably relied; and (f) that reliance proximately caused damages.[38] The Rule 10b-5 requirements mirror the elements of the common law tort action of deceit.[39]

The federal securities laws provide that there is no general duty to speak[40] and "silence, absent a duty to disclose, is not misleading under Rule 10b-5."[41] Most courts have held that mere silence or inaction will not even give rise to secondary securities fraud liability as an aider and abettor under section 10(b) and Rule 10b-5 of the Exchange Act.[42]

Prior to the 1994 Supreme Court decision rendered in *Central Bank v. First Interstate Bank*,[43] courts held that section 10(b) and Rule 10b-5 impose liability not only on those who themselves commit fraud, but also upon those who assist, aid, and abet, others who do so.[44] According to a majority of courts, aiding and abetting liability existed if someone committed a primary violation, the alleged abettor had knowledge of the wrong and his role in it, and the alleged abettor substantially assisted in the violation.[45] In *Central Bank*, the Supreme Court eliminated the most common approach to suing secondary defendants by eliminating aiding and abetting liability under section 10(b) and Rule 10b-5.[46] The *Central Bank* decision has been viewed as a tremendous legal victory for accountants and other professionals since now they only face securities liability as primary violators. Congress chose not to overrule *Central Bank* under the Reform Act, although the statute authorizes the SEC to proceed with civil administrative actions against those who aid and abet a securities fraud.[47]

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38. Stransky v. Cummins Engine Co., 51 F.3d 1329, 1331 (7th Cir. 1995); Huddleston v. Herman & MacLean, 640 F.2d 534, 543 (5th Cir. 1981); Rehm v. Eagle Fin. Co., 654 F. Supp. 1246, 1250-51 (N.D. Ill. 1997); James J. Armstrong et al., *Securities Fraud*, 33 AM. CRIM. L. REV. 973, 976-83 (1996) (discussing in detail these fraud elements); Julie A. Herzog, *Fraud Created the Market and an Unwarranted Extension of Section 10(B) and Rule 10b-5*, 63 GEO. WASH. L. REV. 359, 360 (1995).

39. Martin, *supra* note 36, at 408; *see also* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 105, at 728 (5th ed. 1984).

40. Dileo v. Ernst & Young, 901 F.2d 624, 628 (7th Cir. 1990).

41. Basic, Inc. v. Levinson, 485 U.S. 224, 238 n.17 (1988).

42. *See, e.g.*, Schatz v. Rosenberg, 943 F.2d 485, 490-94 (4th Cir. 1991); Robin v. Arthur Young & Co., 915 F.2d 1120, 1125-26 (7th Cir. 1990); *Dileo*, 901 F.2d at 628-29; Latigo Ventures v. Laventhal & Horwath, 876 F.2d 1322, 1327 (7th Cir. 1989); Prentice, *supra* note 11, at 761 & n.314.

43. 511 U.S. 164 (1994).

44. Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 80-85 (1981); *see, e.g.*, *Dileo*, 901 F.2d at 628.

45. *See, e.g.*, SEC v. Seaboard Corp., 677 F.2d 1301, 1311 (9th Cir. 1982).

46. *Central Bank*, 511 U.S. at 191.

47. Reform Act sec. 104(2), 15 U.S.C. § 78t(f) (Supp. I 1995).

Prior to the Reform Act, courts did not take a consistent approach as to whether auditors have a duty to report fraud to third parties.[48] In some cases where auditors had been sued for aiding and abetting liability under Rule 10b-5, courts found that accountants had no duty to blow the whistle on their clients unless a law imposed such a duty or if the accountant certified financial statements with knowledge of their material falsity.[49]

> [I]f an accountant does not issue a public opinion about a company, although it may have conducted internal audits or reviews for portions of the company, the accountant cannot subsequently be held responsible for the company's public statements issued later merely because the accountant may know those statements are likely untrue.[50]

According to the Seventh Circuit, accountants owe a duty to exercise reasonable care in discharging their professional obligations to provide accurate and adequate financial statements, but they do not owe a broader duty to "search and sing" out fraud.[51] Imposing primary fraud liability upon accountants for failing to disclose would create adverse consequences in the accountant-client relationship: clients would (1) not repose in accountants the trust necessary to encourage accurate audits; (2) withhold documents if they feared such access would lead to destructive or misunderstood disclosure; and (3) face increased accounting costs as accountants raised their fees to cover anticipated liabilities.[52]

The Eleventh and Ninth Circuits, unlike the Seventh Circuit, recognized the possibility of such a duty where the auditor has actual knowledge of the fraud and allows its name to be used in its client's offering memoranda.[53] In *Rudolph v. Arthur Andersen & Co.*,[54] the Eleventh Circuit found a duty to disclose where the auditor's audit reports were believed to be accurate when first included in its client's private placement offering memorandum, but learned subsequently that the partnership's funds were not used for the purposes initially stated in the offering and failed to cure any public misapprehension about the partnership's situation.[55] According to the Eleventh Circuit standards, an auditor may have a duty to blow the

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48. *See* Edward Brodsky, *The Auditor's New Duty to Blow the Whistle on Its Client*, N.Y. L.J., June 12, 1996, at 3.

49. *In re* Cascade Int'l Sec. Litig., 894 F. Supp. 437, 442 (S.D. Fla. 1995).

50. *Cascade Int'l*, 894 F. Supp. at 443.

51. Dileo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990) (citing Latigo Ventures v. Laventhol & Horwath, 876 F.2d 1322, 1327 (7th Cir. 1989)).

52. *Dileo*, 901 F.2d at 629.

53. *See* Prentice, *supra* note 11, at 761-68 (discussing various judicial approaches to the accountant's duty to blow the whistle on its client's fraudulent activities).

54. 800 F.2d 1040 (11th Cir. 1986).

55. *Rudolph*, 800 F.2d at 1044. The *Rudolph* court found the existence of a duty, reasoning that "[s]tanding idly by while one's good name is being used to perpetuate a fraud is inherently misleading." *Id.* Furthermore, "[i]t is not unreasonable to expect an accountant, who stands in a 'special relationship of trust vis-a-vis the public' and whose 'duty is to safeguard the public interest,' to disclose fraud in this type of circumstance." *Id.* (internal citations omitted) (quoting Gold v. DCL Inc., 399 F. Supp. 1123, 1127 (S.D.N.Y. 1973) and *In re* Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 670 (1957)).

whistle on its client's fraud when the auditor: (1) possesses superior information than that of the investors; (2) incurs minimal costs from fraud disclosures; and (3) exposes investors to potentially enormous costs by failing to make such disclosures.[56]

A five-part test has been applied by the Ninth Circuit in *Roberts v. Peat, Marwick, Mitchell & Co.*[57] and several other courts in determining an auditor's duty to disclose his client's fraud.[58] The five factors considered are: (1) the defendant's relationship to the plaintiff; (2) a comparison of the defendant's and the plaintiff's access to information; (3) benefits obtained by the defendant from his relationship with the plaintiff; (4) defendant's awareness of plaintiff's reliance; and (5) defendant's involvement in initiating the securities transaction.[59]

In *Roberts,* the Ninth Circuit held that Peat Marwick may have had a duty to disclose as a secondary aider and abettor violator of section 10(b) and Rule 10b-5.[60] Peat Marwick's consent to the use of its name on reports and offering memoranda that it knew were fraudulent could give rise to a duty to disclose fraud especially where the accountant possessed superior information and the cost to the accountant of disclosure was minimal.[61] The *Roberts* court applied the five-part test to find no duty to disclose by a co-defendant law firm that was retained only to determine marketable title by reviewing the title records, omitted information which had nothing to do with marketability of title, provided equal access to information and did not initiate the securities transactions.[62]

In *In re American Continental Corp./Lincoln Savings and Loan,*[63] auditors were held to a stringent whistle blowing standard.[64] The court indicated that when auditors stand around in silence while knowing of their client's fraud this may constitute "substantial assistance" of that fraud even if the auditors had never completed their audits, never issued a report and were not named in any SEC filed document.[65] However, an opposite result was reached in *Allard v. Arthur Andersen & Co.,*[66] where

56. *Id.* at 1044-45; *see also In re* Rospatch Sec. Litig., 760 F. Supp. 1239, 1251 (W.D. Mich. 1991) (following the *Rudolph* standard).

57. 857 F.2d 646 (9th Cir. 1988).

58. *Roberts,* 857 F.2d at 653-54; *see also* Pegasus Fund, Inc. v. Laraneta, 617 F.2d 1335, 1340 (9th Cir. 1980); First Va. Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977); Prentice, *supra* note 11, at 764-65 & n.332 (citing Camp v. Dema, 948 F.2d 455, 460 (8th Cir. 1991)); *cf.* Arthur Young & Co. v. Reves, 937 F.2d 1310, 1330-31 (8th Cir. 1991) (providing a different articulation of the five elements), *aff'd sub nom.* Reves v. Ernst & Young, 507 U.S. 170 (1993).

59. *Roberts,* 857 F.2d at 653-54.

60. *Id.* at 653, *rev'g in part* Roberts v. Heim, 670 F. Supp. 1466, 1482, 1497 (N.D. Cal. 1987) (reversing the district court's dismissal of an aiding and abetting claim for failure to state a claim).

61. *Id.*

62. *Id.* at 653-54.

63. 794 F. Supp. 1424 (D. Ariz. 1992).

64. *American Continental Corp./Lincoln Sav. & Loan Sec. Litig.,* 794 F. Supp. at 1442.

65. *Id.* at 1442-46.

66. 924 F. Supp. 488 (S.D.N.Y. 1996).

the court stated that "[a]lthough accountants may have a duty to 'correct their own statements which later become false or misleading,' an accountant's mere possession of non public information as to client misconduct does not necessarily give rise to a duty to disclose."[67]

Several scholars argue that the whistle blowing duties judicially imposed upon auditors in these earlier cases do not survive the abolition of secondary aiding and abetting Rule 10b-5 liability in the *Central Bank* decision[68] unless an independent duty to disclose is created by professional accounting standards.[69] In one post-*Central Bank* case, *In re ZZZZ Best Securities Litigation*,[70] the court allowed a primary liability lawsuit to proceed against the auditor based upon the auditor's duty to withdraw or disclose its client's misstatements due to the public's reliance upon its previously reported information.[71]

Securities fraud suits against auditors frequently have included claims alleging violations of the Racketeer Influenced and Corrupt Organizations Act (RICO).[72] Inclusion of such a claim in an auditor liability action subjects the auditor to treble damages.[73] In *Reves v. Ernst & Young*,[74] however, the Supreme Court limited auditor liability under RICO, adopting a narrow interpretation of the relevant liability section.[75] Furthermore, in the Reform Act, Congress eliminated violations of the federal securities laws as predicate acts under RICO.[76]

Of course, as discussed below, duties to detect fraudulent reporting and report illegal acts have now been statutorily created in the Reform Act and professionally promulgated in new auditing standards.[77] However, judicial decisions continue to provide a framework for determining under what circumstances a duty to disclose will be found. This is especially true in light of ambiguities created under the Reform Act and the professional auditing standards. In the face of ambiguity in the language set forth in the Reform Act and the professional auditing standards,

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67. *Allard*, 924 F. Supp. at 492 (internal citation omitted) (quoting *In re* MTC Elec. Tech. Shareholders Litig., 898 F. Supp. 974, 988 (E.D.N.Y. 1995)).

68. James D. Hansen & Michael J. Garrison, *The Significance of* "Central Bank" *on Auditor Liability*, 54 OHIO CPA J., 20, 20-23 (1995); Prentice, *supra* note 11, at 765; *cf.* Fischel, *supra* note 44, at 103 (proposing that the courts should eliminate secondary liability and, therefore, the "whistle blowing" theory of liability, but preceding the *Central Bank* decision).

69. Hansen & Garrison, *supra* note 68, at 23; *see* Prentice, *supra* note 11, at 765.

70. 864 F. Supp. 960 (C.D. Cal. 1994).

71. *ZZZZ Best Sec. Litig.*, 864 F. Supp. at 976 (denying, in part, defendant's motion for summary judgement).

72. 18 U.S.C. §§ 1961-1968 (1994), *amended by* 18 U.S.C. § 1964(b) (Supp. I 1995); *see, e.g.*, Reves v. Ernst & Young, 507 U.S. 170 (1993) (involving both securities fraud and RICO claims brought against accountants).

73. Reform Act sec. 107, 18 U.S.C. § 1964(c) (Supp. I 1995).

74. 507 U.S. 170 (1993).

75. *Reves*, 507 U.S. at 182-83.

76. Reform Act sec. 107, 18 U.S.C. § 1964(c).

77. *See infra* Part II.

auditors may resort to judicial decisions, as well as legislative history, for future guidance.

II. STATUTORY DUTY AND PROFESSIONAL AUDITING STANDARDS FOR DETECTING FRAUDULENT REPORTING AND DISCLOSING ILLEGAL ACTS

A. *The Reform Act*

Section 10A of the Reform Act specifies procedures to be followed by auditors in connection with the discovery and subsequent reporting of fraudulent financial reporting and illegal acts.[78] Accountants are required to include in their audits:

> (1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts; (2) procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and (3) an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.[79]

If an auditor determines that an illegal act has or may have occurred, then the Reform Act requires the auditor: (1) to make a determination as to the likelihood that the illegal act has in fact occurred;[80] (2) if so, to determine the possible effect on the issuer's financial statements, giving consideration to any contingent effects such as fines, penalties, and damages;[81] and (3) to inform management.[82] If management does not take "timely and appropriate remedial action" and the auditor determines that the illegal acts will have a material effect on the client's financial statements by being clearly not inconsequential, the auditor is required to report this information to the client's board of directors or the board's audit committee.[83]

This provision does not refer to disclosure of fraudulent acts although the title of the provision is "Fraud Detection and Disclosure."[84] Furthermore, the Reform Act does not define the meaning of the phrase "timely and appropriate remedial action." Thus, the auditor must use his discretion in this regard. The failure to take remedial action may reasonably warrant the auditor's resignation or departure from a standard audit report.[85]

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78. Reform Act sec. 301(a), § 10A(a), 15 U.S.C. § 78j-1(a) to (b) (Supp. I 1995).

79. Reform Act sec. 301(a), § 10A(a) to (b), 15 U.S.C. § 78j-1(a).

80. Reform Act sec. 301(a), § 10A(a), 15 U.S.C. § 78j-1(b)(1)(A)(i).

81. Reform Act sec. 301(a), § 10A(b)(1)(A)(i), 15 U.S.C. § 78j-1(b)(1)(A)(ii).

82. Reform Act sec. 301(a), § 10A(b)(1)(B), 15 U.S.C. § 78j-1(b)(1)(B)

83. Reform Act sec. 301(a), § 10A(b)(2), 15 U.S.C. § 78j-1(b)(2).

84. Reform Act sec. 301, 109 Stat. 737, 762 (1995).

85. Pursuant to the Securities Act of 1933, the SEC imposes detailed requirements for reporting a change in accountants in item 304 of Regulation S-K. 17 C.F.R. § 229.304 (1997). Item 304 requires the

Pursuant to the Reform Act, the company must then inform the SEC not later than one business day after receipt of the report and must give the auditor a copy of the notice that has been sent to the SEC.[86] If the company fails to give such notice, even if the auditor elects to resign, the auditor still must furnish a copy of its report to the SEC within one business day.[87] This provision has been pejoratively referred to as the "whistle blower provision."[88] Although the SEC's Regulation S-K already requires the company to report any alleged impropriety or illegality,[89] the Reform Act now clearly requires the auditor to make such a disclosure.[90] As our discussion of the applicable auditing standards will emphasize, SAS No. 54 and SAS No. 82 do not require the auditor to make a public disclosure.[91] Pursuant to those standards, if the auditor detects fraudulent acts, and the client refuses to take corrective action, the auditor need not make a disclosure to the SEC or to any other party, but simply must withdraw from the engagement.[92] Nonetheless, SAS No. 82 refers to the Reform Act's disclosure requirement as a circumstance in which public disclosure of illegal acts by the auditor may be required.[93]

An auditor could face direct fraud liability pertaining to matters found but not included in the report and an auditor found to have "willfully violated" the statute by failing to make the required disclosures will be liable for civil penalties.[94] However, the Reform Act provides the auditor with protection from liability in a private action for any "finding, conclusion, or statement expressed in a report" received by the SEC.[95] No implied private right of action is provided by the Reform Act,[96] but the statute does not eliminate the preexisting implied private right of action pursuant to Rule 10b-5. Nothing in the Reform Act or its legislative history supports such elimination. The conference report to the bill that became the Reform Act provides that "[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their

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company to report a change of accountant, as well as four categories of "reportable events" which include that the auditor has advised the company that the internal controls needed to develop reliable financial statements do not exist or that the auditor has determined that he can no longer rely on management representations. 17 C.F.R. § 229.304(a)(1). Pursuant to the Exchange Act, the SEC requires this information to be discussed in item 4 of Form 8-K. Item 304 also requires the issuer to provide the former auditor with a copy of the disclosure and request that the former auditor furnish the SEC with a letter stating whether the auditor agrees with the disclosures and, if not, stating the matter on which there is disagreement. *Id.* § 229.304(a)(3).

86. Reform Act sec. 301(a), § 10A(b)(3), 15 U.S.C. § 78j-1(b)(3).

87. Reform Act sec. 301(a), § 10A(b)(4), 15 U.S.C. § 78j-1(b)(4).

88. Karen Donovan, *Bean Counters in a Bind: Trade-off Expands Duties*, NAT'L L.J., Apr. 29, 1996, at B1.

89. 17 C.F.R. § 229.304.

90. Reform Act sec. 301(a), § 10A(b), 15 U.S.C. § 78j-1(b).

91. *See infra* notes 110-77 and accompanying text.

92. SAS NO. 82, *supra* note 6, at ¶ 40; AU, *supra* note 5, at § 317.18-.20, .23.

93. SAS NO. 82, *supra* note 6, at ¶ 40.

94. Reform Act sec. 301(a), § 10A(d), 15 U.S.C. § 78j-1(d).

95. Reform Act sec. 301(a), § 10A(c), 15 U.S.C. § 78j-1(c).

96. Reform Act sec. 203, 15 U.S.C. § 78j-1 note (Construction).

losses without having to rely upon government action."[97] Many of the Reform Act's other provisions, including the ones that change the joint and several liability rules, indicate that Congress had no intention of eliminating the implied right of action.

The issue arises as to what happens if the auditor reports an alleged illegal act to the SEC and he turns out to be wrong. Obviously, the company's stock price will be affected. In addition, the future relationship of the auditor and the company will be affected and probably destroyed.[98] As set forth above, however, the Reform Act provides that the auditor will not be subject to liability in a private action for such a mistake.[99] In a 1993 hearing on this provision, Representative Markey, one of its sponsors, stated that this provision "[was] designed to protect auditors [who] comply with the reporting requirements of the bill from exposure to private litigation."[100] Representative Markey went on to state that "we create[d] a whistle blower safe harbor for the auditor as he or she goes to the SEC so that they don't feel as though they are going to be necessarily exposing themselves to additional legal ramifications if they do so."[101]

In addition, the potential for auditor exposure to liability still exists even if he issues an adverse opinion or disclaims an opinion on the financial statements. A plaintiff can argue that once the auditor was in a position to know that management was not taking appropriate remedial actions in response to a significant fraudulent or illegal act, such as reporting the matter to an appropriate governmental agency, the law required the auditor to notify the directors and make sure that they notified the SEC. By not so reporting, the auditor arguably allowed the illegal act to continue unabated, thereby increasing the financial damage to the company and providing insufficient warning to investors.

Finally, the Reform Act may expose auditors to increased litigation for failure to discover and disclose illegal acts other than management fraud.[102] These situations could expose auditors to securities fraud law-

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97. H.R. CONF. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730.

98. While the Reform Act provides a safe harbor from liability for any auditor who makes a report to the SEC pursuant to the Reform Act section 301, § 10A(c), 15 U.S.C. § 78j-1(c), this statutory provision may compel companies to publicly disclose defenses to alleged illegal actions in a very short time frame and with incomplete knowledge of the underlying facts at issue.

99. Reform Act sec. 301(a), 15 U.S.C. § 78j-1(c).

100. *Financial Fraud Detection: Hearings on H.R. 574 Before the Subcommittee on Telecommunications and Finance of the House of Representatives Comm. on Energy and Commerce*, 103d Cong., 1st Sess. 2 (1993) (opening statement of Representative Markey).

101. *Id.* at 85 (response of Representative Markey to questions following the presentation of H.R. 574).

102. Robert Sidorsky, *Auditor's Duty to Blow the Whistle Under the Litigation Reform Act*, N.Y. L.J., Feb. 9, 1996, at 1, 7.

suits based upon direct primary liability under Rule 10b-5.[103] As stated above, section 10(b) and Rule 10b-5 impose a duty to disclose a misleading omission. The Reform Act's disclosure requirement arguably runs to investors. Therefore, it seems reasonable to argue that an auditor's breach of a duty to blow the whistle on his client will give rise to Rule 10b-5 liability.

The Cronos Group has become the first company whose outside accounting firm, Arthur Andersen, applied this new whistle blower provision of the Reform Act.[104] Cronos, a Luxembourg corporation based in England, manages fleets of shipping containers and was a sponsor of more than $400 million in limited partnerships investing in containers.

Arthur Andersen found what it believed to be illegal activity and, after informing the board of directors (which did not provide the accounting firm with an adequate explanation, refused to investigate the matter, and did not cause "senior management to take timely and appropriate remedial actions with respect to these matters"), submitted a report, which Cronos filed with the SEC in February, 1997, as required by the Reform Act.[105] Arthur Andersen simultaneously resigned as Cronos's auditor.[106]

According to Arthur Andersen's report, the accounting firm questioned a $1.5 million dollar "disbursement."[107] That disbursement, along with subsequent correspondence from Cronos's bank concerning the repayment of the disbursement to the company "may have violated laws and regulations to which the [c]ompany is subject including U.S. securities laws, and that these matters may have a material effect upon the 1996 financial statements of the [c]ompany."[108]

As of this date, we are not aware of any other accounting firm that has applied this new whistle blower provision. Furthermore, to date, the SEC has had only limited experience with section 10A because the new provision becomes effective in two stages. For companies that file selected quarterly financial data with the SEC, section 10A applies to annual reports for fiscal years beginning on or after January 1, 1996. For

103. After the U.S. Supreme Court decision in *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994), accountants no longer face secondary liability under Rule 10b-5 for aiding and abetting their clients' securities fraud violations. *See infra* Part I.

104. Letter from Arthur Andersen to the Board of Directors for the Cronos Group (Feb. 3, 1997) (visited Nov. 14, 1997) <http://www.sec.gov/Archives/edgar/data/912605/0000950149-97-000229.txt> [hereinafter Andersen Letter]. This letter was submitted to the SEC as required by the Reform Act section 301(a), § 10A(b)(4), 15 U.S.C. § 78j-1(b)(4).

105. Andersen Letter, *supra* note 104.

106. *Id.*

107. *Id.*

108. *Id.*

companies that do not file these reports, the provision applies to annual reports for fiscal years beginning on or after January 1, 1997.[109]

B. *GAAS Requirements: SAS No. 82 and SAS No. 54*

Although the Reform Act's new section 10A is entitled "Fraud Detection and Disclosure," much of it is worded in terms of disclosure of "illegal acts."[110] Section 10A(f) defines an "illegal act" as "an act or omission that violates any laws, or any rule or regulation having the force of law."[111] Management fraud typically does involve illegal acts, such as violation of securities and tax laws, money laundering, embezzlement, bribery and price fixing.

However, the terms "fraud," "illegal acts," "errors," and "irregularities" also are terms of art in the auditing community. As stated earlier, the Reform Act's new statutory provision must be discussed in conjunction with two auditing standards: (1) SAS No. 82, entitled "Consideration of Fraud in a Financial Statement Audit,"[112] and (2) SAS No. 54, entitled "Illegal Acts by Clients."[113]

1. SAS No. 82

The enactment of SAS No. 82 is a result of the AICPA's multi-year study to improve the auditing profession's ability to detect fraud.[114] In early 1993, the Public Oversight Board of the SEC Practice Section of the AICPA concluded that

> to a greater extent than it now does, the profession must accept responsibility for the detection of fraud by management. The profession cannot, and it cannot be expected to, develop methods that will assure that every fraud, no matter how cleverly contrived, will be unearthed in the course of the audit, but it must develop means of increasing significantly the likelihood of detecting fraud.[115]

Later in 1993, the AICPA Auditing Standards Board formed a task force to study SAS No. 53 and develop a new SAS that focused on financial statement fraud.[116]

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109. Reform Act sec. 301(b), 15 U.S.C. § 78j-1 note (Effective Date); *see also* 143 CONG. REC. S1412-01 (daily ed. Feb. 13, 1997) (letter from SEC Chairman Arthur Levitt to Sen. Wyden (Jan. 31, 1997)).

110. Reform Act sec. 301(a), § 10A, 15 U.S.C. § 78j-1.

111. Reform Act sec. 301(a), § 10A(f), 15 U.S.C. § 78j-1(f).

112. *See generally* SAS NO. 82, *supra* note 6.

113. AU, *supra* note 5, at § 317.08.

114. *See* Mancino, *supra* note 9, at 32.

115. PUBLIC OVERSIGHT BOARD OF THE SEC PRACTICE SECTION OF THE AICPA, *supra* note 10, at 42.

116. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, MEETING THE FINANCIAL NEEDS OF THE FUTURE: A PUBLIC COMMENT FROM THE ACCOUNTING PROFESSION (1993).

The AICPA had adopted SAS No. 53 in 1988. It required that the auditor design the audit to provide "reasonable assurance" of detecting material irregularities.[117] In exercising his professional skepticism, the auditor was no longer permitted to assume honesty by management in the absence of evidence to the contrary.[118] SAS No. 53 stated that the auditor "neither assumes that management is dishonest nor assumes unquestioned honesty."[119] It also made more explicit the requirement that in developing an audit plan, an auditor consider factors that affect audit risk.[120]

In May 1996, the Accounting Standards Board released an exposure draft of a proposed SAS.[121] After reviewing comment letters, the draft was revised, and in November 1996, the ASB voted to issue SAS No. 82.[122] It was adopted in February 1997.[123]

SAS No. 82 provides clarification of the auditor's responsibility to detect fraud. It does not change the auditor's responsibility to detect fraud which is still framed by the key concepts of materiality and reasonable assurance.[124] However, Edmund Noonan, the chairman of the Accounting Standards Board and an audit partner at KPMG Peat Marwick, in addressing an AICPA conference in December 1996, said: "If you don't want to make changes to your practice, you're at grave risk."[125] He described SAS No. 82 as "a free-standing, performance or field work standard [that] is intended to drive auditor performance and drive it hard."[126] At the same AICPA conference, Michael Sutton, the chief accountant of the SEC, stated that with the enactment of SAS No. 82, auditors "'should not be able to skip lightly' over the issue of fraud or to

117. *See* Joseph I. Goldstein & Catherine Dixon, *New Teeth for the Public's Watchdog: The Expanded Role of the Independent Accountant in Detecting, Preventing, and Reporting Financial Fraud*, 44 BUS. LAW. 439, 476 (1989).

118. *See id.*

119. AU, *supra* note 5, at § 316.16.

120. Goldstein & Dixon, *supra* note 117, at 476-77.

121. Mancino, *supra* note 9, at 32.

122. *Id.*

123. *Id.*

124. SAS NO. 82, *supra* note 6, at app. A ¶ 2 (amending AU § 110, "Responsibilities and Functions of the Independent Auditor"). This section provides:

> The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.

Id.

125. Steven Burkholder, *New Fraud Reporting Rules are Not Mere Clarification, ASB Chairman Warns*, 28 SEC. REG. & L. REP. 1528, 1528 (1996).

126. *Id.* at 1529 (alteration in the original). Burkholder writes that the chairman warned that "newly enacted rules increasing the duties of auditors to detect and report fraud are not merely a clarification of existing standards, but instead represent a raising of the bar that puts auditors at peril if ignored." *Id.* at 1528.

assert that it is not the mission of the audit to discover fraud that is material to the financial statements."[127] Soon after the enactment of SAS No. 82, several knowledgeable commentators wrote that this new SAS raised the standard for an auditor's duty to detect fraud.[128]

In contrast, according to Glenn Vice of the ASB, there is no change in the duty to detect fraud. At an AICPA National Conference on Fraud held in June 1996, he stated: "The proposed standard reaffirms the auditor's present responsibility—that is, to plan and perform the audit to obtain reasonable assurance about whether the financial statements are materially misstated."[129]

The title to SAS No. 82 directly refers to fraud instead of the title to SAS No. 53, its predecessor, which used the terms "errors" and "irregularities." The original standard, SAS No. 16 entitled "Errors or Irregularities," was issued by the AICPA in 1977.[130] It established the basic framework in which the auditor has the responsibility to: (1) plan his examination to search for errors or irregularities that would have a material effect on the financial statements; (2) exercise an attitude of professional skepticism; and (3) evaluate internal controls before placing reliance thereon in conducting the audit.[131]

SAS No. 82 concentrates on two types of misstatements: those arising from intentional falsification of financial statements and those arising from misappropriation or theft of assets.[132] It provides a more extensive and detailed listing of the warning signals that should alert an auditor to the possibility of fraud than its predecessor, SAS No. 53. It also provides more specific guidance as to the types of auditing procedures that the auditor should employ in response to the presence of an increased risk of fraud.

a. *Fraud Risk Factors Under SAS No. 82*

As part of the auditor's fraud risk assessment in designing the audit procedures, the auditor must inquire of management to obtain its understanding of the risk of fraud.[133] In addition, the auditor must document in

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127. *Id.* at 1529 (quoting statement made by Michael Sutton, chief accountant of the SEC, during AICPA conference).

128. *See* Douglas R. Carmichael & James L. Craig, *Proposal to Say the "F" Word in Auditing Standards*, CPA J., June 1996, at 22, 22; Gary D. Zeune, *Auditors Will Be Required to Detect Fraud*, BUS. CREDIT, Sept. 1996, at 16.

129. AICPA, NATIONAL CONFERENCE ON FRAUD (June 1996) (visited Nov. 1, 1997) <http://www.aicpa.org/members/div/auditstd/frconf.htm at 12 of 15>.

130. *See* AICPA, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, STATEMENT ON AUDITING STANDARDS Pt. I (1995) (providing historical table).

131. AUDITING STANDARDS BOARD, STATEMENT ON AUDITING STANDARDS NO. 16, ERRORS OR IRREGULARITIES (1977), *reprinted in* AU, *supra* note 5, at § 337.

132. SAS No. 82, *supra* note 6, at ¶ 12.

133. *Id.* at ¶¶ 12-13.

his working papers "the assessment of the risk of material misstatement due to fraud" and if, during the performance of the audit, that assessment changes, the changed circumstances and the response also must be documented.[134]

SAS No. 82 states that fraud risk factors "cannot easily be ranked in order of importance or combined into effective predictive models."[135] However, it emphasizes the necessity to evaluate risk factors in combination.[136] Unlike its predecessor, it distinguishes between risk factors relating to fraudulent financial reporting and those relating to misappropriation of assets.[137] It also provides examples of specific responses to the risk of fraudulent financial reporting in the areas of revenue recognition and inventory,[138] as well as examples of specific responses to an identified risk of misappropriation of assets.[139]

Under SAS No. 53, risk factors relating to fraudulent financial reporting were grouped according to Management Characteristics, Operating and Industry Characteristics and Engagement Characteristics. SAS No. 82 now sets forth more detailed examples arranged under similar, but not identical, categories: Management's Characteristics and Influence Over the Control Environment, Industry Conditions, and Operating Characteristics and Financial Stability.[140] These risk factors may provide strong circumstantial evidence of management's conscious misbehavior or recklessness which could establish the requisite scienter to support a securities fraud cause of action against either management or the auditor.[141]

In discussing risk factors relating to Management Characteristics, SAS No. 82 lists specific indicators of management's motivation to engage in fraudulent financial reporting, such as when management compensation is tied to the achievement of aggressive financial targets.[142] Specific evidence that management had the motive and opportunity to commit fraud will satisfy a plaintiff's fraud cause of action against either management or the auditor.[143] More emphasis is placed on risks arising from management's failure to act appropriately with respect to internal control and financial reporting.[144] Furthermore, management's attempts to

134. *Id.* at ¶37.

135. *Id.* at ¶21.

136. *Id.*

137. *Compare id.* at ¶¶ 16-17 (fraudulent financial reporting), *with* ¶¶ 18-20 (misappropriation of assets).

138. *Id.* at ¶30.

139. *Id.* at ¶16(a)-(c).

140. *Id.* at ¶31.

141. *See infra* Part III.

142. SAS No. 82, *supra* note 6, at ¶17(a).

143. *See infra* Part III.

144. SAS No. 82, *supra* note 6, at ¶17(a).

limit the scope of the auditor's work is another type of risk factor to be taken into account by the auditor.[145]

SAS No. 82 also sets forth specific examples of risk factors relating to misstatements arising from misappropriation of assets.[146] These factors are grouped under the category of Susceptibility of Assets to Misappropriation and Controls.[147] The auditor also may become aware of financial pressures on employees or dissatisfaction on the part of employees, which may bear on the risk of misappropriation of assets.[148]

For example, in *Herbert H. Post & Co. v. Sidney Bitterman Inc.*,[149] the jury rendered a verdict of $17.1 million against an accounting firm for its accountant's malpractice due to his failure to discover an employee embezzlement of more than $3 million that occurred over a four year period.[150] The New York State Appellate Division subsequently reversed and remanded the case for a new trial largely due to procedural errors.[151] However, the substance of the accountant's defalcations is informative in relationship to SAS No. 82, especially since the damage award was significant.

The defendant accounting firm may have avoided liability by examining management controls, or the lack thereof, as dictated by SAS No. 82. The accounting firm could have inquired

> of the elderly principals whether they had adequately evaluated the employee they appointed to manage the import department. The accountants should have insisted that the company follow the required procedures for check cashing. When the gap in the transaction documents became obvious, the accountants should have meaningfully inquired into the genuineness of the transactions. Instead the accountants looked the other way . . . .[152]

b. *Duty to Detect Fraud and Possibly Resign from the Audit Under SAS No. 82*

SAS No. 82 retains and expands upon the basic principle that if the auditor believes that there has been fraud that is material to the financial statements, he must discuss the matter with an "appropriate level of management that is at least one level above those involved and with senior management."[153] By requiring that any fraud that causes a material mis-

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145. *Id.*
146. *Id.* at ¶18.
147. *Id.* at ¶18(a), (b).
148. *Id.* at ¶20.
149. 639 N.Y.S.2d 329 (N.Y. App. Div. 1996).
150. *Herbert H. Post & Co.*, 639 N.Y.S.2d at 331-32.
151. *Id.* at 339.
152. Norman B. Arnoff & Sue C. Jacobs, *Accountants' and Employee Defalcations*, N.Y. L.J., Apr. 8, 1997, at 3, 7 (discussing in detail the relationship of *Herbert H. Post & Co.* to SAS No. 82).
153. SAS No. 82, *supra* note 6, at ¶35(b).

statement of the financial statements must be reported directly to the audit committee of the board of directors, SAS No. 82 expands upon SAS No. 53's requirement that only fraud involving senior management should be reported to the board's audit committee.[154]

SAS No. 82, however, maintains the AICPA's position that an auditor is not required to disclose the existence of such fraud to third parties and, in fact, is "precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report."[155] Instead of requiring whistle blowing, SAS No. 82 promulgates an opt out provision—where, if the auditor's evaluation of risk factors and results of audit tests indicate that a significant risk of fraud exists, "the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee."[156] With respect to illegal acts, however, SAS No. 82 provides that the auditor may be required to disclose outside the client entity in circumstances such as "comply[ing] with certain legal and regulatory requirements."[157] In a footnote to this paragraph, the SAS refers to the Reform Act's required report to the SEC.[158]

2. SAS No. 54

Although SAS No. 54, entitled "Illegal Acts by Clients," covers the auditor's responsibility for detection of illegal acts, it states that an audit in accordance with GAAS normally "does not include audit procedures specifically designed to detect illegal acts."[159] In contrast, SAS No. 82 requires the auditor to make a fraud risk assessment in designing audit procedures,[160] and the Reform Act requires that audits of public companies' financial statements include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts."[161]

According to SAS No. 54, whether an act is illegal "is a determination that is normally beyond the auditor's professional competence."[162] SAS No. 54 distinguishes between (i) illegal acts that have a direct and material effect on the financial statements, requiring a different method of classification of a material balance such as tax laws and the determination of revenue earned under a government contract in which case the auditor's responsibility for detection is the same as for fraud[163] and (ii)

154. *Id.* at ¶38.
155. *Id.* at ¶40.
156. *Id.* at ¶36.
157. *Id.* at ¶40(a).
158. *Id.* at ¶40(a) n.24.
159. AU, *supra* note 5, at § 317.08.
160. SAS No. 82, *supra* note 6, at ¶¶ 12-13.
161. Reform Act sec. 301(a), § 10A(a)(1), 15 U.S.C. § 78j-1(a)(1) (Supp. I 1995).
162. AU, *supra* note 5, at § 317.03.
163. *Id.* at § 317.05.

illegal acts that have a material but indirect effect on the financial statements, such as violations of laws or regulations that relate to the operating aspects of the company, like "securities [issuance and] trading, occupational safety and health, food and drug administration, environmental protection, equal employment, price fixing or other antitrust violations."[164] Violations of these laws ordinarily do not have a direct impact on the financial statements but may be material because they expose the company to potential legal liability for damages, penalties and fines.[165]

Since U.S. businesses are subject to so many laws and regulations that, if violated, could lead to material consequences, it is questionable whether an audit can be designed to provide reasonable assurance of detecting all illegal acts that may have a material effect on financial statements. "As a practical matter auditors have little chance of detecting most illegal acts unless informed of them by the client" or by available corporate documents which disclose the existence of a government investigation or enforcement proceeding.[166]

SAS No. 54, like SAS No. 82 with respect to fraud, provides that if the auditor concludes that the illegal act is material to the financial statements and has not been properly accounted for or disclosed, he must express a qualified or adverse opinion.[167] If the auditor is precluded from obtaining the necessary information to evaluate whether an illegal act has occurred, the auditor normally should disclaim, i.e., not render an opinion.[168] The auditor should resign if the client refuses to accept the auditor's report as qualified, adverse, or disclaimed.[169]

Regarding fraud, SAS No. 54 takes the position that the auditor ordinarily has no responsibility to disclose illegal acts to third parties, "unless the matter affects his opinion on the financial statements."[170] The auditor can withdraw from the engagement if management fails to make appropriate disclosures in the financial statements without directly reporting the misconduct to the SEC or to the public. However, as discussed above, SAS No. 82 refers to the Reform Act's requirement of disclosure of illegal acts.

The Reform Act now requires an auditor to determine whether the directors have taken appropriate remedial actions to assess the consequences of actual or likely violations of numerous administrative rules and federal regulations, including those issued by the Federal Trade

164. *Id.* at § 317.06.
165. *Id.* at §§ 317.05-.07.
166. Mancino, *supra* note 9, at 36.
167. AU, *supra* note 5, at § 317.18.
168. *Id.* at § 317.19.
169. *Id.* at § 317.20.
170. *Id.* at § 317.23.

Commission, Federal Drug Administration, Occupational Safety and Health Administration and the Environmental Protection Agency. The auditor will also have to make similar assessments concerning violations of state, local, and foreign laws.

Senator Ron Wyden, one of the members of the congressional committee that drafted the new whistle blower provision of the Reform Act, stated that SAS No. 82

> takes an important step forward by making clear for the first time an auditor's responsibility to detect material fraud in financial statements and by offering various fraud risk factors to be considered in planning and performing all audits. The new revised SAS, read in conjunction with the AICPA's SAS No. 54 relating to an auditor's responsibility to detect illegal acts, is not only consistent with Section 10A [of the Reform Act] but also promotes the intent of that provision to put procedures in place to help detect fraud early.[171]

SEC Chairman Arthur Levitt also stated, with respect to whether new SAS No. 82 and existing SAS No. 54 are consistent with the purpose and intent of the Reform Act, that "[w]e believe that both these standards improve the ability of auditors to detect management fraud and are consistent with the purposes of Section 10A."[172]

Auditors claim to be confused about what, if anything, they should do to detect illegal acts. Though auditors must follow the strictures of the Reform Act, they also have an ethical obligation to follow GAAS.

In a 1994 judicial decision, the Ninth Circuit Court of Appeals held that an auditor did not have a duty to investors to disclose deficiencies in the company's internal controls in its audit report because he relied in good faith on GAAS.[173] However, other courts have held that GAAS are not determinative of the auditor's standard of care.[174]

Patrick McDonnell, vice chairman of Business Assurance Services at Coopers & Lybrand, stated, "[i]f auditors follow the [AICPA] rules, but miss the fraud, one could argue that they still have protection from lawsuits,"[175] but they also may not as indicated by current litigation.

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171. 143 CONG. REC. S1412 (daily ed. Feb. 13, 1997) (statement of Sen. Wyden).

172. *Id.* (letter from Arthur Levitt, SEC Chairman, to Sen. Ron Wyden (Jan. 31, 1997)).

173. *See* Monroe v. Hughes, 31 F.3d 772, 775-76 (9th Cir. 1994).

174. *See, e.g.*, Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1113 (7th Cir. 1974) ("[W]e recognize that we are not constrained to accept faulty standards of practice otherwise generally accepted in an industry or profession."), *rev'd on other grounds*, 425 U.S. 185 (1976); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 122 (S.D.N.Y. 1974), *aff'd in part and rev'd in part*, 540 F.2d 27 (2d Cir. 1976); *see also* Maduff Mortgage v. Deloitte Haskins & Sells, 779 P.2d 1083, 1086 (Or. Ct. App. 1989) (concluding that GAAS is useful in determining the standard of care for an accountant, but not controlling).

175. Elizabeth MacDonald, *Auditors are Ending up Between a Rock and a Hard Place over Securities Law*, WALL ST. J., Dec. 24, 1996, at C1.

For example, under the Reform Act, it may be difficult for an auditor to assess the "materiality" of an illegal act, its possible effect on the issuer's financial statements, or the likelihood that the illegal act has actually occurred. Similarly, SAS No. 82 lists fraud risk factors and SAS No. 53 required that audits provide "reasonable assurance" of detecting material irregularities, concepts which will be susceptible to judicial interpretation. These are necessarily gray areas which may have the net effect of

> tying up the auditor in expensive litigation in instances where hindsight shows that the effect of a fraudulent accounting practice was more or less substantial than the auditor's judgment originally forecast.
>
> . . . .
>
> Auditors [may] be placed in the impossible position of acting not merely as detectives, obliged to seek out and report illegal acts, but clairvoyants, open to liability for a failure to report acts that seem prospectively to pose no material consequence to the financial statements of the issuer.[176]

Besides developing an awareness of prior judicial precedents, accounting firms should plan ahead by creating internal management strategies for dealing with auditor liability under the Reform Act and professional auditing standards.[177]

III. PROVING AUDITOR FRAUD

A. *The Scienter Requirement*

The scienter[178] requirement is currently a controversial element in lawsuits brought against auditors, as well as others, under the Reform Act for violations of section 10(b), Rule 10b-5, and professional auditing standards. The Reform Act does not define scienter or indicate the standards for alleging scienter, and post-Reform Act judicial decisions have formulated different interpretations of how the scienter requirement can be satisfied. Furthermore, various sections of the Reform Act reflect a congressional ambiguity concerning the scienter requirement. For example, the Reform Act's safe harbor rules for statutorily defined forward-

176. Brodsky, *supra* note 48, at 36.

177. Harvey L. Pitt et al., *More Than "Classical GAAS": Audits and Corporate Illegality Under the Litigation Reform Act*, *in* 28TH ANNUAL INSTITUTE ON SECURITIES REGULATION, at 269, 273-81 (PLI Corp. Law and Practice Course Handbook Series No. 962, 1996).

178. Scienter "is frequently used to signify the defendant's guilty knowledge." BLACK'S LAW DICTIONARY 1345 (6th ed. 1990).

looking statements[179] provide that "no liability will attach under the Reform Act in a private action unless the plaintiff proves *actual knowledge* of the false or misleading nature of the statement on the part of a natural person making the statement,"[180] or on the part of an executive officer approving the statement made on behalf of a business entity.[181] In its joint and several liability section, the Reform Act restricts a defendant's liability to an amount corresponding to its proportionate degree of fault if the defendant did not act "knowingly."[182]

Prior to the Reform Act, the Supreme Court, in *Ernst & Ernst v. Hochfelder, Inc.*,[183] held that "scienter," which it defined as "a mental state embracing intent to deceive, manipulate, or defraud,"[184] was a prerequisite to fraud liability under section 10(b) and Rule 10b-5. The *Hochfelder* Court expressly rejected plaintiff's contention that the defendant's accountants could be liable under section 10(b) and Rule 10b-5 based solely upon their negligence.[185] However, the Court left open the question of whether recklessness could satisfy the newly-created scienter requirement: "In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether in some circumstances reckless behavior is sufficient for civil liability under section 10(b) and Rule 10b-5."[186]

After *Hochfelder*, the lower courts were left with the task of determining whether reckless conduct is sufficient to satisfy the scienter requirement of section 10(b) and Rule 10b-5. The Supreme Court has not subsequently addressed this issue.

In a recent Supreme Court case, *United States v. O'Hagan*,[187] the Court upheld the federal "misappropriation theory" for prosecuting insider trading cases under section 10(b) and Rule 10b-5.[188] The misappropriation theory of insider trading is broader than classical insider trading liability as it imposes fraud liability on any individual who misappropriates material, non-public information by breaching a fiduciary duty and

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179. Section 102 of the Reform Act created a safe harbor provision for forward-looking information by adding section 27A to the Securities Act of 1933, 15 U.S.C. § 77z-2 (Supp. I 1995) and by adding section 21E to the Securities Exchange Act of 1934, 15 U.S.C. § 78u-5 (Supp. I 1995).

180. Reform Act sec. 102(a), § 27A(c)(1)(B)(i), 15 U.S.C. § 77z-2(c)(1)(B)(i) (emphasis added); Reform Act sec. 102(b), § 21E(c)(1)(B)(i), 15 U.S.C. § 78u-5(c)(1)(B)(i) (emphasis added).

181. Reform Act sec. 102(a), § 27A(c)(1), 15 U.S.C. § 77z-2(c)(1)(B)(ii)(I); 15 U.S.C. § 78u-5(c)(1)(B)(ii)(I).

182. Reform Act sec. 201(a), § 21D(g)(2)(A), 15 U.S.C. § 78u-4(g)(2)(A).

183. 425 U.S. 185 (1976).

184. *Hochfelder*, 425 U.S. at 193 n.12.

185. *Id.*

186. *Id.*

187. 117 S. Ct. 2199 (1997).

188. *O'Hagan*, 117 S. Ct. at 2213-14.

uses that information in a securities transaction.[189] The *O'Hagan* Court, in its discussion of the misappropriation theory, emphasized the continued importance of the scienter requirement in securities litigation:

> To establish a criminal violation of Rule 10b-5, the government must prove that a person 'willfully' violated the provision.[190] In addition the statute's requirement of the presence of culpable intent as a necessary element of the offense does much to destroy any force in the argument that application of the [statute] in circumstances such as O'Hagan's is unjust.[191]

It has been suggested that *O'Hagan*'s requirement that the government establish a clear intent to defraud in criminal securities fraud prosecutions may raise the "level of scienter enormously . . . . Now, when the SEC tries to deal with the lower standard of intent, recklessness, they may find *O'Hagan* comes back to bite them."[192]

Since *Hochfelder*, commentators and ten courts of appeal have concluded that a reckless misrepresentation or omission satisfies the scienter requirement.[193] In addition to wide ranging judicial support for the concept that recklessness satisfies the *Hochfelder* scienter requirement,[194] there is authority under the tort of common law fraud for this proposition.[195] Accountants have unsuccessfully attempted to convince the courts that recklessness is not enough to prove scienter. The courts have con-

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189. John C. Coffee, Jr., *In 'O'Hagan,' The Supreme Court Gets a Second Chance to Adopt, and Define the Scope of, SEC's 'Misappropriation Theory' of Insider Trading*, NATL. L.J., Feb. 17, 1997, at B5.

190. *O'Hagan*, 117 S. Ct. at 2214 (quoting 15 U.S.C. § 78ff(a)).

191. *Id.* (quoting Boyce Motor Lines, Inc. v. United States, 342 U.S. 337, 342 (1952)).

192. Dominic Bencivenga, *The Right Set of Facts: 'O'Hagan' Court Affirms SEC Rule-Making Power*, N.Y. L.J., July 3, 1997, at 5, 43 (quoting Harvey L. Pitt, law partner in Fried, Frank, Harris, Shriver & Jacobson).

193. Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(B) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV. 667, 673-74 n.22 (1991).

194. *See* Armstrong et al., *supra* note 38, at 980-81 n.38 (citing the following cases in support of the recklessness standard for meeting the scienter requirement: SEC v. Steadman, 967 F.2d 636, 641-42 (D.C. Cir. 1992); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990); *In re* Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1244 (3rd. Cir. 1989); McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814-15 (11th Cir. 1989); Hackbart v. Holmes, 675 F.2d 1114, 1117-18 (10th Cir. 1982); Hoffman v. Estabrook & Co., 587 F.2d 509, 517 (1st Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir. 1978); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977); *In re* American Continental Corp./Lincoln Savings and Loan Sec. Litig., 794 F. Supp. 1424, 1434 (D. Ariz. 1992)); *see also* Paul Vizcarrondo, Jr. & Andrew C. Houston, *Liabilities Under Sections 11, 12, 15 and 17 of the Securities Act of 1933 and Sections 10, 18 and 20 of the Securities Exchange Act of 1934*, *in* UNDERSTANDING THE SECURITIES LAWS 1996, at 585, 645 (PLI Corp. Law & Practice Course Handbook Series No. 956, 1996) (providing survey of cases to illustrate that only the Fourth Circuit holds that recklessness will not satisfy the scienter requirement of Rule 10b-5; all other circuits and several district courts in the Fourth Circuit require either general or severe recklessness).

195. *See* Armstrong et al., *supra* note 38, at 986 (discussing history of common-law fraud in the context of securities litigation).

sistently refused to strengthen their scienter requirements by eliminating recklessness.[196]

The recklessness standard in relationship to accountants has been evaluated in various ways. Some courts define accounting recklessness as accounting practices that are such "an extreme departure from the standards of ordinary care"[197] or "so deficient that the audit amounted to no audit at all."[198] Other courts find recklessness in a failure to investigate the obvious or doubtful.[199] Some courts allow gross departures from GAAP or GAAS as merely negligent actions which do not meet the scienter standard,[200] and other courts conclude that this same conduct may prove reckless enough to establish scienter.[201] Even if accountants heed the professional auditing standards set forth in SAS No. 82 and SAS No. 54, it is not clear whether or not this will absolve or insulate them from securities fraud liability in all jurisdictions, although "auditors who do adhere to the new standard [SAS No. 82] but fail to detect a material fraud will be in a better position to avoid liability on the grounds that SAS No. 82 provides a 'safe haven.'"[202] The Reform Act, together with its legislative history, left "the definition of scienter [intent] an open question for the courts to work out."[203]

B. *Pleading Requirements*

The Reform Act's failure to codify the definition of scienter has focused judicial attention upon the requirements for pleading fraud as a means of clarifying the conduct that gives rise to scienter. Already there exist several types of post-Reform Act cases that differ in their standards for pleading scienter and in their interpretation of the Reform Act's pleading requirements.[204]

Rule 10b-5's scienter requirement is now being measured against the Reform Act's new pleading section enacted by Congress to

196. Coopers & Lybrand pursued this argument unsuccessfully in *In re* Phar-Mor Inc. Sec. Litig., 892 F. Supp. 679, 685 (W.D. Pa. 1995).

197. SEC v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992) (quoting Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)).

198. *Price Waterhouse*, 797 F. Supp. at 1240.

199. *E.g.*, Axel Johnson, Inc. v. Arthur Andersen & Co., 762 F. Supp. 599, 601 (S.D.N.Y. 1991).

200. *E.g.*, *In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 627-28 (9th Cir. 1994); *In re* In-Store Advertising Sec. Litig., 878 F. Supp. 645, 648-49 (S.D.N.Y. 1995); *see* Yankwitt & Moldovan, *supra* note 17, at 4 & n.21. *See generally id.* (providing a further discussion of how courts have been inconsistent in their application of a recklessness/scienter standard in securities fraud litigation against accountants).

201. *E.g.*, Ades v. Deloitte & Touche, 799 F. Supp. 1493 (S.D.N.Y. 1992); *see* Yankwitt & Moldovan, *supra* note 17, at 4 & n.22.

202. Robert Sidorsky, *Independent Auditor's Consideration of Fraud*, N.Y. L.J., Jan. 24, 1997, at 1, 32.

203. Karen Donovan, *Securities Law Review on Tap*, NAT'L L.J., Apr. 14, 1997, at A6 (alteration in original) (quoting Donald C. Langevoort of Vanderbilt University School of Law).

204. *See infra* notes 220-61 and accompanying text.

strengthen existing pleading requirements by requiring plaintiffs to plead with particularity the facts giving rise to the allegations of fraud. One year after the Reform Act's enactment, lawyers report that they have altered their pleading strategies to meet the Reform Act's heightened pleading requirement by making more detailed and specific allegations so that their complaints will survive motions to dismiss.[205]

The Reform Act requires that in securities fraud actions the plaintiff's "complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[206] This represents a departure from the pre-Reform Act standard of Federal Rule of Civil Procedure 9(b) which requires that fraud be alleged with particularity, but expressly allows "[m]alice, intent, knowledge and other condition of mind of a person [to] be averred generally."[207]

The Reform Act's legislative history indicates in its House conference report two major drawbacks to Rule 9(b).[208] Rule 9(b) did "not prevent . . . abuse of the securities laws by private litigants" and "courts of appeals have interpreted Rule 9(b)'s [broad and lenient pleading] requirement in conflicting ways, creating distinctly different standards amongst the circuits."[209] For example, the Seventh Circuit has established that a sufficient level of factual support for a Rule 10b-5 claim is found when the circumstances of fraud are pled "in detail" which "means the who, what, when, where, and how: the first paragraph of any newspaper story."[210] However, some courts have interpreted Rule 9(b) to allow plaintiffs to generally allege fraud without setting forth specific facts in support of their allegations.[211] The Reform Act's new pleading requirement was intended to curtail the filing of meritless lawsuits by establishing more stringent and uniform pleading standards.[212]

The pre-Reform Act pleading standard, set forth in Rule 9(b), was given its strictest interpretation by the Second Circuit. The Second Circuit required a plaintiff to plead facts sufficient to raise a "strong infer-

205. Dominic Bencivenga, *Litigation Re-Formed Lawyers Report on 'Year 1' Under Securities Act*, N.Y. L.J., Jan. 16, 1997, at 5.

206. Reform Act sec. 101(b), § 21D(b)(2), 15 U.S.C. §78u-4(b)(2) (Supp. I 1995).

207. FED. R. CIV. P. 9(b).

208. H.R. CONF. REP. NO. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740.

209. *Id.*

210. Dileo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990); *see also* Williams v. WMX Techs., 112 F.3d 175, 177-78 (5th Cir. 1997), *petition for cert. filed*, 66 U.S.L.W. 3170 (U.S. Aug. 20, 1997) (No. 97-333).

211. This is true in the Ninth and Sixth Circuits. *See* Fecht v. Price Co., 70 F.3d 1078, 1082-83 (9th Cir. 1995); *In re* GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1546-49 (9th Cir. 1994); *In re* Rospatch Sec. Litig., 760 F. Supp. 1239, 1253 (W.D. Mich. 1991); Edward Brodsky, *Scienter Under the Reform Act of 1995*, N.Y. L.J., Jan. 8, 1997, at 3, 3 n.5.

212. H.R. CONF. REP. NO. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. 730, 740.

ence of fraudulent intent."[213] This "strong inference" of fraudulent intent could be "established either (a) by alleging facts to show that defendants had both the motive and opportunity to commit fraud ["motive and opportunity" test], or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness ["circumstantial evidence" test]."[214]

The difficulty in applying the Second Circuit's stringent pleading standard, particularly the motive and opportunity test, is demonstrated by the case law which has led to "arbitrary line-drawing by the courts."[215] In some situations where a plaintiff alleges that the defendant gained personal benefits from inflated stock prices, the motive and opportunity test to commit fraud has been satisfied,[216] whereas in others such evidence has been found insufficient.[217]

In *In re Time Warner, Inc. Securities Litigation*, the Second Circuit found a motive to commit fraud adequately pled where plaintiffs alleged that the defendants artificially maintained a higher stock price in order to raise capital more easily.[218] In contrast, in *San Leandro Emergency Medical Group Profit Sharing Plan*, the same court held that plaintiffs had not adequately pled sufficient motive to commit fraud by alleging that defendant maintained high stock prices in order to issue bonds because "if scienter could be pleaded on this basis alone, virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions."[219]

The Reform Act's pleading standards have created a judicial split over what types of allegations are sufficient to support the scienter requirement in a securities fraud claim.[220] Three types of post-Reform Act

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213. *See* Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994).

214. *Shields*, 25 F.3d at 1128; *see also* San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Co., 75 F.3d 801, 813 (2d Cir. 1996); *In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 268-69 (2d Cir. 1993); O'Brien v. National Property Analysts Partners, 936 F.2d 674, 676-77 (2d Cir. 1991), *aff'g* O'Brien v. Price Waterhouse, 740 F. Supp. 276 (S.D.N.Y. 1990) (affirming the district court's dismissal after implicitly recognizing that the plaintiff failed to satisfy the circumstantial evidence test).

215. Brodsky, *supra* note 48, at 3.

216. *Time Warner, Inc.*, 9 F.3d at 269-70; Hallett v. Li & Fung Ltd., No. 95 Civ. 8917, 1996 WL 487952, at *3 & n.3 (S.D.N.Y. Aug. 27, 1996); Polycast Tech. Corp. v. Uniroyal Inc., 792 F. Supp. 244 (S.D.N.Y. 1992); *see also* Brodsky, *supra* note 48, at 3 & n.21.

217. *San Leandro Emergency Med. Group Profit Sharing Plan*, 75 F.3d at 813-14; Acito v. IMCERA Group, Inc., 47 F.3d 47, 54 (2d Cir. 1995); *see also* Brodsky, *supra* note 48, at 3 & n.22.

218. *Time Warner, Inc.*, 9 F.3d at 269.

219. *San Leandro Emergency Med. Group*, 75 F.3d at 814 (quoting *Acito*, 47 F.3d at 54); *see also* Brodsky, *supra* note 48, at 3 (providing a further discussion of the *Hallett* and *Acito* cases to illustrate the difficulties experienced by courts in determining when the motive and opportunity test has been adequately pled to support the scienter requirement).

220. William R. Maguire & Reid A. Muoio, *Securities Litigation Reform: The First Anniversary*, N.Y. L.J., Dec. 12, 1996, at 2.

cases have evolved:[221] first, cases holding that pleading scienter under the Reform Act is satisfied by establishing reckless conduct and the motive and opportunity to commit fraud;[222] second, cases rejecting the recklessness standard and holding that scienter is only proven by pleading a deliberate and conscious intent to commit fraud;[223] and third, cases holding that although the recklessness standard is still applicable, the motive and opportunity test does not satisfy the Reform Act's heightened pleading requirements.[224]

Some courts have held that allegations of reckless behavior or motive and opportunity may be sufficient in relation to corporate insiders to prove an intent to commit fraud.[225] In *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.*,[226] a federal district court in California held that the Reform Act did not clearly eliminate the Second Circuit's motive and opportunity test since this was not explicitly done in the statute and this test remains "consistent with both the language and purpose of the [Reform Act]" and is a "suitable standard to employ."[227]

The *Marksman* court, as well as other courts, determined that the Second Circuit pleading standard survived passage of the Reform Act.[228] It refers to the Reform Act's legislative history which states that "[t]he conference committee language is based in part on the pleading standard of the Second Circuit" which is "regarded as the most stringent pleading standard. The Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a 'strong inference' of the defendant's fraudulent intent."[229]

The SEC also supports this position as it did in an amicus brief supporting the plaintiff's complaint in *In re Silicon Graphics Inc. Securities Litigation* (*Silicon Graphics I*),[230] wherein it asserted that although Congress intended to adopt a stricter procedural pleading standard in securities fraud cases, Congress did not intend to substantively change securities laws by eliminating recklessness as a basis for scienter.[231] As of Janu-

221. Dennis J. Block & Jonathan M. Hoff, *Scienter Requirement Under Securities Litigation Reform*, N.Y. L.J., July 17, 1997, at 5 (recognizing and discussing the three post-Reform Act approaches to scienter).

222. *See infra* notes 225-32 and accompanying text.

223. *See infra* notes 233-48 and accompanying text.

224. *See infra* notes 249-57 and accompanying text.

225. *E.g.*, Zeid v. Kimberley, 930 F. Supp. 431, 437-38 (N.D. Cal. 1996); Marksman Partners, L.P. v. Chantal Pharmaceutical Corp., 927 F. Supp. 1297, 1310, 1313 (C.D. Cal 1996).

226. *Marksman Partners, L.P.*, 927 F. Supp. at 1297.

227. *Id.* at 1312.

228. *Marksman*, 927 F. Supp. at 1311; *see, e.g.*, *Zeid*, 930 F. Supp. at 434.

229. *Marksman*, 927 F. Supp. at 1311 (citing H.R. CONF. REP. NO. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740).

230. No. C96-0393, 1996 WL 664639 (N.D. Cal. Sept. 25, 1996) [hereinafter *Silicon Graphics I*].

231. Donovan, *supra* note 203, at A6 (discussing the SEC's amicus brief filed in *Silicon Graphics I*).

ary 1997, out of seven courts that have addressed the new pleading standard, six courts have concluded that the Reform Act simply adopted the Second Circuit's rule that a strong inference of fraud is adequately pled if the complaint pleads specific facts establishing circumstantial evidence of reckless or conscious behavior or a motive and opportunity to commit fraud.[232]

Other courts have interpreted the Reform Act as eliminating recklessness as a basis for scienter, requiring instead that scienter be proven by evidence of a conscious or deliberate intent, rather than a motive and opportunity, to commit fraud under more stringent pleading standards than those provided for by the Second Circuit.[233] This position was reflected in *Silicon Graphics I*[234] where the District Court of Northern California, after a detailed review of the Reform Act's legislative history, concluded that Congress did not intend to adopt the Second Circuit's scienter pleading standard.[235]

The *Silicon Graphics I* court decided that Congress intended to adopt a stricter scienter pleading requirement requiring plaintiffs to allege conscious or intentional misconduct, or a deliberate intent to deceive or actual knowledge by the defendant.[236] In the *Silicon Graphics I* case, the court dismissed, with leave to file an amended complaint, the plaintiff's original securities fraud complaint, which alleged that the corporate officers sold stock despite their knowledge that public statements concerning their company's revenue growth were false.[237]

Recently in *In Re Silicon Graphics, Inc. Securities Litigation*[238] (*Silicon Graphics II*), decided May 23, 1997, Judge Smith, of the federal district court in San Francisco, dismissed the amended complaint, ruling that under the Reform Act's heightened pleading standards plaintiffs had not adequately alleged the details of the company's negative internal reports[239] and that "recklessness" in issuing inaccurate reports was insufficient to hold corporate officers liable.[240] Judge Smith dismissed plaintiff's amended complaint, ruling that pleading "deliberate recklessness" would meet the Reform Act's higher standard of "a strong inference of knowing or intentional misconduct."[241] As one commentator noted in reference to Judge Smith's decision in *Silicon Graphics II*, "Congress

232. *See* Grundfest & Perino, *supra* note 21, at 24-27 (discussing the seven cases that addressed the new pleading standard as of January 1997).

233. *See* Block & Hoff, *supra* note 221, at 5 (discussing cases adopting the more stringent pleading standards).

234. *Silicon Graphics I*, 1996 WL 664639, at *5.

235. *Id.* at *5-*6 & n.4.

236. *Id.* at *6-*7.

237. *Id.* at *16.

238. 970 F. Supp. 746 (N.D. Cal. 1997) [hereinafter *Silicon Graphics II*].

239. *Silicon Graphics II*, 970 F. Supp. at 767.

240. *Id.* at 757.

241. *Id.*

intended plaintiffs to show harder factual evidence when bringing cases rather than relying on secondhand information and beliefs based on that information, which has been the foundation of such suits in the past."[242] *Silicon Graphics II* clearly rejects mere recklessness as the scienter standard as well as the motive and opportunity test for pleading scienter.[243] *Silicon Graphics II* advocates a "deliberate recklessness" scienter standard which must be pled through evidence of intentional, conscious or deliberate misconduct sufficient to raise a strong inference of fraud.[244]

The plaintiffs plan to appeal Judge Smith's ruling to the Ninth Circuit Court of Appeals.[245] An appellate court ruling in this closely watched case is expected to provide the first appellate decision concerning the future of the recklessness standard and the scope of the scienter pleading requirements under the Reform Act.

Both *Silicon Graphics* decisions reiterated that if Congress had intended to adopt the Second Circuit's approach it would have done so clearly.[246] They refer to the conference report which states that the "Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard"[247] and "[f]or this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness."[248] Although Congress did not adequately define a new scienter or pleading standard, the Reform Act may indicate its intent to go beyond rules already in effect.[249] Even President Clinton, in his veto of the Reform Act, noted that in his view the legislative history indicated that Congress sought to adopt a more stringent pleading standard than that of the Second Circuit.[250]

Yet another judicial perspective on pleading scienter was declared by Judge Raskoff of the Southern District of New York in *In re Baesa*

242. Paul Beckett, *Silicon Graphics Gains Dismissal of Suit Alleging Securities Fraud*, WALL ST. J., May 30, 1997, at B2; *see Silicon Graphics II*, 970 F. Supp. at 763-64. In finding that the plaintiffs failed to adequately allege the details of the company's negative internal reports under the Reform Act's heightened pleading standards, the court noted that "[t]hese allegations should include the titles of the reports, when they were prepared, to whom they were directed, their content, and the sources from which plaintiffs obtained this information." *Id.* at 764.

243. *See Silicon Graphics II*, 970 F. Supp. at 757.

244. *Id.* at 757. *See generally* Brodsky, *supra* note 48, at 3.

245. Beckett, *supra* note 242, at B2 (noting statement by Bill Lerach, a partner at the law firm representing the plaintiffs).

246. *Silicon Graphics II*, 970 F. Supp. at 756; *Silicon Graphics I*, No. C 96-0393, 1996 WL 664639, at *5 (N.D. Cal. Sept. 25, 1996).

247. H.R. CONF. REP. NO. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740.

248. H.R. CONF. REP. NO. 104-369, at 48 n.23 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 747 n.23.

249. Brodsky, *supra* note 211, at 3.

250. Private Securities Litigation Reform Act of 1995—Veto Message from the President of the United States, *reprinted in* 141 CONG. REC. H15214-06 (daily ed. Dec. 19, 1995). Congress overrode the veto on December 22, 1995. 141 CONG. REC. D1507 (daily ed. Dec. 22, 1995).

Securities Litigation.[251] Judge Raskoff found that the Reform Act did not increase the scienter requirement for securities fraud beyond the recklessness standard because "'recklessness', in its classic formulation, describes a conscious state of mind that is inherently deceptive, i.e., a conscious and purposeful disregard of the truth of a known risk."[252] Judge Raskoff also held that pleading only motive and opportunity is no longer sufficient for proving an inference of scienter under the Reform Act.[253] Instead, the pleadings must set forth sufficient particularized information to raise a strong inference of the required scienter.[254] Based upon this formulation, the *Baesa* court dismissed plaintiff's complaint due to the lack of factual support for plaintiff's allegations that the defendants had knowledge of the fraud.[255]

The *Baesa* ruling runs counter to the *Silicon* cases which elevated the scienter requirement to a deliberate recklessness standard. Furthermore, another federal judge in New York ruled otherwise in *Norwood Venture Corp. v. Converse Inc.*,[256] holding that Congress intended to adopt a higher scienter requirement requiring a plaintiff to plead defendant's knowing misrepresentation.[257] The First Circuit in *Friedberg v. Discreet Logic, Inc.*[258] recently adopted a conscious behavior approach to pleading scienter which is consistent with the *Silicon* approach.[259]

These different judicial standards for pleading scienter under the Reform Act reflect the inherent ambiguities within the statute. Congress's failure to define a clear standard for pleading and proving scienter impede "the Reform Act's further objective of establishing uniform and more stringent pleading requirements with respect to the scienter element of [section] 10(b)."[260] Until the various courts of appeals formulate a clear scienter standard, possibly with the Supreme Court's assistance, this standard "will remain confused and inconsistently applied among the federal district courts."[261]

IV. CONCLUSION

Accountants may believe that the new pleading requirements will curtail litigation against them but that remains to be seen. For example, plaintiffs' attorneys may cite the auditor's new duty under the Reform Act to detect and disclose illegal acts to support their securities fraud

251. 969 F. Supp. 238 (S.D.N.Y. 1997).
252. *Baesa Sec. Litig.*, 969 F. Supp. at 241.
253. *Id.* at 242.
254. *Id.*
255. The *Baesa* plaintiffs were given thirty days to replead their complaint. *Id.* at 243.
256. 959 F. Supp. 205 (S.D.N.Y. 1997).
257. *Norwood Venture Corp.*, 959 F. Supp. at 208.
258. 959 F. Supp. 42 (D. Mass. 1997).
259. *Friedberg*, 959 F. Supp. at 50.
260. Block & Hoff, *supra* note 221, at 7 (internal quotation marks omitted).
261. *Id.*

allegations which now must be pled with factual particularity. Plaintiffs may allege that an auditor's failure to detect fraudulent or illegal acts demonstrates the requisite scienter or recklessness to sustain a primary section 10(b) or Rule 10b-5 fraud liability claim.[262] In fact, recent successful federal securities lawsuits against accountants alleging direct primary fraud violations may fuel future litigation under the Reform Act.[263]

However, in one post-Reform Act case, *Duncan v. Pencer*,[264] a securities fraud complaint which had been lodged against the accounting firm of Coopers & Lybrand, was dismissed after being evaluated under the Second Circuit's motive and opportunity and circumstantial evidence pleading standards rather than the heightened pleading requirements of the Reform Act.[265] In *Duncan*, the plaintiffs alleged that Coopers & Lybrand had a motive to commit fraud due to its desire to maintain a profitable business relationship with the defendant corporation and continue receiving its professional fees.[266] Therefore, the complaint alleged that Coopers falsified corporate financial statements regarding profitability causing investors to buy stock at inflated prices and enabling insiders to sell their stock at inflated market prices.[267] The *Duncan* court dismissed this motive argument, stating that it is "highly unlikely" to assume that any accounting firm would "knowingly condone a client's fraud in order to preserve a fee that, at best, is an infinitesimal percentage of its annual revenues, and by doing so, jeopardize its reputation and . . . subject itself to potential damages literally tens of thousands of times as large as its fees. . . ."[268]

Numerous courts have discredited the argument that every time a professional is paid and then sued for securities fraud a finding of scienter can be made.[269] In discussing the fraud complaint, the *Duncan* court also held that the circumstantial evidence test of conscious misbehavior or recklessness was not satisfied by summarily alleging GAAP violations without making supporting allegations of fraudulent intent.[270] The fact

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262. Lisa S. Kahn & Laura M. Metcalfe, *Accountants, No Longer at Risk of Being Sued for Aiding and Abetting Securities Law Violations, Have Recently Been Found Directly Liable for Their Clients' Fraud*, NAT'L L.J., May 20, 1996, at B6.

263. *Id.* (referring to the Coopers & Lybrand/Phar-Mor Inc. case where a federal jury found the auditors liable, *see* Edward J. DeBartolo Corp. v. Coopers & Lybrand, 928 F. Supp. 557, 559-60 (W.D. Pa. 1996) (discussing scope of appropriate damages after a finding of liability), and the Deloitte & Touche case where a jury found the accounting firm liable for over $81 million, *see* Robbins v. Koger Properties, Inc., 116 F.3d 1441, 1445-46 (reversing jury finding because plaintiff failed to establish the loss causation element of Rule 10b-5, 17 C.F.R. § 240.10b-5 (1997)).

264. No. 94 Civ. 0321, 1996 WL 19043, at *1 (S.D.N.Y. Jan. 18, 1996).

265. *Duncan*, 1996 WL 19043, at *10-*11.

266. *Id.* at *9.

267. *Id.* at *11-*12.

268. *Id.* at *10.

269. *See, e.g.*, Yankwitt & Moldovan, *supra* note 17, at 4.

270. *Duncan*, 1996 WL 19043, at *10.

that Coopers violated a basic and fundamental accounting principle, i.e., giving someone money as an expense, not an asset, does not mean that Coopers necessarily acted recklessly and does not satisfy the requirement to plead fraud with particularity and circumstantial evidence.[271]

The Reform Act has not clarified either the substantive or procedural issues pertaining to the recklessness/scienter requirement in federal securities fraud litigation. Auditors continue to be named as defendants in federal securities lawsuits but face uncertainties as the courts continue to grapple with what constitutes fraud within the accounting context. The Reform Act has created a duty for auditors to report illegal acts but has insulated such reports from private causes of action. However, accountants remain susceptible to private causes of action for fraud and illegal acts not included within their reports to the SEC. Such outside fraud or illegal acts may be sufficient to meet the Reform Act's heightened pleading standards.

Despite the Reform Act, the courts, almost without exception, continue to apply the Second Circuit's amorphous motive and opportunity test and circumstantial evidence test. The question remains whether an auditor's failure to report significant fraudulent and illegal acts could provide sufficient circumstantial evidence of conscious misbehavior and recklessness or motive and opportunity to support a Rule 10b-5 cause of action. The professional auditing standards of SAS No. 82 and SAS No. 54 create a duty to consider fraud and illegal acts in the audit process. It is now up to the judiciary to determine whether these professional standards will be a benchmark for alleging auditor fraud within the federal securities law context. Until now the case law has been inconsistent. It remains to be seen whether these professional standards, in concert with the Reform Act, will stimulate a more unified approach to auditor fraud liability.

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271. *Id.*