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Recklessness as Scienter in Corporate Securities Trading: An Analysis and Evaluation of United States Investor Protection Policy Reforms and Their Implications for the Commonwealth Caribbean

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RECKLESSNESS AS SCIENTER IN CORPORATE SECURITIES TRADING: AN ANALYSIS AND EVALUATION OF UNITED STATES INVESTOR PROTECTION POLICY REFORMS AND THEIR IMPLICATIONS FOR THE COMMONWEALTH CARIBBEAN

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"Before the Law stands a doorkeeper."[1]

I. INTRODUCTION

In a recent issue emphasizing Caribbean law, Darren Skinner in the *Journal of Transnational Law and Policy* noted that

> [t]he interest of stockholders *qua* investor may be subordinated to the opportunity for 'inside dealing.' This is an especially worrisome problem for the Commonwealth Caribbean territories with nascent stock exchanges such as Jamaica, Trinidad & Tobago and Barbados, which have inadequate or non-existent securities regulations or other means of investor protection [from] the ravages of insider trading."[2]

Indeed, no single set of measures has proven more effective in combating the pernicious practice of insider trading in the United States than the federal securities law provisions of section 10(b) of

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1. KAFKA, (DER PROZESS) THE TRIAL (1916), *reprinted in* KAFKA, THE COMPLETE STORIES AND PARABLES 3 (Nahum N. Glatzer ed., 1983). Scienter has become the doorkeeper under the Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1982), and the SEC Rule, 17 C.F.R. § 240.10b-5 (1987).

2. Darren Skinner, *Unlocking the Interlocks: Common Law Fiduciary Duties and the Phenomenon of Interlocking Corporate Directorates in the Commonwealth Caribbean*, 3 J. TRANSNAT'L L. & POL'Y. 53, 78 (1994).

the Securities Exchange Act[3] and the Securities and Exchange Commission (SEC) rule in 17 C.F.R. § 240.10b-5 (1987).[4]

Now, in a shift in the correlation of policy values and investor protection philosophy with regard to trading in corporate securities, the 104th Congress in section 204 of H.R. 10 of January 4, 1995[5]

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3. Section 10(b) makes it

> "unlawful for any reason . . . (b) [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

4. Section 240.10b-5 promulgated in 1942 pursuant to the SEC's rule-making authority provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with purchase or sale of any security."

This paper presumes that all references to § 10(b) include § 240.10b-5.

5. Section 204. Prevention of "Fishing Expedition" Lawsuits.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 10 the following new section:

"Sec. 10A. Requirements for Securities Fraud Actions.

"(a) Scienter.—In any action under section 10(b), a defendant may be held liable for money damages only on proof—

"(1) that the defendant made an untrue statement of a material fact, or omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading; and

"(2) that the defendant knew the statement was misleading at the time it was made, or intentionally omitted to state a fact knowing that such omission would render misleading the statements made at the time they were made.

"(b) Requirement for Explicit Pleading and Proof of Scienter.—In any action under section 10(b) in which it is alleged that the defendant—

"(1) made an untrue statement of a material fact; or

"(2) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred. The complaint shall also specify each statement or omission alleged to have been misleading, and the reasons the statement or omission is misleading. If an allegation regarding the statement or omission is made on information and belief, the complaint shall set forth with specificity all information on which that belief is formed. Failure to comply fully with this requirement shall result in dismissal of the complaint for failure to state a cause of action.

"(c) Reliance.—In any action arising under section 10(b) based upon a material misstatement or omission concerning a security, the plaintiff must prove that he or she had actual knowledge of and actually relied on such statement in connection with the purchase or sale of a security and that the misstatement or omission proximately caused (through both transaction causation and loss causation) any loss incurred by the plaintiff.

"(d) Limits on Windfall Damages.—In any action arising under section 10(b) based on a material misstatement or omission concerning a security, an award of damages that exceeds the

purports to radically modify the legal definition of scienter for purposes of civil suits under the federal securities laws by amending section 10(b) and concomitantly 17 C.F.R. § 240.10b-5.[6] If the amendments become law in their present form, an entire jurisprudence developed by the vast majority of the circuit courts based upon the inclusion of recklessness as scienter in civil suits to impose liability for violation of section 10(b) and 17 C.F.R. § 240.10b-5 will be abrogated. The outstanding substantive efforts of the circuits in this regard will be nullified.

Commonwealth Caribbean jurisdictions should not embrace the policy value judgments and fundamental philosophy underlying this purported reform of the U.S. federal civil justice system and, most emphatically, should not emulate this U.S. policy shift in the regulation of its corporate securities markets. On the contrary, in light of the profound advances in modern data technology and the evolving significance of the Commonwealth Caribbean as an emerging commercial market center, strengthening investor protection provisions in the Commonwealth Caribbean has become an even more critically necessary today than it was just over two decades ago.[7] Moreover, under European Union (EU)[8] Council Directive 89/592,[9] the twelve member states of the EU have all recently updated and expanded their own enactments to more effectively circumscribe the deleterious effects of insider trading on the efficiency and integrity of their own securities markets.

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price paid for a security purchased in reliance upon a material misstatement or omission shall not exceed the lesser of—

"(1) the difference between the price paid for the security which was purchased in reliance upon a material misstatement or omission, and the market value of the security immediately after dissemination to the market of information which corrects the misstatement or omission; and

"(2) the difference between the price paid for the security which was purchased in reliance upon a material misstatement or omission, and the price at which the relying party sold the security after dissemination of information correcting the misstatement or omission."

6. *Id.*

7. *See* Stephen J. Leacock, *Essentials of Investor Protection in the Commonwealth Caribbean and the United States*, 6 LAW. AM. 662, 680-81, 685-86 (1974).

8. Rome Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11, *amended by*, The Single European Act of 1986, 1987 O.J. (L 169) 1, 7. At present, twelve nations are signatories to the Treaty: Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain and the United Kingdom.

9. *See* Council Directive 89/592 Coordinating Regulations on Insider Dealing, 32 O. J. EUR. COMM. (No. L. 334) 30 (1989), 1 Common Mkt. Rep. (CCH) ¶ 1761, *reprinted in* EEC DIRECTIVES ON COMPANY LAW AND FINANCIAL MARKETS 284-288 (D. D. Prentice ed., 1991). The policy initiatives in Council Directive 89/592 are more transcendent in direction than H.R. 10, 104th Congress (1995) and serve as a much more valuable example for the Commonwealth Caribbean to follow.

II. BACKGROUND TO THE DEVELOPMENT AND INTERPRETATION OF SCIENTER IN U.S. SECURITIES LAWS

In *Ernst & Ernst v. Hochfelder*,[10] the U.S. Supreme Court held that in order to succeed on a cause of action brought under section 10(b) and 17 C.F.R. § 240.10b-5, the plaintiff must prove that the defendant acted with scienter. Reviewing the language of the statute and its legislative history, the Supreme Court concluded that negligence alone did not satisfy the scienter requirement.[11] Furthermore, in defining the requisite mental elements necessary to support a finding of scienter, the Supreme Court declared that scienter is "a mental state embracing intent to deceive, manipulate, or defraud."[12]

In the course of its decision, the Supreme Court noted that some circuit courts of appeal decided that negligence alone would suffice in order to impose civil liability under section 10(b) and 17 C.F.R § 240.10b-5. Other circuit courts of appeal have held that a higher degree of reprehensible conduct was required to impose civil liability.[13] Although the Supreme Court conceded that recklessness is regarded as a form of intentional conduct for the purpose of imposing liability in certain areas of the law, the Supreme Court nevertheless specifically declined to address the question of whether or not recklessness would be a sufficiently culpable state of mind to satisfy the scienter requirement for civil liability under section 10(b) and 17 C.F.R. § 240.10b-5.[14]

Some seven years later, in *Herman & MacLean v. Huddleston*,[15] the Supreme Court yet again declined ruling on whether or not recklessness satisfied the scienter requirement under section 10(b) and rule 10b-5.[16] In deciding *Herman & MacLean*, the Supreme Court restricted its ruling to observing that the District Court had instructed the jury that liability could be found only if the defendants acted with scienter. The Court noted that reckless behavior could conceivably satisfy the requirement of scienter, but refrained from explicitly deciding the issue.[17]

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10. 425 U.S. 185 (1976).
11. *Id.*
12. *Id.* at 194 n.12.
13. The following are examples of degrees of reprehensible conduct that are higher than negligence: intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud. *See, e.g., id.* at 194 n.12; Clegg v. Conk, 507 F.2d 1351, 1361-62 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975); Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973).
14. *Ernst & Ernst*, 425 U.S. at 214.
15. 459 U.S. 375 (1983).
16. *Id.* at 378 n.4.
17. *Id.*

A. Policy Goals of S.10(b) and Rule 10(b)(5)

The goal of section 10(b) and rule 10(b)(5) is to prevent the employment of manipulative or deceptive devices in connection with the sale or purchase of securities.[18] Judge Frank in *Fischman v. Raytheon Manufacturing Company*[19] stated that to be actionable under 10(b) there must be an "ingredient of fraud."[20] The Supreme Court has put its seal of approval on this approach by declaring that the congressional intent is to proscribe only "knowing or intentional misconduct."[21]

Thus, the ingredient of fraud necessary to sustain an action under 10(b) has become somewhat more difficult to distinguish from that necessary to sustain the common-law action of deceit.[22] With respect to negligence, proof of negligence is insufficient to state a cause of action under 10(b).[23] Regardless of the nature of the relief sought or the identity of the plaintiff, scienter is invariably a fundamental element of a 10(b) action that the plaintiff must plead and prove.[24]

B. Primary Liability

Although the Supreme Court has made it clear that negligence alone is insufficient and has twice expressly left open the question as to whether "recklessness" will satisfy the scienter requirement for

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18. Aaron v. SEC, 446 U.S. 680 (1980).

19. 188 F.2d 783 (2d Cir. 1951).

20. *Id.* at 786-87.

21. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197-99 (1976); *see* Aaron v. SEC, 446 U.S. 680, 690 (1980); Bernes & Franklin, *Scienter and SEC Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder*, 51 N.Y.U. L. REV. 769 (1976); Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213 (1977); Bunch, *Aaron: The Demise of Equitable Fraud Under Section 10(b)*, 30 EMORY L. J. 305 (1981); Cox, *Ernst & Ernst v. Hochfelder: A Critique and an Evaluation of Its Impact Upon the Scheme of the Federal Securities Laws*, 28 HASTINGS L. J. 569 (1977).

22. *See* Bucklo, *supra* note 21, at 228-40.

> Fraud is proved [at common law] when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, *I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states.* (emphasis added).

Derry v. Peek, (1889) 14 App. Cas. 337, *reprinted in* SEALY, CASES AND MATERIALS IN COMPANY LAW 478, 480 (1971) (*per* Lord Herschell).

The Supreme Court has specifically left open the question of liability for recklessness under § 10(b) and rule 10(b)-5. *See infra* note 25.

23. *Ernst & Ernst*, 425 U.S. at 203, 214. "In our view, the rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation § 10(b) and Rule 10b-5, *regardless of the identity of the plaintiff or the nature of the relief sought.*" Aaron v. SEC, 446 U.S. 680, 691 (1980) (*per* Mr. Justice Stewart) (emphasis added).

24. *Id.*

10(b) actions,[25] practically all circuits have interpreted section 10(b) and Rule 10(b)(5) as allowing recovery on the basis of "recklessness."[26] The definition of "recklessness" applied in connection with section 10(b) differs in some aspects from traditional common-law standards for proving the tort of deceit. For example, at common law, deceit traditionally consists of acts of commission involving disregard of truth or outright falsity.[27] However, many of the section 10(b) cases where the recklessness standard has been applied involve omissions of material facts.

The standard most often applied is essentially derived from *Sundstrand Corporation v. Sun Chemical Corporation*[28] and articulated in the following terms:

> [R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[29]

The Court in *Sundstrand* categorized such recklessness "as the functional equivalent of intent"[30] and policy arguments support a recklessness standard in satisfaction of the scienter requirement, because recklessness in this context, encompasses an objective standard[31] and is an alternative to deliberateness.[32] Under this

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25. *Ernst & Ernst*, 425 U.S. at 194 n.12; Herman & McLean v. Huddleston, 459 U.S. 375, 379 n.4 (1983).

26. *See* Hackbart v. Holmes, 675 F.2d 1114 (10th Cir. 1982); White v. Sanders, 689 F.2d 1366 (11th Cir. 1982); G.A. Thompson, Inc. v. Partridge, 636 F.2d 945 (5th Cir. 1981); Healey v. Catalyst Recovery of Pa., 616 F.2d 641 (3rd Cir. 1980); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979); Rolf v. Blyth, Eastman, Dillon & Co., 570 F.2d 38, 44 (2nd Cir.) (sufficient at least when a fiduciary duty exists), *op. amended by* No. 77-7104 and 77-7124, 1978 WL 4098 (2d Cir.) *and cert. denied*, 439 U.S. 1039 (1978); Nelson v. Serwold, 576 F.2d 1332 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189 (8th Cir. 1978); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir.), *cert. denied sub nom.*, Meers v. Sundstrand Corp. 434 U.S. 875 (1977); Kaufman v. Magid, FED. SEC. L. REP. (CCH), ¶ 98, 713 (Mass. 1982).

27. *See supra* note 22.

28. 553 F.2d 1033 (7th Cir. 1977), *cert. denied sub nom.*, Meers v. Sundstrand Corp., 434 U.S. 875 (1977).

29. *Id.* at 1045 (quoting Franke v. Midwestern Oklahoma Dev. Auth., 428 F. Supp. 719 (W.D. Okl. 1976)).

30. *Id.*; cf. Bucklo, *Scienter and Rule 10b-5*, 67 NW. U. L. REV. 562, 570-71 (1972). *But see* Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5, Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213, 227-40 (1977).

31. *Sundstrand*, 553 F.2d at 1045.

> [I]t measures conduct against an external standard which . . . results in the conclusion that the reckless [person] should bear the risk of his [or her] omission. . . .

definition, recklessness charges the actor with knowledge of and responsibility for the clear-cut risks created by his extreme lack of care. This approach is particularly valuable because, in contrast, limiting the definition of scienter simply to actual knowledge impairs enforcement of the rule, makes success under it exceedingly difficult and deliberate ignorance, though unseemly, would unfortunately be rewarded under the latter approach.

Supporting policy arguments establish that first, the Securities Acts are to be broadly construed to achieve their remedial goal.[33] Second, requiring the plaintiff to always prove actual intent would be unduly burdensome. Third, the Securities Acts were intended to accomplish regulation of the securities markets in circumstances where the common law had proven itself rather ineffective. In enacting the Securities Acts, the Federal Legislature intended to supplement, repair and improve the common law by proscribing actions akin to common law fraud, which unfortunately slipped through the cracks.[34]

A year or so after *Sundstrand* was decided by the Seventh Circuit, the Ninth Circuit adopted the *Sundstrand* standard in *Nelson v. Serwold*.[35] In *Nelson*, Serwold, president of a rural telephone company, entered into an agreement with three other shareholders to purchase enough shares to gain control of the company.[36] In 1965, the executor of an estate found certificates for thirty-six shares of stock in the phone company among the deceased's belongings. The executor wrote to the company inquiring as to the status of the stock and requesting remittance of any refunds to which the estate was entitled. One of Serwold's three associates responded to the letter with a check for $180 and information that no dividends had ever been declared, because the corporation never retained any surplus from which to declare them. The executor then replied, stating that he assumed the $180 represented the fair market value of the shares, but requested $250 more. In response, a check for an additional $250 was sent to him. In 1971, under Serwold's control, the phone company was reorganized with United Utilities, Inc., and all of the phone company's assets were exchanged for United stock at the rate of

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When measured against this external standard, it may be said that such a reckless [person] has 'use[d] or employ[ed] [a] deceptive device' within Section 10(b).

Id. (footnotes omitted).

32. For example, actual intent.

33. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972).

34. *Ernst & Ernst*, 425 U.S. at 193-94.

35. 576 F.2d 1332 (9th Cir. 1978), *cert. denied*, 439 U.S. 910 (1978).

36. In 1965, the stock value was $60 per share, but Serwold anticipated an increase in its value when the company modernized.

twenty-five shares of United[37] for each share of the old company. Thereafter, a nephew of the deceased obtained releases from the other relatives and sued for a violation of section 10(b).

The District court found Serwold liable for the profits derived from the sale of the deceased's shares to United.[38] It based liability on the omission of material information about: (a) the existence of a control group and (b) the informal, long-range plan of that control group to acquire a majority of the stock and build the company into a marketable entity.[39]

The Appellate court affirmed, declaring that defendant's awareness that the existence of the control group would have influenced a "reasonable investor's conduct"[40] made it culpably reckless for him not to voluntarily disclose that information to the executor.[41]

The Court of Appeals did not base its decision on any traditional fiduciary or other special duty of disclosure owed to the estate by Serwold. The affirmative obligation to disclose the existence of the control group, apparently arose as soon as the executor inquired about the status of the company.

C. *The Duty Requirement*

Discussion of scienter is not complete, however, unless a note of caution is sounded at this juncture. In addition to proof of scienter, the recent Supreme Court decision in *Dirks v. SEC*,[42] requires proof of the breach of a duty owed by the defendant as a precondition to culpability in all suits under section 10(b).[43] With respect to all cases pertaining to scienter, therefore, it is necessary to clarify intellectually whether they are pre-*Dirks*, or post-*Dirks* decisions, since in all

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37. The fair market value was $500.

38. The District court found that although Serwold had made three misrepresentations none were material.

39. The Court of Appeals for the Ninth Circuit agreed with this imposition of liability based on these specifics. *See Nelson*, 576 F.2d at 1337.

40. *Id.* at 1336.

41. *Id.* at 1338.

42. 463 U.S. 646 (1983).

43. The Court held that two requirements must be met before a duty owed by a defendant will be established: (1) the existence of a relationship (e.g., corporate insider) which provides access to inside information restricted to use for corporate purposes only and (2) misuse (e.g., trading without disclosure of that information) of that information by a corporate insider (i.e., breach of a fiduciary duty). *See* In re Cady, Roberts & Co., 40 S.E.C. 907 (1961). Under *Cady, Roberts*, insiders owe a corporation and its shareholders a duty not to trade on inside information. In Carpenter v. United States, 484 U.S. 19 (1987), the Supreme Court held that, *inter alia*, based on the fiduciary duty owed by an agent to his principal, the agent in issue had breached the fiduciary duty owed to his employer by misappropriating his employer's confidential information; and that this breach satisfied, in general terms, the requirements of a scheme to defraud others in connection with a purchase or sale of securities.

pre-*Dirks* decisions, had they come before the courts post-*Dirks*, no liability would have been imposed in any of them, unless a breach of a duty owed by the defendant was proven, as a condition precedent to any such liability.

Indeed, in *Dirks*, the Supreme Court found defendant not liable under section 10(b) for disclosing allegedly inside information, because of the SEC's failure to meet the precondition of proof of a breach of duty owed by the defendant. The Supreme Court made it clear that the typical tippee does not owe the prerequisite duty and consequently, did not expressly determine whether Dirks demonstrated any degree of scienter in disseminating the alleged inside information, since the threshold requirement to a finding of potential liability was not satisfied.

Although handed down prior to *Dirks*, the decision of the Tenth Circuit Court of Appeals in *Hackbart v. Holmes*[44] is consistent with the precondition of proof of breach of a duty owed by the defendant. In *Hackbart*, the Court held that, on the facts in issue, a material omission gave rise to section 10(b) liability.[45] In *Hackbart*, the defendant operated a tire business essentially as a sole proprietor. In 1971, he agreed to go into business with the plaintiff. The plaintiff had little or no experience with running a business in general or with the tire business in particular. The defendant promised the plaintiff 40% participation in the new store provided that the plaintiff would manage it. The plaintiff agreed.

Subsequent to this oral agreement between them, the defendant discussed the details with his lawyer. The defendant's lawyer suggested that they first embark upon a trial period so that the new working relationship could be tested. To facilitate the smooth operation of the trial period, the defendant's lawyer suggested to him that he should issue the plaintiff non-participating stock. The defendant agreed and, thereupon, authorized his lawyer to implement these new plans.[46] The defendant's lawyer was scheduled to meet with the plaintiff to discuss the details of the complete business arrangement. As a result of the meeting, the defendant relied on his lawyer to update the plaintiff and to explain the new plans.[47] The company prospered from 1971 until 1977. In 1977, the parties had a disagreement

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44. 675 F.2d 1114 (10th Cir. 1982).

45. The fiduciary duty owed to plaintiff was presumably that owed by one joint-venturer to another in the same joint-venture.

46. The stock would not share in corporate growth until the board of directors (controlled by the defendant by virtue of his 51% share-holding in the corporation) converted it into common stock (permitted only when the plaintiff's work proved satisfactory to the board).

47. The plaintiff met with the defendant's attorney, but left the attorney's office with "no understanding of the change of plans." *Id.* at 1116.

and ended their business relationship. Only then did the plaintiff really learn that his stock was non-participating preferred.

The Court of Appeals for the Tenth Circuit affirmed the District Court's decision. The Tenth Circuit imposed liability on the defendant based on recklessness and ruled that the defendant owed the plaintiff a duty to ascertain whether the plaintiff sufficiently understood the significance of his preferred stock with a fixed liquidation value and the implications that, for an indefinite period, the plaintiff would not share in the company's equity growth.[48] The Court of Appeals in *Hackbart* thereby adopted the *Sundstrand* standard of recklessness.[49]

In harmony with the Tenth Circuit Court of Appeals approach in *Hackbart*, the Second Circuit has also allowed reckless conduct to satisfy the scienter requirement where a fiduciary relationship is proven.[50] For example, in *Rolf v. Blyth, Eastman, Dillon & Co.*,[51] the Court of Appeals held the defendant secondarily liable for a material misrepresentation by applying the *Sundstrand* standard. The Court of Appeals defined recklessness as "at the least, conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'"[52]

In fact, the primary violation had been committed by the plaintiff's investment advisor, but the defendant, as the plaintiff's broker, was charged with supervising the investment advisor's decisions. The investment advisor, through fraudulent transactions, used his own discretion in depleting the equity in the plaintiff's portfolio from

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48. This duty was based on the following facts: (1) the defendant originally promised the plaintiff a 49% share of the corporation in exchange for the plaintiff's original contribution and management; (2) the parties were old friends and the defendant knew that the plaintiff was relying on his business expertise in organizing the new corporation; (3) the defendant knew that the plaintiff was naive in business matters, and the defendant should have known that the plaintiff might not understand that preferred stock with a stated liquidation value did not share in the equity growth of the company.

49. The defendant had asserted that the plaintiff should be fixed with knowledge of the nature of the stock because all rights of stockholders were set out in the company's articles of incorporation. The court, however, ruled that the company's articles were ambiguous and, therefore, violated state law.

50. *See* Woodward v. Metro Bank of Dallas, 522 F.2d 84, 95 (5th Cir. 1975). "The scienter requirement scales upward when activity is more remote; therefore, the assistance rendered should be both substantial and knowing." *Id.* (*per* Judge Goldberg).

Woodward was decided prior to *Ernst & Ernst*. Nevertheless, this dictum has been cited with approval in opinions handed down by the Second Circuit since *Ernst & Ernst*. *See e.g.*, IIT v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980); Edwards & Hanly v. Wells Fargo Securities Clearance Corp., 602 F.2d 478, 484-85 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980).

51. 570 F.2d 38 (2d Cir. 1978).

52. *Id.* at 47 (quoting Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977)).

approximately $1.4 million to approximately $710,000 in ten months. The Court of Appeals, however, approved of the District Court's finding that the defendant undertook "a hand holding operation whereby [he] would reassure [the plaintiff of the investment advisor's] competence [whenever the plaintiff] questioned it."[53]

The Court of Appeals reasoned that, by virtue of the defendant's reckless disregard of (a) whether or not the assurances that he gave to the plaintiff were true or false and (b) the substantial body of evidence that the plaintiff's investment advisor was improperly and fraudulently managing the plaintiff's account, the defendant "participated in and lent assistance to the fraud upon" the plaintiff.[54] This articulation of the applicable standard tends to suggest that the Court of Appeals in *Rolf* applied a somewhat less strict test than that proposed a year or so earlier by the Court of Appeals for the Seventh Circuit in *Sanders v. John Nuveen & Company*[55]

In *Nuveen*, the Court of Appeals stated the test as one in which the party allegedly in violation either (i) actually knew of the facts and also appreciated that such facts amounted to violations of the securities laws or (ii) the facts constituting the violation were so obvious that the party allegedly in violation must have been aware of them and also the party allegedly in violation appreciated that such facts amounted to violations of the securities laws.[56]

By way of comparison, in *Stern v. American Bankshares Corporation*,[57] the District Court for the Eastern District of Wisconsin articulated a somewhat weaker test than that in *Nuveen*, by proposing that instead of proof that the alleged violator actually knew or *must* have known, proof that the alleged violator actually knew or *should* have known would suffice.[58]

The Court of Appeals in *Rolf* deliberately avoided applying the weaker *Stern* test,[59] although unquestionably, by satisfying the more stringent *Nuveen* test of a violation, the conduct in *Rolf* would *a fortiori* have satisfied the weaker *Stern* test of a violation as well. The more stringent *Sundstrand* test is preferred, however. The philosophical and the practical demarcation between negligence, however gross, and recklessness need to be at its clearest and sharpest in

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53. *Id.* at 42.
54. *Id.* at 44.
55. 554 F.2d 790 (7th Cir. 1977).
56. *Id.* at 793.
57. 429 F. Supp. 818 (E.D. Wis. 1977).
58. *Id.* at 827.
59. 570 F.2d at 47 n.16 (*citing Stern*, 429 F. Supp. at 827). In *Stern*, the court declared that the "plaintiff must allege . . . that the defendants knew or *should have known* of the facts and circumstances concerning the fraud." 429 F. Supp. at 827 (emphasis added).

section 10(b) and rule 10(b)(5) cases to promote clarity in judicial decision-making.

D. Secondary Liability

In light of *Dirks*, where the defendant is being tried on a theory of secondary liability, courts are no longer permitted to allow recovery based on recklessness. An exception to this rule arises when proof "clear and convincing evidence" is presented that the defendant committed a breach of a duty owed to the plaintiff.[60] In pre-*Dirks* cases, a recklessness standard was applied where no fiduciary obligation existed. For example, although an accountant and a client are not necessarily in a fiduciary relationship, in suits by third parties against accountants, Second Circuit judges have applied a recklessness standard to those accountants whose audits or opinion letters were allegedly misleading to third parties whose reliance upon such pronouncements was foreseeable.[61]

In *Fund of Funds, Ltd. v. Arthur Andersen*,[62] an accountant committed himself to an unqualified opinion without sufficient information.[63] The District Court for the Southern District of New York held that the accountant evinced the requisite scienter because he persisted in misleading disclosures. He pursued these ventures despite the significant facts of which he was aware and the reasonable foreseeability that investment decisions would be based on his audit.[64]

Significantly, the District Court held that not only could the jury reasonably find that the accountant had actual knowledge of the primary fraud,[65] but also that his liability could be based on gross recklessness with respect to pertinent material facts which he should

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60. In *Herman & McLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983), the Supreme Court reiterated its express reservation of whether or not secondary liability may be imposed in a section 10(b) suit. In *Stokes v. Lokken*, 644 F.2d 779, 782-83 (8th Cir. 1981) with respect to secondary liability, the Eight Circuit Court of Appeals referred to a sliding scale representing the degree of scienter necessary to establish culpability as the quantum of "substantial assistance" rendered by the secondary to the primary party in consummation of the primary violation. However, even where substantial assistance is great, there must also be a showing of something more than "mere negligence."

61. *See, e.g.*, Harmsen v. Smith, 693 F.2d 932 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); Hudson v. Capital Management, Inc., 565 F. Supp. 615 (N.D. Cal. 1983).

62. 545 F. Supp. 1314 (S.D.N.Y. 1982); *see* Oleck v. Fischer, 623 F.2d 791 (2nd Cir. 1980) (accountant's duty to disclose triggered a recklessness standard). Recklessness is not equated with negligence in such circumstances either. *See* Adams v. Standard Knitting Mills, Inc., 623 F.2d 422 (6th Cir. 1980), *cert. denied*, 449 U.S. 1067 (1980) ("[T]he accountant's potential liability for relatively minor mistakes would be enormous under [a] negligence standard.").

63. *Fund of Funds*, 545 F. Supp. at 1353.

64. *Id.*

65. *Id.* at 1358.

have disclosed with the audit.[66] Furthermore, the District Court's holding in regard to secondary liability based upon proof of aiding and abetting by the accountant provides further insight into the degree of scienter required by the court. While conceding that a fiduciary duty owed by the alleged aider and abettor is an indispensable element of proof of liability, the District Court in *Fund of Funds* held that the accountant's "conduct under the unusual circumstances of [the] case easily [met] a recklessness test."[67]

It is acknowledged that intractable problems would arise if too low a degree of recklessness were used as the violative standard. In fact, sufficient flexibility is critical so that the imposition of liability based upon reckless conduct can be determined on a case by case basis and dependent upon such factors as (1) the relationship between the parties (whether the defendant is being tried as a primary violator or as an aider and abettor) and (2) the nature of the pertinent misrepresentation or omission.

The following section provides a more detailed analysis of a number of pertinent cases applying a recklessness standard.

III. SPECIFIC CIRCUIT COURTS OF APPEALS APPROACHES

While the U.S. Supreme Court has not, to date, ruled on whether recklessness constitutes scienter in the section 10(b) and rule 10b-5 context, several circuit courts of appeals have done so. As a result, every circuit addressing the issue has either expressly adopted or assumed that recklessness constitutes scienter.[68] The circuits differ in the definition of recklessness, rather than in the rational efficacy of accepting recklessness as scienter.

A. The Sundstrand Standard

At least seven circuit courts of appeals[69] and one district court in the fourth circuit (namely, the western district of Virginia)[70] have

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66. *Id.*

67. 545 F. Supp. at 1357.

68. SEC v. Burns, 816 F.2d 471, 474 (9th Cir. 1987); Kennedy v. Tallant, 710 F.2d 711, 720 (11th Cir. 1983); *Hackbart*, 675 F.2d at 1117; Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961 (5th Cir. 1981), *cert. denied*, 454 U.S. 965 (1981); *IIT*, 619 F.2d at 923 (1980); *Mansbach*, 598 F.2d at 1023; McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Berdahl v. SEC, 572 F.2d 643, 647 n.6 (8th Cir. 1978); Hoffman v. Estabrook & Co., 587 F.2d 509, 516 (1st Cir. 1978); *Nelson*, 576 F.2d at 1337; *Sundstrand*, 553 F.2d at 1044.

The fourth circuit does not appear to have addressed the issue directly. Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 464 F. Supp. 528, 537 (D. Md. 1978) expressed agreement with other courts ruling that recklessness is sufficient to fulfill the scienter requirement. Frankel v. Wyllie & Thornhill, Inc., 537 F. Supp. 730, 740 (W.D. Va. 1982) cited other cases in which recklessness satisfies the intent requirement without expressly adopting the standard.

69. Those circuits are the first, second, third, fifth, sixth, seventh, and tenth.

adopted the *Sundstrand* definition of recklessness which was initially articulated in *Franke v. Midwestern Oklahoma Development Authority.*[71] In *Franke*, the plaintiff alleged damages arising from his investment in certain industrial revenue bonds.[72] The plaintiff claimed that important information had been omitted from the materials he received in connection with purchasing the bonds. Smith, Leaming & Swan (Smith, Leaming), one of the defendants, had been retained as bond counsel to advise as to the bond-sale's legality and to verify the tax exempt status of interest payments accruing to the bondholders.[73]

The District Court for the Western District of Oklahoma granted Smith, Leaming's motion for summary judgment on the grounds that, because of its limited role in the offering, it neither prepared nor had knowledge of the materials relied upon by the plaintiff.[74] Noting that scienter was an element of section 10(b) liability, the court held that no evidence indicated that Smith, Leaming had knowledge that would successfully support a finding of scienter at a full trial on the merits.[75]

Additionally, in response to the plaintiff's contention that recklessness was a substitute for deliberateness with respect to scienter, the court declared:

> In the context of an omissions case, reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[76]

Based upon its own evaluation, however, the Court concluded that there was no evidence of the appropriate degree of recklessness asserted by the plaintiff.[77]

1. Seventh Circuit

The Seventh Circuit Court of Appeals approved and adopted the *Franke* definition of recklessness in *Sundstrand Corporation v. Sun*

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70. *See infra* n.131 and accompanying text.
71. 428 F. Supp. 719, 726 (W.D. Okla. 1976).
72. *Id.*
73. *Id.* at 719.
74. *Id.*
75. *Id.*
76. *Id.* at 725.
77. *Id.*

Chemical Corporation[78] In *Sundstrand*, the plaintiff brought a section 10(b) and rule 10b-5 action on the grounds that the defendants had misrepresented material facts and failed to disclose material facts in the context of merger negotiations that resulted in plaintiff's purchase of the target company's stock. The court noted that, in the context of the affirmative disclosure of information with reckless disregard for the truth, it had already ruled that appropriately egregious reckless behavior was sufficient to maintain a rule 10b-5 action.[79]

In contrast and in the context of reckless nondisclosure, the Seventh Circuit reasoned that a more extended and complex analysis was justified.[80] The court noted that, at common law, reckless behavior was sufficient to support causes of action grounded in fraud or deceit.[81] The court then reasoned that it would be "highly inappropriate to construe the Rule 10b-5 remedy to be more restrictive in substantive scope that its common law analogs."[82] The court in *Sundstrand* held that (1) an appropriately reckless omission of material facts upon which a party justifiably relies is actionable under section 10(b) and rule 10b-5 and (2) that this was established on the facts in issue.[83]

The court cited with approval the *Franke* definition of recklessness and then categorized proven violative conduct as "the kind of recklessness that is equivalent to wilful fraud."[84] Conduct of this nature required that the danger of misleading buyers be actually known or so prevalent that a reasonably prudent person would be objectively treated as knowing and that the omission must emanate from something more egregious than "white heart/empty head" good faith.[85]

In light of this evaluation, the court was persuaded that recklessness as defined in *Franke* functioned as a rational equivalent to intent because it measured conduct against an external and objective standard. This finding lead to the conclusion that a reckless person should normatively bear the risk and suffer the consequences of her or his own omission.[86]

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78. 553 F.2d 1033 (7th Cir. 1977).
79. *Id.* at 1044.
80. *See id.*
81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.* at 1045 (*quoting* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969)).
85. *Id.*
86. *Id.*

The Seventh Circuit republished its adoption of the *Franke* definition in *Sanders v. John Nuveen & Company*,[87] expanding discussion of the pertinent criteria for adequately proving recklessness by adding that the definition "should not be a liberal one lest any discernible distinction between scienter and negligence be obliterated . . . [R]ecklessness . . . comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree, but also in kind."[88]

2. Sixth Circuit

The Sixth Circuit expressed its approval of the *Sundstrand* definition of recklessness in *Mansbach v. Prescott, Ball & Turben*.[89] In *Mansbach*, the court drew an analogy between the common law tort of deceit and section 10(b). The *Mansbach* court compared them to other settings in which recklessness meets the legally sufficient required standards for liability. Emphasizing defamation cases as a clear and sharp example, the court demonstrated that the definition of malice included publication "with knowledge that [the statement] was false or with reckless disregard of whether it was false or not."[90] The court reasoned that this approach was indicative of a more generalized policy initiative in tort law which equates recklessness with intent in appropriate circumstances and elevates a sufficiently egregious degree of recklessness to the level of scienter in proscribing tortious conduct generally.

In order to avoid inflexibility, however, the court declined to articulate a complete and precisely drawn definition applicable to all reckless conduct. Rather, the court interpreted the *Sundstrand* formulation as encompassing "highly unreasonable conduct which is an extreme departure from the standard of ordinary care. While the danger need not be [actually] known, it must at least be so obvious that any reasonable [person] would have known of it."[91]

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87. 554 F.2d 790, 793 (7th Cir. 1977). This case was decided after remand for reconsideration in light of the Supreme Court decision in *Ernst & Ernst*, 425 U.S. at 185. The defendant in *Nuveen*, an underwriter, had initially been held liable under section 10(b) and rule 10b-5 on the theory that the defendant breached a duty to make reasonable inquiries into the accuracy of the issuer's financial statements. 554 F.2d at 793. Since liability had been based on negligence, and there was no evidence the defendant had acted recklessly, the judgment was reversed. *Id.*

88. *Id.*

89. 598 F.2d 1017 (6th Cir. 1979).

90. *Id.* at 1025 (quoting New York Times Co. v. Sullivan, 376 U.S. 254, 280 (1964)).

91. *Id.*

3. Third Circuit

The Third Circuit declared that proof of recklessness met the requirement of scienter in *Coleco Industries v. Berman*,[92] thereby approving the lower court's dictum that proof of scienter required "a conscious deception or . . . a misrepresentation so recklessly made that the culpability attaching to such conduct closely approaches that which attaches to conscious deception."[93]

A few years later, in *McLean v. Alexander*,[94] the *Sundstrand* standard was explicitly adopted by this circuit. In *McLean*, an accounting firm had prepared a certified report in connection with a sale of stock. The court ruled that the plaintiff failed to prove that the defendant acted with scienter. The Third Circuit, however, expressly indicated that the *Sundstrand* formula applied to cases in which either misstatements or omissions were at issue.[95] The court reasoned that the *Sundstrand* standard provided a federal right of action for the kind of fraud ordinarily actionable at common law.[96]

Furthermore, in *Healy v. Catalyst Recovery of Pennsylvania*,[97] the Third Circuit reiterated its adoption of the *Sundstrand* definition. The Third Circuit reasoned that this approach properly interpreted and applied the Supreme Court's decision in *Ernst & Ernst*, since it defined recklessness in terms which closely approximated intentional conduct.[98]

4. Fifth Circuit

The Fifth Circuit has also cited with approval the *Sundstrand* standard. In *Broad v. Rockwell International Corporation*,[99] the court expressly held that proof of scienter is established on proof that the defendants acted: (i) with severe recklessness, which is limited to highly unreasonable omissions or misrepresentations that go beyond negligence to such an extreme degree that they present a danger of misleading buyers or sellers; (ii) (a) which is either known to the defendant, or (b) is so obvious that the defendant must have been aware of it.[100]

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92. 567 F.2d 569 (3d Cir. 1977) (per curiam), *cert. denied*, 439 U.S. 830 (1978).

93. *Id.* at 574 (quoting Coleco Indus., Inc. v. Berman, 423 F. Supp. 274, 296 (E.D. Pa. 1976), *aff'd in part and remanded in part*, 567 F.2d 569 (3d Cir. 1977), *cert. denied*, 439 U.S. 830 (1978)).

94. 599 F.2d 1190 (3d Cir. 1979).

95. *Id.* at 1197.

96. *Id.* at 1198.

97. 616 F.2d 641 (3d Cir. 1980).

98. *Id.* at 649.

99. 642 F.2d 929 (5th Cir. 1981).

100. *Id.* at 961-62.

In *Rockwell International*, the class action suit brought by a debenture holder alleged that (a) the issuing corporation, (b) its successor, (c) controlling officers, and (d) trustee failed to disclose material facts regarding the manner in which the debentures operated in the event of a merger. Regardless of a finding of recklessness, the District Court granted the defendants' motion for a directed verdict. The District Court found no evidence that any defendant had acted with scienter, even if recklessness were sufficient. The Court of Appeals affirmed the judgment of the District Court with respect to the section 10(b) and Rule 10b-5 claims.

5. First Circuit

In *Hoffman v. Estabrook & Co.*,[101] the First Circuit accepted, without actually ruling, that recklessness would suffice to support a successful action under section 10(b) and Rule 10b-5.[102] The lower court held that two corporate officers were knowingly and intentionally responsible for material misstatements and omissions in connection with the confidential memorandum given to the underwriter. The underwriter was held not liable based upon conduct categorized as "carelessness approaching indifference."[103]

The appellate court found this definition less rigorous and demanding than the one which it had approved in *Cook v. Avien, Inc.*[104] Nevertheless, the appellate court concluded that the definition was not legally incorrect.[105] The court reached this conclusion after reviewing Prosser's definition,[106] the *Restatement (Second) of Torts* definition,[107] and the *Sundstrand* standard, as explained in *Nuveen*.[108]

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101. 587 F.2d 509 (1st Cir. 1978).

102. *Id.* at 516.

103. *Id.*

104. 573 F.2d 685, 692 (1st Cir. 1978). The court cited with approval the definition that "[reckless conduct] comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence." *Id.* (quoting *Nuveen*, 554 F.2d at 793). Thus it would appear that the First Circuit has tacitly adopted the *Sundstrand* definition.

105. 587 F.2d at 516.

106. *Id.* Prosser's definition is:

> The usual meaning assigned to "wilful," "wanton" or "reckless," according to taste as to the word used, is that the actor has intentionally done an act of an unreasonable character in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow. It usually is accompanied by a conscious indifference to the consequences, amounting almost to willingness that they shall follow.

W. PROSSER, LAW OF TORTS 185 (4th ed. 1971).

107. *Id.* The *Restatement* definition is:

> The actor's conduct is in reckless disregard of the safety of another if he does an act or intentionally fails to do an act which it is his duty to the other to do, knowing or having reason to know of facts which would lead a reasonable man to

6. Tenth Circuit

The Tenth Circuit has, on principle, accepted the *Sundstrand* formulation by virtue of its decision in *Hackbart v. Holmes*,[109] where the plaintiff and the defendant were friends who entered into a partnership agreement. The lower court decided that the defendant acted recklessly in failing to ensure that the plaintiff understood the limited characteristics of the preferred stock sold to him pursuant to the partnership agreement.

In rejecting the defendant's argument, the court of appeals ruled that his behavior did not legally demand the application of a standard higher than recklessness. The court explicitly ruled that proof of recklessness met the requirement of proof of scienter for three reasons. First, the Securities Acts were to be broadly construed to achieve their remedial goals. Secondly, requiring the plaintiff to show intent would be unduly burdensome. Finally, the Securities Acts were intended to proscribe actions closely akin to common law fraud.[110]

7. Second Circuit

The Second Circuit has tacitly adopted the *Sundstrand* definition of recklessness as well in *Rolf v. Blyth, Eastman Dillon & Company*[111] *Rolf* concerned section 10(b) and rule 10b-5 claims brought by an investor against his broker and his investment advisor. The lower court held that the investment advisor had engaged in fraudulent stock manipulations. Furthermore, the court found the broker liable for aiding and abetting the investment advisor because of (i) the broker's assumption of supervision over the investment advisor's activities and (ii) the court's determination that the broker owned a fiduciary duty to the investor.

The Second Circuit's analysis of the broker's liability reinforced earlier decisions in which it had ruled recklessness sufficient to meet section 10(b) and rule 10b-5 scienter requirements.[112] Citing *Nuveen*, the court drew strength from the fact that reckless behavior satisfied

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realize, not only that his conduct creates an unreasonable risk of physical harm to another, but also that such risk is substantially greater than that which is necessary to make his conduct negligent.

RESTATEMENT (SECOND) OF TORTS § 500 (1977).

108. *Nuveen*, 554 F.2d at 790.

109. 675 F.2d 1114 (10th Cir. 1982). *See supra* note 44 and accompanying text.

110. *Id.* at 1117-18 (citing the *Sundstrand* standard as the most effective definition of reckless behavior for the purposes of applying rule 10b-5); *see also supra* text accompanying notes 71 and 77.

111. 570 F.2d at 38; *see supra* note 51 and accompanying text.

112. *Id.* at 44 n.7, 46.

common law scienter requirements for purposes of the tort of deceit.[113]

B. Other Standards

As indicated below, the remaining circuit courts of appeals addressing the issue have adopted recklessness as scienter, but have either failed to give any concise definition of recklessness or have used some formulation other than the *Sundstrand* definition.

1. Eleventh Circuit

The Eleventh Circuit does not fit neatly into any category. For example, in *SEC v. Southwest Coal & Energy Co.*,[114] the court cited the *Franke* formulation in defining reckless conduct.[115] The Eleventh Circuit has, however, interpreted this standard as requiring knowing misconduct or severe recklessness.[116]

In declaring the defendant liable, the court held that the defendant's failure to correct glaring omissions from a prospectus constituted extreme recklessness. The Court later reiterated its "knowing misconduct or severe recklessness" standard in *Kennedy v. Tallant*.[117] In *Kennedy*, the court held that the defendants' awareness that all material facts were not being disclosed to the plaintiffs and their knowing assistance in failing to disclose such facts supported at least an inference of severe recklessness, if not intentional and wilful misconduct. The court's reference to severe recklessness does not clearly

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113. *Id.* at 47. There appears to be some question whether the recklessness standard is more stringent in the context of aiding and abetting cases. The Second Circuit indicated the standard should be more stringent in *Cornfeld*, 619 F.2d at 909. The court in *IIT* found that where the alleged aider and abettor owes a fiduciary duty to the defrauded party, recklessness satisfies the scienter requirement. *Id.* (citing *Rolf*, 570 F.2d at 44). However, where there is no such fiduciary duty, the court noted that "'[t]he scienter requirement scales upward when activity is more remote; therefore, the assistance rendered should be both substantial and knowing.'" *Cornfeld*, 619 F.2d at 923 (quoting *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 95, 97 (5th Cir. 1975)). The court went on to state that "[w]hen it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved." *Id.* at 925.

This sliding scale was adopted by the Maryland district court in *Martin v. Pepsi-Cola Bottling Co.*, 639 F. Supp. 931, 935 (D. Md. 1986). The court found the requirement of "high conscious intent" and "conscious and specific" motivation likely to deter nuisance suits against defendants who merely perform clerical duties without knowledge that they were furthering allegedly fraudulent transactions. *Id.*

114. 624 F.2d 1312 (5th Cir. 1980). The Eleventh Circuit is bound by all Fifth Circuit cases handed down prior to the close of business on September 30, 1981 unless and until the Eleventh Circuit en banc speaks on the issue presented.

115. *Id.* at 1321.

116. *See SEC v. Carriba Air, Inc.*, 681 F.2d 1318, 1324 (11th Cir. 1982).

117. 710 F.2d 711, 720 (11th Cir. 1983).

indicate whether a more stringent standard than that inherent in the *Franke/Sundstrand* line of cases is intended. The Eleventh Circuit Court has not yet had to decide a case in which the defendant was simply reckless.

2. Ninth Circuit

In *Nelson v. Serwold,*[118] a pre-*Dirks* case, the Ninth Circuit joined the other circuits in ruling that recklessness satisfied the scienter requirement of section 10(b) and rule 10b-5. In *Nelson,* the court held that the defendants failed to disclose a material fact in negotiating the repurchase of its stock from the plaintiff. The court agreed that Congress intended section 10(b) to reach "a broad category of behavior, including knowing or reckless conduct,"[119] but avoided a precise definition of recklessness.

Some eight years later, in *Shad v. Dean Witter Reynolds, Inc.,*[120] a post-*Dirks* case, the Ninth Circuit Court of Appeals was content to state, without citing any authority, that scienter was defined as intent to defraud, or acts in reckless disregard of whether others were defrauded.[121] A year or so later, in *SEC v. Burns,*[122] the Ninth Circuit Court of Appeals cited *Shad* as authority for the statement that scienter was satisfied if the defendant acted recklessly.

3. Eighth Circuit

The Eighth Circuit has to date not expressly held that recklessness satisfies the scienter requirement of section 10(b) and rule 10b-5. In cases addressing the issue, the court has either ruled that the defendant acted intentionally and knowingly (in which case liability was imposed) or that the defendant was merely negligent (where liability was not imposed).

For example, in *Berdahl v. SEC,*[123] the petitioner, the registered principal of a broker-dealer, was held liable under sections 17(a) and 10(b) of the Securities Exchange Act of 1934 for failing to promptly escrow the proceeds of an offering as promised in the offering circular. In the context of this SEC disciplinary proceeding, the court determined that it was unnecessary to decide whether the SEC was

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118. 576 F.2d 1332 (9th Cir. 1978).

119. *Id.* at 1337. Prior to this statement, the court cited, among others, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc) (Friendly, J., concurring), *cert. denied,* 394 U.S. 976 (1969); Bailey v. Meister Brau, Inc., 535 F.2d 982 (7th Cir. 1976).

120. 799 F.2d 525 (9th Cir. 1986).

121. *Id.* at 530.

122. 816 F.2d 471, 474 (2d Cir. 1987).

123. 572 F.2d 643 (8th Cir. 1978).

legally required to prove scienter. The court reasoned that, even if the SEC were required to do so, the petitioner's knowing and intentional acquiescence in the fraudulent practice constituted a sufficient showing of scienter.[124]

In a footnote, the court declined "to become embroiled in a semantic controversy over the varying shades of meaning of such terms as intentional, wilful, deliberate, or knowing."[125] In any event, the court opined that the petitioner's conduct was, at a minimum, grossly reckless. The court also cited other courts' opinions adopting recklessness as an appropriate level of culpability to satisfy the requirement of scienter.[126]

Subsequently, in *Stokes v. Lokken*,[127] the Eighth Circuit ruled that the defendant's conduct fell short of any reasonable formulation of the requisite legal standard. In *Stokes*, the plaintiffs argued that, in preparing an opinion letter, the defendant had recklessly relied on the statements of a corporate officer who was a convicted felon. The court rejected this argument, stating that the issue was "whether [the defendant] acted knowingly . . . or with *reckless disregard* of the correctness . . . of the opinion he was giving."[128]

Similarly, in *Harris v. Union Electric Co.*,[129] the Eighth Circuit approved the lower court's instruction that reckless behavior would constitute scienter. The court in *Harris* added that the instruction reflected the prevailing view of the courts of appeals.[130]

4. D.C. Circuit

The D.C. Circuit has declined to rule directly as to whether or not recklessness alone suffices as scienter under section 10(b) and rule 10b-5. In *SEC v. Falstaff Brewing Corporation*,[131] the court affirmed a lower court's ruling that a corporation and its chairman, a controlling stockholder, had issued a proxy statement that misstated certain material facts and omitted others. The court concluded that the chairman had acted knowingly and therefore the court declined to address the recklessness issue.[132] The court acknowledged that "knowing" embraced "recklessness."[133] Thus, a conclusion that the

124. *Id.* at 647.
125. *Id.* at 647 n.6.
126. *Id.*
127. 644 F.2d 779 (8th Cir. 1981).
128. *Id.* at 783 (emphasis added).
129. 787 F.2d 355 (8th Cir.), cert. denied, 479 U.S. 823 (1986).
130. *Id.* at 369 n.12.
131. 629 F.2d 62 (D.C. Cir. 1980), *cert. denied*, 449 U.S. 1012 (1980).
132. *Id.*
133. *Id.*

defendant acted knowingly therefore included a finding that he also acted recklessly.[134] The court cited other courts of appeals' decisions ruling that reckless disregard for the consequences of one's actions is enough to demonstrate scienter under rule 10b-5.[135]

5. Fourth Circuit

The Fourth Circuit has not clearly ruled on whether recklessness constitutes scienter for the purposes of section 10(b) and rule 10b-5, although a number of the district courts within the circuit have addressed the issue with varying results.

a. Maryland

The U.S. District Court for the District of Maryland decided that recklessness was sufficient to establish scienter in *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith,*[136] where the defendants were charged with "churning" and making material misrepresentations or omissions in the handling of the plaintiff's account. The defendants moved for summary judgment on the grounds that the plaintiff had failed to satisfy the scienter requirement of rule 10b-5 and argued that recklessness did not suffice. In rejecting the defendants' argument, the court expressed its agreement with other courts that had held recklessness sufficient to fulfill the requirement of scienter.[137] The court did not, however, clearly articulate a specific definition of violative reckless conduct.

The same court also addressed the issue in the context of allegations of aiding and abetting unlawful conduct in *Martin v. Pepsi-Cola Bottling Co.*[138] In rejecting the defendants' motion to dismiss, the court ruled that the plaintiff had satisfactorily alleged scienter of "high conscious intent" in accordance with the sliding scale for scienter announced in *IIT v. Cornfeld.*[139]

b. Western District of Virginia

In *Frankel v. Wyllie & Thornhill, Inc.,*[140] the Western District of Virginia cited with approval the *Franke* definition of recklessness.[141] In *Frankel,* bondholders sued the defendants in connection with a

134. *Id.* at 77 n.27.
135. *Id.*
136. 464 F. Supp. 528 (D. Md. 1978).
137. *Id.* at 537.
138. 639 F. Supp. 931 (D. Md. 1986).
139. *Id.* at 934; *see supra* note 106.
140. 537 F. Supp. 730 (W.D. Va. 1982).
141. *Id.* at 740.

sale of bonds. The plaintiffs specifically alleged that the appraisers, who were bank employees, had performed appraisals (1) knowing or recklessly disregarding the knowledge that the property values were grossly inflated and (2) knowing or recklessly disregarding the fact that the appraisals were to be used in connection with the issuance of bonds. The court held that the plaintiffs had made sufficient allegations to defeat the defendants' motion for summary judgment, but reserved for trial the determination of whether the defendants had acted recklessly.

c. Eastern District of Virginia

The Eastern District of Virginia has addressed the issue of scienter in the rule 10b-5 context, but has not clearly adopted the *Franke* definition of recklessness.[142]

IV. CONCLUSION

Reception into the laws of the Commonwealth Caribbean of the investor protection policies epitomized in the purported reforms proposed in section 204 of H.R. 10 of January 4, 1995 would be lamentable. The foregoing analysis and evaluation of the impressive effort of the United States Circuit Courts to bring the highest levels of honesty and integrity to corporate securities trading to the United States securities markets indicates the dimensions of the impending tragedy if section 204 of H.R. 10 of January 4, 1995 becomes law in the United States in its present form.

Undoubtedly, a United States Supreme Court decision explicitly embracing recklessness as scienter for purposes of civil suits under section 10(b) and rule 10(b)(5), that forthrightly declared this set of principles to be the law of the United States with regard to trading in corporate securities in the marketplace may have so securely established this principle in United States securities regulation law, that Congress may have treated it as impregnable. The added weight of United States Supreme Court opinion is immeasurable in the calculus of political policy dynamics. In this regard, the United States circuit courts were exemplary in generating for the United States Supreme Court, the necessary record of transcendently reasoned cases to provide guidance in resolving the efficacy of recklessness as scienter under the securities laws. It is regrettable that the United States Supreme Court refrained from taking the critical step of

142. *Id.* at 1171 n.8.

declaring that recklessness does indeed pass muster as actionable scienter for purposes of section 10(b) and rule 10(b)-5.

The investing public—both domestic in the United States and internationally—undeniably owes a debt of gratitude to the heroic efforts of the United States circuit courts in stepping into the breach left by the United States Supreme Court and so effectively protecting the viability of civil litigation under the implied private right to bring suit based on recklessness as scienter for violations of the United States securities laws.[143] Section 204 of H.R. 10 puts at risk significantly all this substantive effort that has been based upon recklessness as an efficient tool for genuine equity and justice in the United States and international capital markets.

What is needed at this juncture is the courage in the United States Legislature to reject section 204 of H.R. 10. By rejecting section 204, the Legislature eliminates the imminent threat to investor protection so carefully nurtured since the enactment of the Securities Act of 1933[144] and the Securities Exchange Act of 1934[145] followed the Great Crash of 1929. Section 204 of H.R. 10 is as subtle as a sledgehammer where a scalpel would be more suitable. The Commonwealth Caribbean should pay heed to the paradigm of actionable scienter so carefully constructed by the United States Circuit Courts. For, undeniably, the doorkeeper should be wise.

143. J. I. Case Co. v. Borak, 377 U.S. 426 (1964).
144. 15 U.S.C. § 77a *et seq.*
145. 15 U.S.C. § 78a *et seq.*