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Negligence or Scienter - The Appropriate Standard of Liabiltiy for outside Accountants for Misleading Proxy Statements under Section 14(a) of the Securities Exchange Act of 1934

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NEGLIGENCE OR SCIENTER?—THE APPROPRIATE STANDARD OF LIABILITY FOR OUTSIDE ACCOUNTANTS FOR MISLEADING PROXY STATEMENTS UNDER SECTION 14(a) OF THE SECURITIES EXCHANGE ACT OF 1934

I. INTRODUCTION

Should an outside accountant[1] be held liable for negligently[2] providing incorrect information to be included in a corporation's proxy statement in a shareholder action under section 14(a) of the Securities Exchange Act of 1934[3] (the 1934 Act)? Or should the plaintiff in a section 14(a) action be required to show that the accountant intended to deceive the shareholder; that is, should liability be imposed only where the accountant acted with scienter?[4]

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1. "Outside accountant" as used throughout this comment means a firm of accountants hired by a corporation to perform a specific accounting function. (An inside accountant is an employee of the corporation.) *See* Adams v. Standard Knitting Mills, 623 F.2d 422, 424, 428 (6th Cir. 1980) (accounting firm hired by corporation to prepare financial statements is outside accountant).

2. RESTATEMENT (SECOND) OF TORTS § 552 (1981) defines negligent misrepresentation by a professional as the failure "to exercise reasonable care or competence in obtaining or communicating . . . information" for the guidance of others in business transactions. *See* note 11 *infra*; 23 EMORY L.J. 567, 571 (1974) [hereinafter cited as EMORY L.J.].

3. 15 U.S.C. § 78n(a) (1976), which provides:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, 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, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

4. "Scienter" was defined as "intent to deceive, manipulate, or defraud" by the United States Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). Although the Court found that a private cause of action for damages will not lie under § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1980), without a showing of scienter, it reserved the question of whether recklessness is sufficient for civil liability under § 10(b) and Rule 10b-5. 425 U.S. at 193 n.12. The Sixth Circuit Court of Appeals in Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023-24 (6th Cir. 1979), followed the lead of five other circuits in finding that recklessness satisfies the § 10(b)/Rule 10b-5 scienter requirement: Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir.), *cert. denied* 439 U.S. 1039 (1978); Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir.), *cert. denied* 439 U.S. 970 (1978); Coleco Industries, Inc. v. Berman, 567 F.2d 569, 574 (3d Cir. 1977), *cert. denied* 439 U.S. 830 (1978); First Virginia Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1039-40 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). The court defined recklessness generally as "highly unreasonable

Section 14(a) makes it unlawful for any person to solicit proxies in violation of rules prescribed by the Securities and Exchange Commission (SEC).[5] Rule 14a-9,[6] implementing section 14(a), prohibits proxy solicitations which contain false or misleading statements with regard to, or which omit, any material fact. Although neither the statute nor the rule provides for civil liability, a private right of action[7] and the elements of such a suit, such as materiality,[8] causation,[9] and the standard of liability,[10] have emerged as judge-made law from a series of

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conduct which is an extreme departure from the standards of ordinary care. While the danger need not be known, it must at least be so obvious that any reasonable man would have known of it." 598 F.2d at 1025 (citing Sundstrand, 553 F.2d at 1045).

5. 15 U.S.C. § 78n(a) (1976).

6. 17 C.F.R. § 240.14a-9(a) (1980), which provides:

> No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

7. J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (the purpose of § 14(a), to protect investors, implies the availability of relief through private action). *See* Note, *Private Enforcement of the Federal Proxy Rules: Remedial Alternatives*, 15 Wm. & Mary L. Rev. 286 (1973) [hereinafter cited as *Private Enforcement*].

8. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) (fact omitted from a proxy statement is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote). *Accord*, Gould v. American-Hawaiian Steamship Co., 535 F.2d 761, 771 (3d Cir. 1976); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1302 (2d Cir. 1973).

9. Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970) (where the omission or misrepresentation has been found to be material, the shareholder has made a sufficient showing of causation if he proves that the proxy itself, rather than the defect, was essential to the voting transaction). *Accord*, Galef v. Alexander, 615 F.2d 51, 65-66 (2d Cir. 1980); Weisberg v. Coastal States Gas Corp., 609 F.2d 650 (2d Cir. 1979).

10. *See, e.g.*, Gould v. American-Hawaiian Steamship Co., 535 F.2d 761 (3d Cir. 1976) (the proper standard of liability for false or misleading statements or omissions in proxy solicitation materials is negligence, not lack of good faith or scienter); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973) (plaintiffs are not required to establish evil motive or reckless disregard of facts). *See* 40 Brooklyn L. Rev. 1345-58 (1974) [hereinafter cited as Brooklyn L. Rev.]; Emory L.J. *supra* note 2.

"Standard of liability" as used throughout this comment means the type of conduct—*e.g.*, negligence or scienter—the plaintiff is required to show the defendant engaged in when preparing the misleading proxy statement.

Taken together, *Borak, TSC Industries, Mills* and *Gould* and *Gerstle* establish the elements of a private action against corporate directors as follows: materiality—the plaintiff must show that a reasonable shareholder would have considered the misinformation or omitted fact important in deciding how to vote; causation—the proxy solicitation must have been an essential link in the voting transaction; negligence—the plaintiff must show that the defendant failed to exercise reasonable care in preparing and issuing the proxy statement. *See* Brooklyn L. Rev., *supra; Emory* L.J. *supra* note 2; *Private Enforcement*, *supra* note 7, at 291-300.

shareholder actions brought under section 14(a) and Rule 14a-9. Where the defendants have been corporate directors, whether insiders or outsiders,[11] the courts have uniformly held that the plaintiff is not required to establish that the defendant acted with scienter.[12] In the sole proxy misrepresentation case in which the defendant was an outside accountant,[13] however, the court applied the scienter standard.[14]

When the United States Supreme Court implied a private right of action under section 14(a) in *J.I. Case Co. v. Borak*,[15] it relied primarily on the language of the statute as an expression of congressional intent to protect the shareholder.[16] In the section 14(a) cases that have followed, this focus on the purpose of the Act has been central.[17] If the

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11. Inside directors are those who are economically or psychologically dependent on the corporation's executives, or are themselves executives or employees of the corporation. Outside directors are those who do not have such ties. W. CARY, M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 216 (5th ed. 1980).

12. *See, e.g.,* Gould v. American-Hawaiian Steamship Co., 535 F.2d 761 (3d Cir. 1976); and Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973). *See* Comment, *Securities Law—Misleading Proxy Statements—Outside Accountants Can Be Held Liable under Rule 14a-9 Only upon a Showing of Scienter,* 56 NOTRE DAME LAW. 579, 583-84 (1981) [hereinafter cited as *Misleading Proxy Statements*]; Comment, *The Proper Standard of Fault for Imposing Personal Liability on Corporate Directors for False and Misleading Statements in Proxy Solicitations under Section 14(a) of the Securities Exchange Act of 1934 and SEC Rule 14a-9,* 34 OHIO ST. L.J. 670 (1973) [hereinafter cited as *Proper Standard*].

13. Adams v. Standard Knitting Mills, Inc., 623 F.2d 422 (6th Cir. 1980), *cert. denied,* _ U.S. _, 101 S. Ct. 795 (1981). The defendant, Peat, Marwick, Mitchell & Co., a firm of certified public accountants, provided financial statements for use in a proxy statement by means of which the corporation that hired the firm was seeking approval of a merger by the shareholders of the firm with which it sought to merge.

14. *Id.* at 428. The court held that scienter is the standard of liability for outside accountants in actions under § 14(a) and that the accounting firm was not liable because it had not acted with intent to deceive. *See* text accompanying notes 51-65 *infra.*

15. 377 U.S. 426 (1964). Although the Supreme Court has recently refused to find a private right of action under federal law where Congress did not expressly provide for it, Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) (no private remedy under section 206 of the Investment Advisors' Act, 15 U.S.C. § 80b-6 (1976)); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979) (no private right of action under section 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78q(a) (1970)), the private right established in **Borak** appears to be secure. Writing for the Court in *Touche Ross,* Justice Rehnquist said, "We do not now question the actual holding of [*Borak*], but we decline to read the opinion so broadly that virtually every provision of the securities Acts gives rise to an implied private cause of action." 442 U.S. at 577. In the case of Cannon v. University of Chicago, 441 U.S. 677 (1979), where the Court found a private right under a non-securities federal law, Justice Powell in his dissent similarly noted that although he disagreed with *Borak* he would not seek to overturn it: "Although I do not suggest that we would consider overruling *Borak* at this late date, . . . the lack of precedential support for this decision militates strongly against its extension beyond the facts of the case." *Id.* at 736 n.6.

16. 377 U.S. at 432. The language of § 14(a) stating that the SEC may prescribe rules and regulations "for the protection of investors" evidences Congress' "broad remedial purposes." *Id.* at 431-32.

17. *See* text accompanying notes 30-50 *infra.*

defendant is an outside accountant, however, the way courts have dealt with the liability of accountants to third parties in cases outside of securities laws may be an additional factor for the court to consider. Until quite recently, accountants were insulated from liability to third parties for negligent misrepresentation because of the absence of privity.[18] Under early common law, where privity was absent, the plaintiff was required to show that the defendant acted with scienter, or intent to defraud.[19] In recent cases dealing with accountants' liability to third parties, however, accountants have been held liable for negligent misrepresentation where they knew the third party would rely on the information they provided.[20] If the rule developed in these cases were applied in a section 14(a) action, an accountant could be liable for negligent misrepresentation where he knew the information he supplied to the client corporation would be used in a proxy statement.

This comment will examine the reasoning behind the emergence of

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18. *See, e.g.*, Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170, 174 N.E. 441 (1931). The plaintiff was a factoring corporation that relied on a financial statement negligently prepared by the defendant certified public accounting firm for the borrower. The court held in accordance with the common law that where there was no contract between the plaintiff and the defendant, the plaintiff would be required to show that the defendant acted fraudulently. *Id.* at 189, 174 N.E. at 448. "Liability for negligence is . . . bounded by the contract, and is to be enforced between the parties by whom the contract has been made." *Id.*, 174 N.E. at 448. *Accord,* Stephens Industries, Inc. v. Haskins & Sells, 438 F.2d 357 (10th Cir. 1971) (accountant not liable for negligence in the absence of privity); Investment Corp. of Florida v. Buchman, 208 So. 2d 291 (Dist. Ct. App.), *cert. denied,* 216 So. 2d 748 (1968) (no liability to third party for negligence in preparation of certified financial statement); State Street Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416, *reh. denied,* 278 N.Y. 704, 16 N.E.2d 851 (1938). *See* text accompanying notes 94-95 *infra*; Comment, *Accountants' Liabilities to Third Parties under Common Law and Federal Securities Law,* 9 B.C. IND. & COMM. L. REV. 137, 143-49; Note, *Accountants' Liabilities for False and Misleading Financial Statements,* 67 Col. L. Rev. 1437, 1438-44 (1967) [hereinafter cited as *Accountants' Liabilities*].

19. Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170, 189, 174 N.E. 441, 448 (1931).

20. Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968) (accountant liable for negligent misrepresentation where accountant knew the financial statement would be relied on by third-party lenders); Ryan v. Kanne, 170 N.W.2d 395 (Iowa 1969) (where accountant was informed that financial statements would be used by a corporation planning to take over client's business, accountant held liable to that corporation for negligently misrepresenting accounts payable); Bonhiver v. Graff, 311 Minn. 111, 248 N.W.2d 291 (1976) (accounting firm liable to receiver of insolvent insurance company for negligently failing to discover the company's officers were misappropriating funds; examiner employed by accounting firm knew insurance commissioner would rely on his report); Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Civ. App. 1971) (defendant public accountants liable to third-party lender where accountants knew financial statement would be used by client to seek credit). *See* text accompanying notes 102-15 *infra.*

See Coakley, *Accountants' Legal Liability,* 126 J. ACCOUNTANCY 58-61 (July 1968), *reprinted in* W. BOUTELL, CONTEMPORARY AUDITING 285-91 (1970) [hereinafter cited as Coakley, *Accountants' Legal Liability*]; Dondanville, *Defending Accountants' Liability: Trends and Implications,* 15 FORUM 173, 175-80 (1979); Gormley, *Accountants' Professional Liability—A Ten-*

negligence as the standard of liability in private actions under section 14(a), the rationale used by the court in applying the scienter standard in a recent section 14(a) action against accountants, and the development of accountants' liability for negligent misrepresentation to third parties under the common law. The comment will suggest that limiting liability for negligent misrepresentation to those who the accountant knew would rely on the information provides a sensible approach to accountants' liability under section 14(a).

II. Congressional Intent

A. *Protecting the Investor—The Language of Section 14(a)*

Reacting to the need to provide safeguards for the trading of securities, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934.[21] According to the language of the Senate report on the 1934 Act, the specific concern behind section 14(a) was to "protect investors from promiscuous solicitation of their proxies . . . by irresponsible outsiders . . . and . . . unscrupulous corporate officials."[22] The language of section 14(a) reflects this purpose. It authorizes the SEC to prescribe "such rules and regulations . . . as [are] necessary or appropriate . . . *for the protection of investors*."[23]

The Supreme Court found this language significant in establishing a private right of action for shareholders under section 14(a) and Rule 14a-9 in *J.I. Case Co. v. Borak*.[24] The Court quoted from House[25] and Senate reports[26] which indicate congressional concern that shareholders be informed about the issues on which their proxies are solicited.[27] The Court stated, "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."[28] Those remedies include both injunctive relief and damages through private enforcement of the proxy rules in both direct actions against those responsible for misleading proxy statements and share-

21. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976); Cohen, *The SEC and Proxy Contests*, 20 Fed. B.J. 91, 93 (1960); Wheat, *"Truth in Securities" Three Decades Later*, 13 How. L.J. 100, 100-02 (1967).

22. S. Rep. No. 1455, 73d Cong., 2d Sess. 77 (1934).

23. 15 U.S.C. § 78n(a) (1976) (emphasis added). Rules 14a-1 through 14a-12 (17 C.F.R. § 240.14a-1 through § 240.14a-12 (1980)), promulgated pursuant to § 14(a), specify when proxy statements are required, what they must and may not contain, and what form they must take.

24. 377 U.S. 426, 431-32 (1964). The Court did not rely solely on the language of § 14(a) but said that the intent of Congress was "evidenced in the language of the section." *Id.*

25. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934).

26. S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934).

27. 377 U.S. at 431.

28. *Id.* at 433.

holder derivative actions.[29]

In two subsequent cases brought under section 14(a),[30] the Supreme Court has found the purpose of the section, to assure that shareholders are informed about the issues on which they are being asked to vote, crucial in determining the standards of causation[31] and materiality[32] a plaintiff must meet in a private action under section 14(a) and Rule 14a-9. The Court held in *Mills v. Electric Auto-Lite Co.*[33] that the plaintiff need not show that the misrepresentation actually affected the outcome of a merger vote. The plaintiff need only show that it was material, meaning, the Court said, that it had a "significant *propensity* to affect the voting process."[34] Even though the merger itself might be fair, to allow the defendant to escape liability by using fairness as a complete defense when the proxy statement was misleading would discourage shareholders from private section 14(a) actions and frustrate congressional policy.[35] Again, in *TSC Industries, Inc. v. Northway, Inc.*,[36] the Court looked to "the broad remedial purpose"[37] of section 14(a) and Rule 14a-9 for guidance in determining what the standard of materiality should be. "That purpose is not merely to ensure . . . that the transaction . . . is fair and otherwise adequate, but to ensure disclosures by corporate management in order to enable the shareholders to make an informed choice."[38] The standard must not be set so low that management's fear of liability would cause it to inundate the shareholders with trivial information and thus defeat the purpose of informed decision making.[39] On the other hand, the Court said, the "prophylactic purpose" of Rule 14a-9 requires that doubts as to the materiality of misinformation be resolved in favor of those the statute is designed to protect, *i.e.*, the shareholders.[40]

29. *Id.* at 431.

30. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976); Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970). Plaintiffs in both cases alleged that defendant corporations omitted material facts from proxy solicitations seeking aproval of proposed mergers.

31. 396 U.S. at 381-85. The plaintiff establishes causation by showing that the defective proxy solicitation was essential to the voting procedure. *Id.* at 385.

32. 426 U.S. at 448-50. "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *Id.* at 449.

33. 396 U.S. 375 (1970).

34. *Id.* at 384 (emphasis in original). "This requirement that the defect have a significant *propensity* to affect the voting process is found in the express terms of Rule 14a-9. . . ." *Id.* (emphasis in original).

35. *Id.* at 382, 383.

36. 426 U.S. 438 (1976).

37. *Id.* at 448.

38. *Id.*

39. *Id.* at 448-49.

40. *Id.* The Court said that ideally the court's role would be to determine whether the shareholders would have approved the proposed transaction had there been no misstatement or

Thus, the Supreme Court has firmly established that congressional intent to protect the shareholder is the primary consideration in establishing a private right of action and in determining the elements of such an action under section 14(a). Two federal circuit courts have followed this approach in determining that negligence should be the standard of liability under section 14(a) and Rule 14a-9.[41] In *Gould v. American-Hawaiian Steamship Co.*,[42] the Third Circuit Court of Appeals upheld the district court in applying the negligence standard in a shareholder derivative suit to an outside nonmanagement director[43] for misrepresentation in the company's proxy statement. The director knew that a draft of the proxy statement contained false information, but he did not read the statement in its final form. The district court held that the director would have known that the statement was false if he had read it, and that it was his duty as a director to read it.[44] The circuit court cited the "importance of the proxy provisions to informed voting by shareholders" and "the broad remedial purpose" of section 14(a) as reasons for imposing a negligence standard.[45] The Second Circuit Court of Appeals, too, looked to the language of section 14(a) as an

omission. Since it would be impossible to make such a determination with certainty, doubts will arise. Given the purpose of Rule 14a-9 "to ensure disclosures by corporate management in order to enable the shareholders to make an informed choice," the doubts should be resolved in favor of shareholders. *Id.* at 448.

41. Gould v. American-Hawaiian Steamship Co., 535 F.2d 761 (3d Cir. 1976); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973).

42. 535 F.2d 761 (3d Cir. 1976). In addition to examining the language and legislative history of § 14(a), the *Gould* court examined § 14(a) in the context of other sections of the securities acts. The defendant argued that § 14(a) was analogous to § 10(b), which deals with the use of manipulative devices in connection with the purchase or sale of securities; § 10(b) requires the plaintiff to establish scienter. The court, however, concluded that § 14(a) is closer in subject matter to § 11 of the 1933 Act as amended by the 1934 Act, 15 U.S.C. § 77k (1976), which provides for civil liability for false registration statements and establishes negligence as the standard. *Id.* at 777.

43. *Id.* One of the defendants, Casey, was a director of the corporation, but because he owned no stock and was not employed by the corporation, he was an "outside nonmanagement director." *Id.* at 766, 777. Casey urged that the trial court should have applied a scienter standard rather than negligence, at least in the case of an outside nonmanagement director. *Id.* The circuit court, however, made no distinction between the duty owed to a shareholder by an outside director and that owed by an inside director under the § 14(a) disclosure requirement. *Id.* at 778.

44. *Id.* at 776.

45. *Id.* at 777-78. In its holding concerning Casey's liability, the court said, "the district court did not err in applying the standard of due diligence," using the phrase "due diligence" for the first time in the case. *Id.* at 778. The court was not, however, introducing a new standard of liability. In other references in the case to Casey's liability, it is clear that the standard of liability applied to him is negligence: "[T]he district court stated that negligence is the appropriate standard of culpability to establish an individual's liability for damages for a violation of § 14(a) of the Act, and Rule 14a-9(a) of the Regulations, which standard, the court decided was applicable to the four defendants [including Casey]," *id.* at 768; "the district court held negligence to be the appropriate standard under section 14(a) and we agree," *id.* at 777.

indication of congressional concern with protection of the shareholder whose proxy is being solicited.[46] In *Gerstle v. Gamble-Skogmo, Inc.*, General Outdoor Advertising (GOA), seeking shareholder approval of a merger, issued a proxy statement saying the company's business would continue to be managed by its current officers and directors but failed to disclose that the future parent company intended to sell off most of GOA's plants.[47] In finding that shareholder-plaintiffs are not required to establish evil motive or reckless disregard of the facts,[48] the court emphasized the broad rulemaking authority granted under section 14(a), which "contains no . . . evil-sounding language,"[49] by contrasting it with the section 10(b) authorization of rules dealing with "any manipulative or deceptive device or contrivance."[50]

B. Protecting the Accountant—Adams v. Standard Knitting Mills, Inc.

Despite these decisions that favor the plaintiff shareholder, the Sixth Circuit Court of Appeals favored the defendant accountant by reading the legislative history of section 14(a) to indicate a congressional intent that scienter be the standard of liability.[51] In *Adams v.*

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46. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1299 (2d Cir. 1973).

47. *Id.* at 1288.

48. *Id.* at 1301. The court used the terms "evil motive" and "reckless disregard of the facts" interchangeably with "scienter": "a reading of Rule 14a-9 as imposing liability without scienter . . . is completely compatible with the statutory scheme," *id.* at 1299; "plaintiffs . . . are not required to establish any evil motive or even reckless disregard of the facts," *id.* at 1301.

49. *Id.* at 1299.

50. 15 U.S.C. § 78j(b) (1976), which provides in part:

> It shall be unlawful for any person . . . —To 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 Commission may prescribe as necessary or appropriate in the public interest.

51. Adams v. Standard Knitting Mills, Inc., 623 F.2d 422 (6th Cir. 1980), *cert. denied,* 101 S. Ct. 795 (1981). While this case deals with the liability of outside accountants rather than directors, and while the court appeared to find this difference a significant factor in determining what the standard of liability should be, 623 F.2d at 428-29, the legislative materials the court quoted did not indicate any congressional intent that there be different standards for outsiders than for corporate insiders: "It is contemplated that the rules and regulations promulgated by the Commission will protect investors from *promiscuous* solicitation of their proxies . . . by irresponsible outsiders . . . and . . . by *unscrupulous* corporate officials. . . ." *Id.* at 429 (quoting S. REP. No. 1455, 73d Cong., 2d Sess. 77 (1934) (emphasis added by court).

Like the *Gould* court (*see* note 42 *supra*), the *Adams* court compared § 14(a) with other sections of the securities acts in its search for the standard of liability. 632 F.2d at 428-29. Whereas *Gould* compared the subject matter of the various sections, 535 F.2d at 777, the *Adams* court based its comparison on what the plaintiff must show. Section 12(2) of the 1933 Act, 15 U.S.C. § 77*l*(2) (1976), which imposes liability for negligent misrepresentation in a prospectus, requires privity. 623 F.2d at 428. Section 11, 15 U.S.C. 77k (1976), the court said, requires proof of actual investor reliance, *id.* at 428-29, whereas Rule 14a-9, like Rule 10b, uses the less exacting standard of materiality. *id.* at 429. While the court was not explicit as to the point of these

Standard Knitting Mills, Inc., outside accountants hired by Chadbourn, Inc. prepared financial statements for inclusion in a proxy statement sent to shareholders of Standard Knitting Mills, Inc., in which Standard's management recommended merger with Chadbourn. The financial report prepared by the accountants, Peat, Marwick, Mitchell & Co. (Peat, Marwick), incorrectly said that a loan agreement restricted payments of dividends on Chadbourn's common stock, when in fact the agreement restricted dividends on all capital stock, including preferred.[52] The district court found that Peat, Marwick had acted with scienter.[53] Even though Peat, Marwick had been informed of the error in the financial statements several weeks before the merger vote occurred and made no effort to inform Standard management or shareholders of the error, the circuit court reversed the district court and found that Peat, Marwick had acted negligently[54] and therefore was not liable under the scienter standard.[55] The circuit court examined the Senate report,[56] floor debates[57] and committee reports[58] connected with the passage of section 14(a) and found language indicating that the type of abuse Congress was trying to stop was fraud:

> The words "unscrupulous," "concealing," and "distorting" all imply knowledge or scienter; and we interpret "promiscuous" to mean reckless. In addition, the characterization of irresponsible outsiders trying to "wrest control . . . from *honest* . . . corporate officials," implies dishon-

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comparisons, it appeared to be saying that where other elements of the plaintiff's case must meet strict standards of privity and actual reliance, negligence is the appropriate standard; but where the privity requirement is absent and the less stringent standard of materiality is required (*see* note 32 *supra*), scienter is appropriate.

52. In September 1969, Chadbourn borrowed $6 million from three banks, repayable in installments over five years. The agreement prohibited Chadbourn and its subsidiaries during the term of the loan from redeeming or paying dividends on its capital shares of any class in an amount in excess of $2 million less the repayments on the loan plus future earnings after the 1968-69 fiscal year. A second loan agreement was similar but less restrictive. 623 F.2d at 425.

53. *Id.* at 426.

54. *Id.* at 426-28. The circuit court said that it could "find in the record nothing to indicate that a desire to deceive, defraud or manipulate motivated Peat to omit" the information concerning debt restrictions on capital stock, *id.* at 427, and that the evidence suggested that Peat's failure to notify Standard shareholders or officers was "a mistake, an oversight, the failure to foresee a problem." *Id.* at 428. Judge Weick in his dissent, however, protested: "If [the incorrect footnote] originally was only a slip of the pen, it became a deliberate fraud when Chadbourn's own lawyer called this to the attention of Peat's manager in charge of the audit and the manager corrected [it] in his own copy and did not correct the original because it would have defeated the merger." *Id.* at 442.

55. *Id.* at 431.

56. *Id.* at 429-30 (citing S. REP. NO. 1455, 73d Cong., 2d Sess. 77 (1934)).

57. 623 F.2d at 430 (citing 78 CONG. REC. 6544, 7712-14, 7961 (1934)).

58. 623 F.2d at 430 (citing *Hearings on H.R. 7852 Before the House Comm. on Interstate & Foreign Commerce*, 73d Cong., 2d Sess. 480 (1934)).

esty—and hence scienter—on the part of the outsiders.[59]

From this language, the court concluded that the authors of section 14(a) contemplated it would be applied against the knowing or reckless wrongdoing of outsiders.[60]

The court also looked to the legislative history[61] of section 14(e)[62] of the Securities Exchange Act for confirmation of its conclusion that the plaintiff must show the defendant acted with scienter. According to the House report for the Williams Act governing tender offers, a tender offer is similar to a proxy contest.[63] Both are subject to the same kind of abuse. The sponsor of the Williams Act said that the bill would "provide the *same kind of disclosure requirements which now exist . . . in contests through proxies*."[64] The court concluded that this testimony logically implies similar standards of liability for proxy statements and tender offers. The use of the words "fraudulent," "deceptive" and "manipulative" in section 14(e) indicates that section 14(e) requires scienter. Thus, the court concluded, section 14(a) also requires proof of scienter.[65]

Thus, while the Supreme Court[66] and two circuit courts[67] focused on the language of the statute as an indication of congressional intent, the *Adams* court made no attempt to examine the language of section 14(a) itself but rather looked to the language of committee reports and floor debates. To this extent, the court violated a principle of statutory construction as applied to securities law by the Supreme Court in *Ernst & Ernst v. Hochfelder*,[68] in which the Court examined the language of the statute itself to determine that scienter is the standard of liability under section 10(b) of the 1934 Act.[69] The Court said, "Ascertainment

59. 623 F.2d at 430 (quoting S. REP. NO. 1455, 73d Cong., 2d Sess. 77 (1934)) (emphasis added by court).

60. 623 F.2d at 430. The court, in overturning the district court's finding that Peat, Marwick acted with scienter, appeared to equate "scienter" with intent to deceive (*see* note 54 *supra*). In looking at the legislative history of § 14(a) to determine whether scienter should be the standard of liability, however, the court used "scienter" in such a way that it encompasses knowledge and recklessness: "The words 'unscrupulous,' 'concealing,' and 'distorting' all imply knowledge or scienter; and we interpret 'promiscuous' to mean reckless." *Id.*

61. *Id.* (citing H.R. REP. NO. 1711, 90th Cong., 2d Sess., *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 2811, 2813 [hereinafter cited as H.R. REP. NO. 1711].

62. 15 U.S.C. § 78n(e) (1976). The amendment to §§ 13 and 14 (15 U.S.C. §§ 78m and 78n) are commonly known as the Williams Act. *See* CARY, *supra* note 11, at 1561-64.

63. 623 F.2d at 430 (quoting H.R. REP. NO. 1711).

64. 623 F.2d at 430-31 (quoting 113 CONG. REC. 24665 (1967)) (emphasis added by court).

65. 623 F.2d at 431.

66. *See* text accompanying notes 24-40 *supra.*

67. *See* text accompanying notes 41-50 *supra.*

68. 425 U.S. 185 (1976).

69. *Id.* at 197-99.

of congressional intent with respect to the standard of liability created by a particular section of the Acts must . . . rest primarily on the language of that section. Where we deal with a judicially implied liability, the statutory language certainly is no less important."[70] The Court found that the words "manipulative," "device" and "contrivance", "make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence."[71] The Court looked to legislative history only to confirm its reading of the statutory language.[72] When the *Adams* court said, "We can see no reason for a different standard of liability for accountants under the proxy provisions than under 10(b),"[73] it was ignoring the absence from section 14(a) of such words as "manipulative," "device" and "contrivance," the language that the Supreme Court found to indicate scienter in section 10(b).[74] A comparison with section 10(b), rather than supporting a scienter standard under section 14(a), in fact leads to a conclusion that section 14(a) does not require scienter. Had Congress intended to prevent only fraudulent behavior, it could have employed words such as "manipulative" and "contrivance," the language used in section 10(b) that connotes intentional misconduct.[75]

III. Policy and the Common Law Treatment of Accountants' Liability

A court hearing a claim brought under a statute that does not expressly provide for such an action can look to several sources for guidance in fleshing out the elements of the action. It can look to the language and the legislative history of the statute, as the Supreme Court did in *Ernst & Ernst v. Hochfelder*.[76] Where neither the statutory language nor the legislative history gives firm guidance, however, the court may have to look elsewhere. "Federal courts created the private right of action under section 14, and they have a special responsibility to consider the consequences of their rulings and to mold liability fairly to reflect the circumstances of the parties."[77]

70. *Id.* at 200-01. *See Misleading Proxy Statements, supra* note 12, at 581-83; Brodsky, *Corporate and Securities Litigation: Accountants' Liability*, New York Law Journal, June 3, 1981, at 1, col.1.

71. 425 U.S. at 199.

72. *Id.* at 201. The Court found in the legislative history of § 10(b) repeated assertions that the section was intended to prohibit the use of manipulative devices. *Id.* at 201-06. "It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions." *Id.* at 203.

73. 623 F.2d at 429.

74. 425 U.S. at 199.

75. *See* Richland v. Crandall, 262 F. Supp. 538, 553 n.12 (S.D.N.Y. 1967).

76. 425 U.S. at 197-201.

77. 623 F.2d at 428.

When the Supreme Court found it difficult to ascertain congressional intent with regard to who is a proper plaintiff under section 10(b), it turned to policy considerations. In *Blue Chip Stamps v. Manor Drug Stores,*[78] the Court held that offerees of a stock offering who have neither purchased nor sold any of the offered shares may not maintain a private cause of action under section 10(b) and Rule 10b-5. Justice Rehnquist, writing for the majority, found that a comparison of section 10(b) with other sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 supported limiting section 10(b) plaintiffs to those who have actually purchased or sold securities.[79] Such a comparison, however, is not decisive:

> Having said all this, we would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express "intent of Congress" as to the contours of a private cause of action under Rule 10b-5. When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it, . . . but it would be disingenuous to suggest that either Congress . . . or the [SEC] . . . foreordained the present state of the law with respect to Rule 10b-5.[80]

Because the congressional intent was not ascertainable, and because private remedies under section 10(b) have been fashioned by the judiciary, Justice Rehnquist concluded, "[i]t is therefore proper that we consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance."[81] Justice Rehnquist then adduced the danger of vexatious litigation as an important policy consideration in support of limiting section 10(b) actions to those who have actually bought or sold shares.[82]

This same approach is appropriate for determining the standard of liability under section 14(a), for neither the language of the statute nor the legislative history mandates a negligence or scienter standard.[83]

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78. 421 U.S. 723 (1975).
79. *Id.* at 735-36.
80. *Id.* at 737.
81. *Id.*
82. *Id.* at 740. Justice Rehnquist's concern for vexatious litigation is based on two grounds. First is that a securities lawsuit that may have little chance of success may have a disproportionately large settlement value. *Id.* at 740-43. The second ground is that allowing as plaintiffs those who had not actually bought or sold stock would "throw open to the trier of fact many rather hazy issues of historical fact the proof of which depended almost entirely on oral testimony." *Id.* at 743.
83. *See Proper Standard, supra* note 12, at 676-81.

Two circuit courts have looked at the language of the statute and decided that negligence is the standard,[84] but another circuit court examined the legislative history and concluded that scienter is the standard.[85] The *Gerstle* and *Adams* courts claimed to be divining congressional intent.[86] The use of policy considerations is particularly appropriate when the defendant is an outside accountant, because the history of the common law treatment of accountants' liability to third parties is built on policy considerations. Until recently, the enormous potential liability of accountants made courts reluctant to find liability for negligence in the absence of privity.[87] In the last two decades, though, some courts have viewed the importance of protecting the innocent third party as outweighing the need to protect the accountant and have held accountants liable for negligent misrepresentation even in the absence of privity.[88]

In establishing the negligence standard of liability for proxy misrepresentation by corporate directors under section 14(a), the courts have focused on protecting the investor.[89] When the issue is the proper standard of liability for outside accountants under section 14(a), however, it is important to acknowledge the competing consideration of the tremendous potential liability of accountants to shareholders whose proxies have been solicited. In *Adams v. Standard Knitting Mills, Inc.*,[90] the first case to deal with the issue, the court based its holding that the standard should be scienter in part on its concern for protecting the accountant.[91] The court distinguished the accountant from the

84. Gould v. American-Hawaiian Steamship Co., 535 F.2d 761 (3d Cir. 1976); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973). *See* text accompanying notes 41-50 *supra*.

85. Adams v. Standard Knitting Mills, Inc., 623 F.2d 422 (6th Cir. 1980). The problem with finding support for the scienter standard in the legislative history is that "the mere fact that Congress was concerned with intentional abuses of the solicitation process does not clearly establish that Congress was not also concerned with the possibility of negligent wrongdoing." *Misleading Proxy Statements, supra* note 12, at 585.

86. 478 F.2d at 1299; 623 F.2d at 430.

87. *See, e.g.*, Ultramares v. Touche, Niven & Co., 255 N.Y. 170, 174 N.E. 441 (1931), and text accompanying notes 94-95 *infra*.

88. *See* text accompanying notes 102-15 *infra*.

89. *See* text accompanying notes 45-46 *supra*.

90. 623 F.2d at 422.

91. *Id.* at 428. It is not clear from the opinion whether the court was distinguishing the § 14(a) cases in which negligence was held to be the standard on the ground that the defendants in those cases were directors, or if it was deciding that the other cases were simply wrong and that scienter should be the uniform standard for any defendant under § 14(a). It appears it was doing both. On the one hand, the court devoted considerable attention to the legislative history of § 14(a), from which it concluded that Congress intended the standard under § 14(a) to be scienter. *Id.* at 429-30. Since the statute itself does not mention either directors or accountants, nor does the legislative history make any distinction, this conclusion would seem to apply to any defendant. On the other hand, since the case concerned the liability of accountants, not directors, the court narrowed its holding to apply the scienter standard to outside accountants: "[W]e conclude that

corporate issuer of a proxy statement on three grounds: (1) the accountant does not directly benefit from the proxy vote; (2) the accountant is not in privity with the stockholder; and (3) because the preparation of financial statements for use in proxies and other reports is "the daily fare of accountants, . . . the accountant's potential liability for relatively minor mistakes[92] would be enormous under a negligence standard."[93]

Although the *Adams* court did not look to common law for support, its concern for the enormous potential liability of accountants in section 14(a) actions under a negligence standard echoed the words of Justice Cardozo in *Ultramares v. Touche, Niven & Co.*,[94] a seminal case in the common law treatment of accountants' liability. The New York Court of Appeals denied recovery for negligence to a third party creditor not in privity with the defendant accountant who had issued an incorrect financial statement to a client seeking a loan. Justice Cardozo expressed concern for the threat of potentially unlimited liability accountants would face if they could be held liable to third parties in the absence of intent to deceive:

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scienter should be an element of liability in private suits under the proxy provisions as they apply to outside accountants." *Id.* at 428.

92. *Id.* at 428. This expression of concern for potential liability for "minor mistakes" is somewhat misleading in that the mistake made by Peat, Marwick was not minor; it was of major proportions, especially when viewed in light of the goal of the securities acts of an informed shareholder electorate (*see* text accompanying note 27 *supra*). The Standard shareholders were being asked to give up their historically sound, dividend-paying Standard stock in exchange for Chadbourn preferred. Because of the improperly undisclosed restriction on Chadbourn preferred, when Chadbourn suffered a huge loss it was unable to redeem or pay dividends on the preferred stock. As the court said, the Peat, Marwick manager in charge of the audit, who knew of the inaccuracy before the merger vote, "did not foresee that the bottom would drop out of Chadbourn's earnings and that what appeared to be a minor error at the time would become a major bone of contention." 623 F.2d at 428. Arguing to support the district court finding that the misrepresentation was material, Circuit Judge Weick said in his dissent:

> It is clear that no prudent Standard shareholder in his right mind would ever have voted for the merger if he had known of the restrictions. . . . Because of the restrictions . . . he would not receive any dividends on the preferred stock for a long time and possibly he would never receive either [*sic*] dividends or secure the redemption of the preferred shares.

Id. at 443.

93. *Id.* at 428. While the court in *Adams* found the policy considerations to weigh heavily in favor of restricting an accountant's liability, the same court (but not the same judges) in a case argued just two days prior to the *Adams* decision said, in support of its finding that recklessness satisfies the § 10(b)/Rule 10b-5 scienter requirement, that "the § 10(b)/Rule 10b-5 claim for relief is to be liberally construed in order to effectuate the policies underlying the federal securities laws." Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979). "Recklessness" was defined by the court as "highly unreasonable conduct which is an extreme departure from the standards of ordinary care. While the danger need not be known, it must at least be so obvious that any reasonable man would have known of it." d *Id.* at 1025.

94. 255 N.Y. 170, 174 N.E. 441 (1931). *See, Accountants' Liabilities, supra* note 18, at 1438-44.

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.[95]

While the *Ultramares* holding appears to have set up a sweeping prohibition of recovery for negligent misrepresentation in the absence of privity, Justice Cardozo's opinion left the door open for exceptions. The plaintiff argued that *Glanzer v. Shepard,*[96] along with two other cases, established the doctrine that words negligently written or spoken with the expectation that they would be transmitted to another party would establish a basis for liability even in the absence of privity.[97] In *Glanzer,* a buyer of beans who was to pay the bean seller based on the weight of the beans overpaid the seller because the weigher certified the weight incorrectly. The weigher was held liable to the buyer even though his contract was with the seller. In *Ultramares,* Justice Cardozo distinguished *Glanzer* on the grounds that the transmission of the weight certificate to the buyer was not just one possible outcome but rather the specific aim of the transaction.

> The bond [between the buyer and the weigher] was so close as to approach that of privity, if not completely one with it . . . . In a word, the service rendered by the defendant in *Glanzer v. Shepard* was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee.[98]

In *Ultramares,* according to Justice Cardozo, the balance sheet was prepared primarily for the client, and only incidentally for others to whom the client might show it.[99]

Since *Ultramares,* accountants have been held liable to third parties for negligence, but in each case the scope of such liability has been so narrowly defined by the particular circumstances that *Ultramares* has been distinguished, not overruled.[100] By confining the potential class of third parties to whom accountants may be liable to those individuals or classes of individuals who the accountant knew would rely on the information he supplied, the courts have avoided exposing account-

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95. 255 N.Y. at 179-80, 174 N.E. at 444.
96. 233 N.Y. 236, 135 N.E. 275 (1922).
97. 255 N.Y. at 181-82, 174 N.E. at 445.
98. *Id.* at 182-83, 174 N.E. at 446.
99. *Id.* at 183, 174 N.E. at 446.
100. Coakley, *Accountants' Legal Liability, supra* note 20.

ants to the danger of indeterminate liability expressed by Justice Cardozo.[101]

In the first case to hold an accountant liable for negligent misrepresentation to a third party, *Rusch Factors, Inc. v. Levin*,[102] the plaintiff was a single third party whose reliance was actually foreseen by the defendant. The accountant's corporate client sought financing from the plaintiff, a commercial banking and factoring corporation, which requested that the client supply certified financial statements as evidence of its financial stability.[103] The statements showed the client corporation to be solvent when in fact it was insolvent.[104] The court distinguished *Ultramares* on the grounds that the injured third party in the earlier case was a member of an undefined, unlimited class that was foreseeable but not actually foreseen.[105] The court found the relationship between the accountant and the known, potential lender in *Rusch* bore more resemblance to the relationship of the weigher to the bean buyer in *Glanzer*, because in both *Rusch* and *Glanzer* the defendant knew he was providing information for use not by his own client but rather by a third party with whom his client was transacting business.[106] Thus, the court avoided overruling *Ultramares* by following *Glanzer* in holding that an accountant can be liable for negligent misrepresentation relied on by actually foreseen and limited classes of persons.[107]

The *Rusch* court based its expansion of liability for negligent misrepresentation to foreseen third parties on policy considerations. The court expressed these concerns in dictum in which it questioned the wisdom of what it termed the "social utility rationale"[108] of the *Ultramares* decision. Referring to Justice Cardozo's concern with protecting accountants from exposure to "liability in an indeterminate amount for an indeterminate time to an indeterminate class,"[109] the court stated:

> Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional malpractice? Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming

101. *See* note 20 *supra*.
102. 284 F. Supp. 85 (D.R.I. 1968).
103. *Id.* at 86.
104. *Id.*
105. *Id.* at 91.
106. *Id.*
107. *Id.*
108. *Id.* at 90.
109. *Id.* (quoting from *Ultramares*, 255 N.Y. at 179, 174 N.E. at 444).

> public? Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession? For these reasons it appears to this Court that the decision in *Ultramares* constitutes an unwarranted inroad upon the principle that "[t]he risk reasonably to be perceived defines the duty to be obeyed."[110]

The court hinted[111] that if the *Rusch* case had not been distinguishable from *Ultramares*, it might have considered overruling *Ultramares* to hold an accountant liable to foreseeable, as well as actually foreseen, reliant third parties.[112]

The Supreme Court of Iowa in *Ryan v. Kanne*[113] followed *Rusch* in holding accountants liable for negligent misrepresentation to a third party corporation. The accountants knew the corporation would use a financial statement they prepared in deciding whether to take over the client's business and in securing stockholders' subscriptions. The *Ryan* court said the rule of no liability for negligent misrepresentation in the absence of privity should be relaxed where the reliance was by actually known parties.[114] Like the *Rusch* court, the *Ryan* court based this expansion of liability on policy considerations; accountants should be held responsible for their mistakes. "We know of no good reason why accountants should not accept the legal responsibility to known third parties who reasonably rely upon financial statements prepared and submitted by them."[115]

Thus, the absence of privity between the accountant and the third party who relies on the information supplied by the accountant is no

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110. 284 F. Supp. at 91 (quoting from Palsgraf v. Long Island R.R., 248 N.Y. 339, 344, 162 N.E. 99, 100 (1928).

111. *Id.* "This Court need not, however, hold that the Rhode Island Supreme Court would overrule the *Ultramares* decision, if presented the opportunity, for the case at bar is qualitatively distinguishable from *Ultramares*." *Id.*

112. The *Rusch* court did not spell out the implications of overruling *Ultramares* to hold accountants liable to foreseeable (not just actually foreseen) third parties. If the guiding principle were that from *Palsgraf* cited by the *Rusch* court (*see* note 110 and accompanying text *supra*), then negligent misrepresentation would be on the same footing with negligence that results in personal injury. Would such a rule expose an accounting firm to potential liability out of proportion to that of the owner of a nightclub or hotel that burns, killing hundreds of guests? In regard to accountants' liability under § 14(a), expanding the potential claimants for negligent misrepresentation to the class of those who are foreseeable probably would not increase the class beyond those who are actually foreseen, *i.e.*, the shareholders, since § 14(a) deals with the solicitation of shareholders' proxies: "It shall be unlawful for any person . . . in contravention . . . of rules and regulations . . . to solicit . . . any proxy or consent or authorization in respect of any security." 15 U.S.C. § 78n(a) (1976).

113. 170 N.W.2d 395 (Iowa 1969) (a corporation considering taking over a lumber yard relied on financial statements that the preparer of the statements knew the corporation intended to use).

114. *Id.* at 402, 403.

115. *Id.* at 401.

longer the inviolate boundary that the *Adams* court apparently believed it should be.[116] A careful reading of *Ultramares* and the *Rusch* holding supports applying a negligence standard of liability to an accountant who negligently supplies incorrect information for use in a proxy statement.[117] The shareholders whose votes are being solicited are third parties whose reliance the accountant foresees. When the accountant provides financial statements specifically for use in a proxy statement, the relationship between the accountant and the shareholders is like that of the weigher and the bean buyer in *Glanzer*. In *Glanzer*, the weigher knew the price the bean buyer would pay would be based on what the weigher said the beans weighed.[118] The accountant who provides financial information for use in a proxy statement knows shareholders may rely on the information in deciding how to vote. In each situation, the absence of a contractual relationship between the user and the provider of the information is much less significant than the fact that the provider of the information knows that the third party may rely on that information. In view of the expressed purpose of section 14(a) to protect the investor,[119] shouldn't the courts protect shareholders from negligent accountants just as Justice Cardozo protected the bean buyer from the negligent weigher?

IV. CONCLUSION

In enacting section 14(a), Congress did not create a private right of action for proxy misrepresentation. This private right has been established and its elements fleshed out by the courts. The courts have

116. 632 F.2d at 428. "[W]e are influenced by the fact that the accountant . . . does not directly benefit from the proxy vote and is not in privity with the stockholder." *Id.*

117. Further support for this position is found in RESTATEMENT (SECOND) OF TORTS § 552 (1981), which provides in pertinent part:

> (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
>
> (2) . . . [T]he liability stated in Subsection (1) is limited to loss suffered
>
> (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or *knows that the recipient intends to supply it*; and
>
> (b) through reliance upon it in a transaction that he intends the information to influence or *knows that the recipient so intends* or in a substantially similar transaction.

(emphasis added) Both the *Rusch* court (284 F. Supp. at 91-92) and the *Ryan* court (170 N.W.2d at 402) cited § 552 in support of their holdings. Two other recent cases finding accountants liable for negligent misrepresentation have also relied on § 552: Bonhiver v. Graff, 311 Minn. 111, 128, 248 N.W.2d 291, 298-99 (1976); Shatterproof Glass Corp. v. James, 466 S.W.2d 873, 879 (Tex. Civ. App. 1971).

118. 233 N.Y. 236, 135 N.E. 275 (1922).

119. Section 14(a) provides that the SEC may prescribe "such rules and regulations . . . [are] necessary or appropriate . . . for the protection of investors." 15 U.S.C. § 78n(a) (1976).

attempted to find in the language and the history of the section some indication of whether Congress intended to sanction negligent, as well as intentional, misrepresentation.

Reading the language of section 14(a) to indicate congressional intent to protect the shareholder, and following the lead of the Supreme Court in looking to the "broad remedial purpose" of section 14(a), the courts have consistently decided where the defendants were corporate directors that the standard for misrepresentation in proxy statements is negligence. Where the defendant was an outside accountant, however, the Sixth Circuit Court of Appeals decided the legislative history of section 14(a) indicates congressional intent that the standard be scienter. Where congressional intent is difficult to ascertain, the Supreme Court has indicated that it is appropriate for courts to turn to policy considerations to provide the contours of a judicially created private action. Although the common law rule regarding accountants' liability following *Ultramares* seemed to be no liability in the absence of privity, courts have recently modified the privity limitation to implement a policy of holding accountants responsible for negligently providing incorrect information to third parties they knew would rely on that information. Using this approach in actions against accountants under section 14(a) would protect the shareholder from the danger of financial loss due to a merger or other transaction, the approval of which followed solicitation in a proxy statement containing false or misleading information. One purpose of the securities acts is to protect investors. To judge accountants by a less stringent standard of care under section 14(a) than under the common law defeats that purpose.

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