Washington and Lee Law Review

Volume 72 | Issue 2 Article 9

Spring 3-1-2015

Adding a Due Diligence Defense to § 13(b) and Rule 13b 2 – 2 of the Securities Exchange Act of 1934

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* Candidate for J.D., Washington and Lee University School of Law, May 2015. I would like to thank the editorial board for their countless edits of this Note, especially Meghan Flinn and Laura Erdman, our Executive Editors, and Olivia Fritsche, my student note advisor. In addition, I would like to thank Professor Christopher Bruner for serving as my faculty advisor. At numerous points in the writing process I found myself lost and confused, but Professor Bruner always found a way, through multiple revisions, to get me back on track. Finally, I would like to thank my family—to them I owe all my success.

I. Introduction

Since the late 1990s, the United States has been engulfed in a "tidal wave" of accounting fraud.[1] In 2001, Enron entered Chapter 11 bankruptcy following the discovery of illegal accounting practices.[2] Investors lost nearly $80 billion.[3] Enron's reign as the largest accounting fraudster in U.S. history did not last long; less than a year later, WorldCom filed bankruptcy following the collapse of an $11 billion fraudulent accounting scheme.[4] WorldCom investors would likely envy Enron investors—they lost nearly three times more.[5]

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1. Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097, 1099 (2007).

2. *See* Gary J. Aguirre, *The Enron Decision: Closing the Fraud-Free Zone on Errant Gatekeepers?*, 28 DEL. J. CORP. L. 447, 453–59 (2003) (detailing Enron's fraudulent accounting scheme).

3. *Id.* at 449.

4. *See* Mark, *supra* note 1, at 1099 (describing Enron's fraud as the "largest in U.S. history"); *see also In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 640–55 (S.D.N.Y. 2004) (discussing in detail the accounting fraud perpetrated by WorldCom during the late 1990s and early 2000s).

5. *See* Emily N. Seymour, Note, *Refining the Source of the Risk: Suspension and Debarment in the Post-Andersen Era*, 34 PUB. CONT. L.J. 357, 372 (2005) (arguing that WorldCom's outside auditors should have been

Congress responded swiftly, passing the Sarbanes–Oxley Act of 2002.[6] To restore investor confidence in capital markets,[7] Congress enhanced corporate audit controls and increased the authority and oversight of the Securities and Exchange Commission (SEC).[8] Coupled with the new provisions in Sarbanes–Oxley, the SEC can combat inaccurate financial records using two provisions implemented decades earlier. Enacted in 1977, § 13(b)[9] of the Securities Exchange Act of 1934 ('34 Act)[10] requires companies to implement procedures designed to protect the accuracy of their books and records.[11] Promulgated in 1979, Rule 13b2–2 supplements § 13(b) by preventing officers and directors from making misleading statements to outside auditors.[12]

Currently, circuit courts are split over whether Rule 13b2–2 contains a scienter requirement.[13] Whereas the Second and Eighth Circuits have found no scienter requirement in

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disbarred due to the magnitude of the accounting fraud).

6. *See* Pub. L. No. 107-204, §§ 101–1107, 116 Stat. 745 (codified at 15 U.S.C. §§ 7201–7266 (2012)) (overhauling corporate financial regulation). Congress passed Sarbanes–Oxley overwhelmingly: 99–0 in the Senate and 423–3 in the House. Thomas C. Pearson & Gideon Mark, *Investigations, Inspections, and Audits in the Post-SOX Environment*, 86 NEB. L. REV. 43, 45 n.7 (2007). The widespread support and rapid congressional response were likely due to the "media frenzy" surrounding Enron and WorldCom. Roberta Romano, *The Sarbanes–Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528 (2005).

7. *See* Pearson & Mark, *supra* note 6, at 45–46 (listing the four major goals of Sarbanes–Oxley as: (1) improving corporate governance; (2) strengthening corporate disclosures; (3) enhancing corporate accounting procedures; and (4) expanding SEC oversight).

8. *See, e.g.*, 15 U.S.C. § 7202(a)–(b) (2012) (granting the SEC authority to investigate violations of Sarbanes–Oxley); Pearson & Mark, *supra* note 6, at 45–46 (discussing the four major goals of Sarbanes–Oxley).

9. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, § 102, 91 Stat. 1494 (codified at 15 U.S.C. § 78m(b)).

10. 15 U.S.C. §§ 78a–pp.

11. *See id.* § 78m(b)(2)(A) (requiring companies to keep their books and records accurate to "a reasonable detail").

12. *See* 17 C.F.R. § 240.13b2–2 (2014) (proscribing materially misleading statements or omissions made to outside auditors).

13. *Compare* SEC v. Das, 723 F.3d 943, 955 (8th Cir. 2013) (finding no scienter requirement in Rule 13b2–2), *and* SEC v. McNulty, 137 F.3d 732, 740–41 (2d Cir. 1998) (same), *with* SEC v. Todd, 642 F.3d 1207, 1219–20 (9th Cir. 2011) (finding a scienter requirement in Rule 13b2–2).

Rule 13b2–2,[14] the Ninth Circuit has held the opposite.[15] This debate offers an opportunity to reevaluate the costs and benefits of these provisions. These provisions protect the accuracy and breadth of corporate financial records.[16] Because investors rely on the disclosure of corporate information, inaccurate and incomplete financial records threaten the efficiency of capital markets.[17] Absent a scienter requirement, however, these provisions could impose liability on good-faith actors,[18] potentially increasing the cost of compliance as companies take excessive action to avoid liability.[19] Thus, the circuit split raises a question: Without scienter, do the costs of § 13(b) and Rule 13b2–2 exceed their benefits?

This Note argues that, while § 13(b) and Rule 13b2–2 do not require scienter as a matter of law, Congress can better align the costs and benefits of these provisions by adding a due diligence defense. Part II examines the policy rationales behind § 13(b) and Rule 13b2–2 by comparing these provisions to other aspects of federal securities law. Part III discusses the current divide between the Second and Eighth Circuits on one end and the Ninth Circuit on the other. In particular, Part III contends that

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14. *See Das*, 723 F.3d at 955 (finding no scienter requirement in Rule 13b2–2); *McNulty*, 137 F.3d at 740 (same).

15. *See Todd*, 642 F.3d at 1220 (finding a scienter requirement in Rule 13b2–2).

16. *See* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363 (2d Cir. 1973) ("[A] major congressional policy behind the securities laws in general, and the antifraud provisions in particular, is the protection of investors who rely on the completeness and accuracy of information made available to them.").

17. *See* SEC v. Dresser Indus., Inc., 628 F.2d 1368, 1377 (D.C. Cir. 1980) ("Dissemination of false or misleading information by companies to members of the investing public may distort the efficient workings of the securities markets and injure investors who rely on the accuracy and completeness of the company's public disclosures.").

18. *See* Promotion of the Reliability of Financial Information and Prevention of the Concealment of Questionable or Illegal Corporate Payments and Practices, Exchange Act Release No. 15570, 16 SEC Docket 1143, 1979 WL 173674, at *9 (Feb. 15, 1979) [hereinafter 1979 SEC Release] (noting that several commenters to Rule 13b2–2 argued it would be unfair to impose liability on good-faith actors).

19. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976) (arguing that corporate managers will take greater precaution to comply with governing regulations as the risk of liability increases).

the Ninth Circuit is wrong. Part IV then questions whether the other circuits are right. Offering specific language, Part IV grafts a due diligence defense onto § 13(b) and Rule 13b2–2, arguing that this proposal would strike the proper cost–benefit balance between ensuring accurate bookkeeping and imposing costs on public companies.

II. Background on § 13(b) and Rule 13b2–2

One of the primary goals of federal securities law is the disclosure of corporate information,[20] and much of federal securities regulation mandates such disclosure.[21] But what good would disclosure serve if the disclosed information was inaccurate? Section 13(b) and Rule 13b2–2 bolster the accuracy of financial records and thus the accuracy of disclosed information.[22] This Part begins by discussing § 13(b) and Rule 13b2–2, focusing in particular on the policy goals underlying these provisions.[23] To fully develop the policy rationale, this Part then compares § 13(b) and Rule 13b2–2 to other provisions in federal securities law.[24]

A. Section 13(b) of the '34 Act

Congress passed § 13(b) as part of the Foreign Corrupt Practices Act of 1977 (FCPA).[25] On May 12, 1977, the SEC

20. *See* Steven J. Cleveland, *The NYSE as State Actor?: Rational Actors, Behavioral Insights & Joint Investigations*, 55 AM. U. L. REV. 1, 4 (2005) (stating that federal securities law addresses "two principal goals . . . disclosure and the prevention of fraud"); Lyman Johnson, *Why Register Hedge Fund Advisors—A Comment*, 70 WASH. & LEE L. REV. 713, 719 (2013) (indicating that, while federal securities law attempts to facilitate capital formation, this goal often conflicts with the goal of protecting investors).

21. *See, e.g.*, 15 U.S.C. § 77g (2012) (mandating disclosure of certain information in registration statements); *id.* § 77j (prospectuses); *id.* § 78m(a) (periodic reports).

22. *See id.* § 77b(b) (instructing the SEC to promulgate rules under the '34 Act promoting efficiency, competition, and capital formation); *Dresser Indus.*, 628 F.2d at 1377 (claiming that accurate financial information promotes efficiency in capital markets).

23. *Infra* Part II.A–B.

24. *Infra* Part II.C.

25. *See* Pub. L. No. 95-213, §§ 101–204, 91 Stat. 1494 (codified at 15 U.S.C.

submitted to Congress a report outlining extensive bribery of foreign officials by domestic corporations.[26] Rather than focus on the bribery itself, the report emphasized that the bribery was undisclosed on financial records.[27] At the SEC's request, § 13(b) heightened corporate accounting oversight through two mechanisms: reporting requirements and internal audit controls.

Section 13(b)(2)(A) provides reporting requirements. It states that every reporting issuer "shall make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."[28] Two parts of this language are critical to understanding the breadth of § 13(b). First, Congress did not intend the language "transactions and dispositions of the assets" to limit § 13(b) to only asset-based transactions.[29] Instead, § 13(b) "encompasses accuracy in accounts of every character."[30] Second, Congress believed the phrase "in reasonable detail" would remove inadvertent and minor accounting oversights from § 13(b)'s reach.[31]

Section 13(b) attempts to strengthen corporate accounting, but it does so at a cost. On one hand, investors rely on financials

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§§ 78dd–1 to –3) (adding numerous provisions to the '34 Act in response to widespread bribery of foreign officials).

26. *See* S. REP. NO. 95-114, at 1–2 (1977) (discussing the need for the FCPA). The original version of the FCPA passed the Senate unanimously in September 1976. *Id.* at 2. The House, however, failed to take up the legislation before adjourning in October 1976, so Congress did not pass the bill until 1977. *Id.* The year-long break did not dampen the widespread support—the bill passed the House unanimously. *See A Guide to the New Section 13(b)(2) Accounting Requirements of the Securities Exchange Act of 1934 (Section 102 of the Foreign Corrupt Practices Act of 1977)*, 34 BUS. LAW. 307, 308 (1978) [hereinafter *Guide to Section 13b*] (noting that the FCPA passed the Senate by voice vote in 1977).

27. *See* S. REP. NO. 95-114, at 1–2 (stating that the "undisclosed" bribery presented a "serious breach" of the SEC's "system of corporate disclosure"); *Guide to Section 13b*, *supra* note 26, at 308 ("[Section 13(b) is] in no way linked either to overseas business activities or to corrupt practices . . . .").

28. 15 U.S.C. § 78m(b)(2)(A) (2012).

29. *See* S. REP. NO. 95-114, at 7 n.5 (stating that § 13(b) also covers financial records regarding equity and liabilities).

30. *Id.*

31. *See* 1979 SEC Release, *supra* note 18, at 9 (stating that the "in reasonable detail" language should alleviate the concern that § 13(b) liability would arise for every single inaccuracy in financial records).

disclosed in periodic reports.[32] These periodic reports aggregate all financial transactions over a period of time.[33] Consequently, *all* transactions bear, to some extent, on the accuracy of information disclosed to investors. Thus, § 13(b) reaches all transactions to promote accurate disclosure.[34] On the other hand, large corporations can have millions of transactions per day.[35] Accounting for all of these transactions is costly.[36] In addition, § 13(b) could potentially subject a company to liability for minor oversights in accounting for these transactions.[37] Recognizing these costs, the "in reasonable detail" language may exempt minor oversights from § 13(b)'s reach.[38]

It appears, however, that Congress tipped the scale in favor of accuracy. Congress recognized that financials "constitute the foundations of our system of corporate disclosure."[39] To maintain "public confidence" in capital markets, Congress imposed "affirmative duties" designed to keep corporate recordkeeping "honest."[40] And although the "in reasonable detail" language limits the scope of § 13(b), other provisions in federal securities law offer greater protection.[41]

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32. *See* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363 (2d Cir. 1973) (noting that both the disclosure requirements and the antifraud provisions in federal securities law serve to provide investors with adequate information); Michael A. Lynn, Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b–5*, 50 GEO. WASH. L. REV. 627, 655 (1982) (arguing that accurate corporate disclosures allow investors to rely on the integrity of pricing mechanisms in the capital markets).

33. *See, e.g.*, Apple Inc., Annual Report (Form 10-K) (Sept. 27, 2014) (stating that Apple's net income from all transactions occurring in fiscal year 2014 surpassed $41 billion).

34. *See* S. REP. NO. 95-114, at 7 n.5 (1977) (stating that § 13(b) covers all financial records).

35. *See* 1979 SEC Release, *supra* note 18, at 9 (addressing the concern that the volume of daily transactions for large corporations would make compliance with corporate accounting requirements nearly impossible).

36. *See* S. REP. NO. 95-114, at 8 (noting that the requirements of § 13(b) will impose costs on companies).

37. *See id.* (stating that only unreasonable violations of § 13(b) are actionable).

38. *See id.* ("[S]tandards of reasonableness must apply.").

39. *Id.* at 7.

40. *Id.*

41. *See infra* Part II.C (comparing § 13(b) to other provisions in federal securities law).

The best evidence of Congress's commitment to accurate financial records is the additional requirements imposed by § 13(b)(2)(B).[42] This subsection requires internal audit controls, stating that every issuer shall:

> [D]evise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that— (i) transactions are executed in accordance with management's general or specific authorization; (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.[43]

Similar to § 13(b)(2)(A), this subsection is limited by a standard of reasonableness.[44] Here, this standard enables Congress to do two things. First, it allows Congress to defer to financial experts in determining the adequacy of internal audit controls.[45] Indeed, Congress suggested that outside auditors recommend improvements to audit controls.[46] Second, Congress recognized that internal audit controls are costly.[47] The reasonableness standard gives executives flexibility in managing these costs by allowing them to adopt cost-efficient procedures.[48] In this manner, Congress attempts to reduce the cost of compliance by deferring to accounting professionals.[49]

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42. *See* 15 U.S.C. § 78m(b)(2)(B) (2012) (imposing audit control requirements).

43. *Id.*

44. *See* S. REP. NO. 95-114, at 8 (1977) ("Here, standards of reasonableness must apply.").

45. *See id.* (indicating that the accounting standards in § 13(b) come from "authoritative accounting literature").

46. *See id.* ("Auditor's comments and suggestions to management on possible improvements are to be encouraged.").

47. *See id.* (arguing that the benefits of this subsection outweigh the costs imposed on registered companies).

48. *See id.* (allowing management to evaluate audit procedures with a cost–benefit analysis).

49. *See id.* (stating that this subsection allows management to exercise

B. Rule 13b2–2 of the '34 Act

The SEC promulgated Rule 13b2–2 to promote compliance with § 13(b).[50] It reads:

> (a) No director or officer of an issuer shall, directly or indirectly: (1) Make or cause to be made a materially false or misleading statement to an accountant in connection with; or (2) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading, to an accountant in connection with: (i) Any audit, review or examination of the financial statements of the issuer required to be made pursuant to this subpart; or (ii) The preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise.[51]

Rule 13b2–2 bars two types of statements made to accountants in connection with an audit or SEC filing. First, it bars "materially false or misleading" *affirmative* statements.[52] Second, it bars the *omission* of any material fact necessary to make affirmative statements "not misleading."[53]

In the Rule's notice-and-comment proceedings, several commenters expressed concerns regarding the cost of compliance.[54] First, many commenters suggested that Rule 13b2–2 should include a scienter requirement.[55] Otherwise, Rule 13b2–2 may unfairly impose liability on good-faith actors.[56] Second, many

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professional judgment in implementing audit controls).

50. *See* 1979 SEC Release, *supra* note 18, at 6 (stating that Rule 13b2–2 is "necessary or appropriate" to implement § 13(b)).

51. 17 C.F.R. § 240.13b2–2(a) (2014).

52. *Id.* § 240.13b2–2(a)(1).

53. *Id.* § 240.13b2–2(a)(2).

54. *See* 1979 SEC Release, *supra* note 18, at 10–14 (discussing and rejecting several changes to Rule 13b2–2 suggested by approximately eighty commenters).

55. *See id.* at 12 (declining to insert a scienter requirement). The concept of scienter is discussed later in this Note. *See infra* Part II.C.3.

56. *See* 1979 SEC Release, *supra* note 18, at 9 ("[I]t would be unfair to impose liability on persons who acted in good faith and made inadvertent or unintentional mistakes."). This argument was made regarding Rule 13b2–1, but the SEC noted that the same concern was raised with Rule 13b2–2 and applied the same analysis to both rules. *See id.* at 12 (refusing to add a scienter requirement to Rule 13b2–2 for "the reasons set forth above . . . with respect to

commenters believed that violations would be "inevitable" because large companies have an "incredible volume of transactions that must be recorded on a daily basis."[57] Both of these concerns could lead individuals to take excessive steps to prevent liability.[58]

The SEC dismissed both of these suggestions, concluding that the benefits of the rule outweighed its costs. The SEC associated inaccurate financial records with corporate fraud, claiming that fraud is rarely reflected in corporate books and that corporate books are often inaccurate to conceal fraudulent activities.[59] Rule 13b2–2, the SEC contended, would "act as a deterrent to the falsification of corporate books," thus limiting corporate fraud.[60] The SEC believed that deterring fraud outweighed the compliance concerns: "[T]he Commission has decided that the advantages of the new Rule outweigh the potential disadvantages suggested by certain commentators."[61]

The commitment to accurate corporate records is clear. Rather than merely require reasonably accurate financials,[62] Congress demands *procedures* that ensure reasonably accurate financials.[63] Congress does so recognizing the high costs of internal audit controls, noting that the benefits of accurate financials outweigh the costs.[64] And in case this "belt and

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Rule 13b2–1").

57. *Id.*

58. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976) (arguing that corporate managers will take greater precaution as the risk of liability increases); *cf.* Ariel Porat, *Offsetting Risks*, 106 MICH. L. REV. 243, 265 (2007) (arguing that increasing potential liability in the medical malpractice context would cause doctors to take "excessive precautions" beyond what is socially optimal).

59. *See* 1979 SEC Release, *supra* note 18, at 1 (arguing that the desire to conceal fraudulent activities often leads individuals to falsify financial records).

60. *Id.* at 11.

61. *Id.* at 12.

62. *See* 15 U.S.C. § 78m(b)(2)(A) (2012) (requiring companies to keep their books and records accurate to a reasonable detail).

63. *See id.* § 78m(b)(2)(B) (requiring internal audit controls designed to protect the accuracy of corporate records).

64. *See* S. REP. NO. 95-114, at 8 (1977) ("The expected benefits to be derived from the conscientious discharge of these responsibilities are of basic importance to investors and the maintenance of the integrity of our capital market system.").

suspenders" approach is not enough,[65] Congress imposes criminal liability on individuals who "knowingly" violate § 13(b).[66] Moreover, the SEC crafted Rule 13b2–2 to impose liability on certain good-faith actors, determining that the benefits of accuracy surpassed the cost of compliance.[67] The aim is clear: eliminate inaccuracy.

C. Comparison to Other Provisions in Federal Securities Law

Although the accuracy of financial records predominated the above discussion, the bulk of federal securities law focuses elsewhere. Primarily, securities law prevents corporate fraud and promotes public disclosure.[68] Often, however, the pursuit of these goals is overly broad, so Congress and the courts have limited different provisions of federal securities law in many ways. By exploring the varying scopes of these provisions, we can gain a better understanding of the policy rationale behind § 13(b). Thus, this subpart compares § 13(b) to two other securities provisions—Rule 10b–5 under the '34 Act[69] and § 11 of the Securities Act of 1933 ('33 Act)[70]—along three different axes: scope of liability,[71] materiality,[72] and scienter.[73] First, however, this subpart describes Rule 10b–5 and § 11 in broad terms.

Promulgated under § 10(b) of the '34 Act,[74] Rule 10b–5 is the "catchall" antifraud provision.[75] It prohibits any deceptive or

65. STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 189 (3d ed. 2012).

66. 15 U.S.C. § 78m(b)(4)–(5).

67. *See* 1979 SEC Report, *supra* note 18, at 12 ("[T]he Commission has decided that the advantages of the new Rule outweigh the potential disadvantages suggested by certain commentators.").

68. *See* Cleveland, *supra* note 20, at 4 (stating that federal securities law addresses "two principal goals . . . disclosure and the prevention of fraud").

69. *See* 17 C.F.R. § 240.10b–5 (2014) (prohibiting manipulative or deceptive practices relating to the sale or purchase of any security).

70. *See* 15 U.S.C. § 77k (2012) (providing liability for materially misleading statements or omissions in registration statements).

71. *Infra* Part II.C.1.

72. *Infra* Part II.C.2.

73. *Infra* Part II.C.3.

74. 15 U.S.C. § 78j(b).

75. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976); *see* Samuel W.

manipulative "device, scheme, or artifice" in connection with a securities transaction.[76] There is an implied private right of action[77] containing six elements: (1) a material misrepresentation or omission; (2) scienter; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation.[78]

Section 11 creates a private right of action for misleading registration statements.[79] Similar to Rule 10b–5, it requires proof of a material misrepresentation or omission; a connection with the purchase or sale of any security; and economic loss.[80] Unlike Rule 10b–5, however, it does not require proof of scienter, reliance, or loss causation.[81] Due to the different causes of action under these provisions, the scope of liability varies substantially.

1. Scope of Liability

Generally, limits on civil enforcement actions balance two interests: judicial economy and prosecution of wrongdoers.

Buell, *What is Securities Fraud?*, 61 DUKE L.J. 511, 540 (2011) (stating that Rule 10b–5 may be the most important rule in the history of American administrative law).

76. 17 C.F.R. § 240.10b–5(a) to (c) (2014).

77. *See* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 514 (1946) (recognizing for the first time that Rule 10b–5 includes an implied private right of action); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) (noting that the private cause of action under Rule 10b–5 is a "judicial oak" that has grown from a "legislative acorn"); Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) (noting that the existence of an implied private right of action under Rule 10b–5 is "simply beyond peradventure").

78. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005) (noting the six requirements of a 10b–5 private action). For the purposes of this subpart, it is more important to note the number of elements rather than analyze the requirements of each. *See infra* notes 84–87 and accompanying text (arguing that Rule 10b–5's burdensome cause of action limits the potential for liability).

79. *See* 15 U.S.C. § 77k(a) (2012) (providing liability for materially misleading statements or omissions in registration statements).

80. *See In re* Global Crossing, Ltd. Sec. Litig., 313 F. Supp. 2d 189, 195 (S.D.N.Y. 2003) ("To state a claim under section 11, an injured plaintiff must allege only that a defendant made or participated in making a 'material misstatement or omission' in a registration statement for a security the plaintiff acquired . . . .").

81. *See id.* (noting that § 11 does not require the intent to defraud).

Although limiting civil actions promotes judicial economy by preventing "inconsequential or tenuous claims,"[82] the same action may allow wrongdoers to escape liability while failing to compensate injured parties.[83] This tension rears its head throughout federal securities law, and the law limits liability in a variety of ways as reflected by comparing Rule 10b–5, § 11, and § 13(b).

Rule 10b–5 is limited by sheer complexity.[84] The cause of action is relatively broad; any person can sue under Rule 10b–5 so long as they bought or sold securities due to the company's fraud.[85] Nevertheless, Rule 10b–5 is one of the hardest actions to prove in federal securities law, requiring proof of six elements resembling those for common law fraud.[86] Each of these elements poses unique issues and stands as a barrier to private plaintiffs.[87] Given the rule's scope, the law makes it more difficult to prove a Rule 10b–5 violation.

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82. Note, *Developments in the Law: Statutes of Limitations*, 63 HARV. L. REV. 1177, 1185 (1950); *see* Christopher R. Dollase, Comment, *The Appeal of* Rind*: Limitations of Actions in Securities and Exchange Commission Civil Enforcement Actions*, 49 BUS. LAW. 1793, 1793 (1994) (noting that limitations on civil actions encourage plaintiffs to file their claims quickly and protect defendants from old and tenuous claims).

83. *See* Mitchell A. Lowenthal et al., *Time Bars in Specialized Federal Common Law: Federal Rights of Action and State Statutes of Limitations*, 65 CORNELL L. REV. 1011, 1015 (1980) ("[W]hile the wrongdoer escapes liability, the injured party is left without a remedy.").

84. *See* Perry E. Wallace Jr., *Securities Arbitration After* McMahon*,* Rodriguez*, and the New Rules: Can Investors' Rights Really Be Protected?*, 43 VAND. L. REV. 1199, 1249 (1990) (noting that private plaintiffs must prove the "complex elements" of a Rule 10b–5 cause of action); Comment, *A Role for the 10b–5 Private Action*, 130 U. PA. L. REV. 460, 464 (1981) (arguing that the complexity of the Rule 10b–5 cause of action results in "severe enforcement difficulties"); Joseph Cachery III, Comment, Lampf v. Gilbertson*: Rule 10b–5's Time Has Come*, 69 DEN. U. L. REV. 135, 147–48 (1992) ("Any survey of Rule 10b–5 claims clearly demonstrates the complexity . . . of such causes of action."); Patricia Groot, Note, *Fraud on the Market Gets a Minitrial:* Eisen *Through* In Re IPO, 58 DUKE L.J. 1143, 1146 (2009) (noting that Rule 10b–5 cases often require "complex market efficiency analyses" and substantial expert witness testimony).

85. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975) (finding that the plaintiff class in a Rule 10b–5 action includes everyone who purchased or sold a security due to fraud).

86. *See* Dura Pharm., Inc., v. Broudo, 544 U.S. 336, 341–42 (2005) (listing the six elements of a 10b–5 cause of action).

87. *See, e.g.*, Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1087 (1991)

Section 11 is more limited in scope than Rule 10b–5.[88] According to Justice Thurgood Marshall: "Although limited in scope, § 11 places a relatively minimal burden on a plaintiff. In contrast, § 10(b) is a 'catchall' antifraud provision, but it requires a plaintiff to carry a heavier burden to establish a cause of action."[89] Rather than limit § 11 through complexity, however, the law limits § 11 in a different way. Notably, § 11(a) limits potential defendants to five classes of people.[90] In addition, § 11 plaintiffs must "trace" their shares to a misleading registration statement.[91] Tracing is practically impossible where the issuer has made multiple offerings because the "tainted" shares under a misleading registration statement become comingled with "untainted" shares already in the market.[92] As a result, § 11 applies to a distinct class of actors performing a distinct task—corporate executives and experts compiling a registration statement.[93]

Section 13(b) is the most limited of these three provisions, and the law, once again, limits § 13(b) in a different fashion. Section 13(b) is plaintiff friendly; unlike Rule 10b–5, § 13(b) does not require proof of materiality, reliance, or causation.[94] It

(deciding whether plaintiffs can claim that a statement of opinion is materially misleading); Basic, Inc. v. Levinson, 485 U.S. 224, 226 (1988) (deciding whether plaintiffs can establish reliance by claiming they relied on the integrity of market price of a stock); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 187–88 (1976) (deciding whether plaintiffs can establish scienter by showing mere negligence).

88. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) (comparing the scope of liability between § 11 and Rule 10b–5).

89. *Id.*

90. *See* 15 U.S.C. § 77k(a)(1)–(5) (2012) (limiting § 11 liability to five classes of defendants).

91. *See* Krim v. pcOrder.com, Inc., 402 F.3d 489, 496 (5th Cir. 2005) (imposing a strict tracing requirement). In *Krim*, the Fifth Circuit found that the plaintiff could not establish tracing even though the probability that the plaintiff had at least one traceable share was "very nearly 100%." *Id.* at 492 n.6.

92. *See id.* at 498 ("Appellants point out that, given the fungible nature of stocks within a street name certificate, it is virtually impossible to differentiate [public offering] shares from [nonpublic-offering] shares.").

93. *See* 15 U.S.C. § 77k(a) (limiting § 11 liability to five classes of people who work on a registration statement).

94. *See* Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 COLUM. L. REV. 1641, 1650 (2006) (charting the requirements of the causes of actions under Rule 10b–5, § 11, and § 13(b)).

only requires proof of unreasonable inaccuracy in corporate records.[95] However, there is no private right of action.[96] Instead, only the SEC can bring a § 13(b) action.[97] Thus Congress limited § 13(b) by vesting enforcement exclusively in the SEC.[98]

So why have Congress and the courts limited these provisions in such fashion? The Supreme Court's decision in *Blue Chip Stamps v. Manor Drug Stores*[99] may provide an answer. There, the Court addressed the outer limits of Rule 10b–5.[100] Relying predominately on policy,[101] the Court held that individuals who failed to buy or sell securities in a company due to fraud could not sue under Rule 10b–5.[102]

The Court noted that three groups cannot sue under Rule 10b–5: (1) those who refused to buy shares in a company due to fraudulent misrepresentations or omissions that made the company appear less attractive;[103] (2) those who refused to sell

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95. *See* 15 U.S.C. § 78m(b)(2)(A) (requiring companies to keep books and records accurate to a reasonable detail).

96. *See, e.g.*, *In re* Remec Inc. Sec. Litig., 388 F. Supp. 2d 1170, 1177 (S.D. Cal. 2005) ("The parties recognize that there is no private right of action under [§ 13(b)(2)] and therefor [sic] no separate cause of action is stated under the statute."); Davis v. DCB Fin. Corp., 259 F. Supp. 2d 664, 673 (S.D. Ohio 2003) ("However, § 13(b) does not provide for a private right of action.").

97. *See Davis*, 259 F. Supp. 2d at 673 (dismissing a § 13(b) claim in a private suit because § 13(b) does not provide a private cause of action). Over the last decade, from January 1, 2004 to January 1, 2014, the SEC has brought roughly 1,325 actions under § 13(b). *Accounting and Auditing Enforcement Releases*, SEC, http://www.sec.gov/divisions/enforce/friactions.shtml (last updated Mar. 20, 2015) (last visited Mar. 22, 2015) (accessed by searching "13(b)", selecting only "litigation", and limiting date range to January 1, 2004 through January 1, 2014) (on file with the Washington and Lee Law Review).

98. *See* Talley, *supra* note 94, at 1650 (charting the requirements of the cause of actions under Rule 10b–5, § 11, and § 13(b)).

99. 421 U.S. 723 (1975).

100. *See id.* at 725 (deciding whether individuals who neither purchased nor sold securities could sue an issuer under Rule 10b–5).

101. *See id.* at 737 ("It is therefore proper that we consider . . . what may be described as policy considerations . . . .").

102. *See id.* (indicating that this holding bars three classes of plaintiffs from suing under Rule 10b–5).

103. While this scenario seems unlikely—why would a company mislead the public to believe the company was doing poorly?—*Blue Chip* presented exactly these circumstances. In 1963, the United States filed an antitrust action against Blue Chip, and a court ultimately required Blue Chip to sell some of its common

shares in a company due to fraudulent misrepresentations or omissions that made the company appear more attractive; and (3) others related to the issuer who suffer a loss due to the fraud.[104] Failing to compensate these injured parties is a "social cost," but the Court concluded that the limitation's benefits outweighed these costs.[105]

The Court's primary concern was "vexatious litigation," or strike suits.[106] The Court stated that many actions under federal securities law have tremendous settlement potential despite being difficult to win at trial.[107] This settlement value arises because companies engaged in lawsuits bear not only litigation expenses but also costs associated with the disruption of normal business activity.[108] The propensity for strike suits is exacerbated by "liberal discovery" provisions, which plaintiffs can use to increase costs and therefore increase the chance of settlement.[109] The Court further concluded that recognizing these plaintiffs would force the courts to decide "hazy issues."[110] To establish reliance, most plaintiffs would use "uncorroborated oral evidence" by stating, for instance, that they read a company's fraudulent prospectus or heard a company's fraudulent misrepresentation on the news.[111] This could increase the likelihood of strike suits because defendants would have no means to refute these claims.[112]

stock to certain retailers. *Id.* at 725–26. To deter retailers from buying these shares, the plaintiffs alleged, Blue Chip gave pessimistic projections about the company's projected growth. *Id.* at 726. If Blue Chip dissuaded retailers from accepting the offering, it could then offer the shares to the public at a substantially higher price. *Id.* at 726–27.

104. *See id.* (discussing the three classes of plaintiffs barred from bringing a 10b–5 action).

105. *Id.* at 741.

106. *Id.* at 740.

107. *See id.* (arguing that these actions "have a settlement value to the plaintiff out of proportion to its prospect of success at trial").

108. *See id.* (arguing that some litigation costs may be "totally unrelated to the lawsuit").

109. *See id.* at 741 (stating that liberal discovery rules are a "cost rather than a benefit" when they are abused in this fashion).

110. *Id.* at 743.

111. *Id.* at 746.

112. *See id.*

These concerns are just as prevalent in § 13(b). Because § 13(b) is less burdensome than Rule 10b–5, the increased chance of success should increase the number of strike suits.[113] And proving the claim would be just as speculative.[114] Imagine, for instance, that Exxon Mobil violated § 13(b). As of June 30, 2014, Exxon Mobil had over 4.2 billion outstanding shares of common stock.[115] In a private § 13(b) action, shareholders could simply claim that they reviewed one of Exxon's public disclosures, which would reflect the inaccurate financial records.[116] Courts may accept these bare assertions because the entire public disclosure regime assumes that investors rely on the information disclosed.[117] In this scenario, the litigation costs could far exceed the benefits of accurate financial information.[118] Because § 13(b)

> The very real risk in permitting those in respondent's position to sue under Rule 10b-5 is that the door will be open to recovery of substantial damages on the part of one who offers only his own testimony to prove that he ever consulted a prospectus of the issuer, that he paid any attention to it, or that the representations contained in it damaged him.

113. *See* Aguirre, *supra* note 2, at 479 (noting that the Supreme Court has narrowed the requirements of a Rule 10b–5 violation to limit frivolous claims); *see also* Cornelius J. Golden & Charles E.M. Kolb, *The Export Trading Company Act of 1982: An American Response to Foreign Competition*, 58 NOTRE DAME L. REV. 743, 779 (1983) (noting that placing the burden of proof on plaintiffs can reduce the likelihood of strike suits).

114. *See Blue Chip*, 421 U.S. at 743 (concluding that parties would litigate "hazy issues" if Rule 10b–5 did not restrict the class of potential plaintiffs).

115. Exxon Mobil Corp., Annual Report (Form 10-K) (June 30, 2014).

116. *See* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363 (2d Cir. 1973) (noting that federal securities law provides investors with accurate corporate information).

117. Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA. L. & BUS. REV. 10, 13 (2006) (arguing that investors will not invest if they cannot rely on the accuracy of corporate disclosures).

118. Without § 13(b), investors would discount the prices they offer for the shares of all companies to compensate for the risk that an individual company's financial information is inaccurate. *See* Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1567 (2000) ("Investors don't know which companies are truthful and which aren't, so they discount the prices they will offer for the shares of all companies."). This ensures that, "on average," investors receive a fair value for the securities. *Id.* As a result, investors can limit the effects of inaccurate financial records without § 13(b)'s protection.

would not be justified from a cost–benefit perspective if it included a private right of action, Congress provided that only the SEC may bring § 13(b) claims.[119]

2. Materiality

Materiality is a gatekeeper in federal securities law.[120] At its core, materiality answers this question: Is an activity important enough to regulate? Material information is important, so regulators mandate its disclosure; nonmaterial information is unimportant, so regulators do not mandate its disclosure.[121] Mandating the disclosure of nonmaterial information would provide little benefit to investors at a significant cost to public companies.[122]

The seminal definition of materiality comes from *TSC Industries, Inc. v. Northway, Inc.*[123] Information is material if there is a "substantial likelihood that the disclosure of the [information] would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[124] In determining whether the reasonable investor would consider information important, courts consider quantitative factors, such as whether the information concerns more than 5% of the company's earnings, as well as qualitative

119. *See, e.g.*, *In re* Remec Inc. Sec. Litig., 388 F. Supp. 2d 1170, 1177 (S.D. Cal. 2005) (noting that § 13(b) does not contain a private right of action); Davis v. DCB Fin. Corp., 259 F. Supp. 2d 664, 673 (S.D. Ohio 2003) (dismissing a private suit for a violation of § 13(b)).

120. *See* James J. Park, *Rule 10b–5 and the Rise of the Unjust Enrichment Principle*, 60 DUKE L.J. 345, 377 (2010) (noting that materiality separates important information from trivial information); Glenn F. Miller, Comment, *Staff Accounting Bulletin No. 99: Another Ill-Advised Foray into the Murky World of Qualitative Materiality*, 95 NW. U. L. REV. 361, 368 (2000) ("Materiality plays a critical gatekeeper role in the disclosure process under the federal security laws.").

121. *See* Park, *supra* note 120, at 377 (indicating that nonmaterial information does not affect investment decisions).

122. *See* Miller, *supra* note 120, at 368 (arguing that such a requirement would be "oppressively burdensome").

123. 426 U.S. 438 (1976).

124. *Id.* at 449.

factors, such as whether the information concealed an unlawful transaction or turned a loss into a profit.[125]

Materiality qualifies several provisions in the federal securities law, including Rule 10b–5[126] and § 11.[127] Thus, unimportant misrepresentations are not fraudulent under Rule 10b–5, and inconsequential omissions in a registration statement do not establish § 11 liability.[128] But § 13(b) is qualified by a standard of reasonableness.[129] Consequently, § 13(b) reaches unreasonable inaccuracy in corporate records even if these inaccuracies are nonmaterial.[130]

There are two reasons for Congress's exclusion of materiality from § 13(b). First, a lower standard of accuracy should strengthen § 13(b)'s deterrent effect.[131] As the Supreme Court stated in *Basic, Inc. v. Levinson*[132] regarding Rule 10b–5:

> Acknowledging that certain information concerning corporate developments could well be of "dubious significance," the Court [in *TSC Industries*] was careful not to set too low a standard of materiality; it was concerned that a minimal standard might bring

125. *See* Litwin v. Blackstone Grp., L.P., 634 F.3d 706, 719 (2d Cir. 2011) (stating that courts must consider both quantitative and qualitative factors in determining materiality); SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,152 (Aug. 19, 1999) (listing several qualitative factors that courts should consider in determining materiality).

126. *See* 17 C.F.R. § 240.10b–5(b) (2014) (making it unlawful to make any untrue statement of "material fact" or to omit a "material fact" necessary to make previous statements not misleading).

127. *See* 15 U.S.C. § 77k(a) (2012) (providing liability for any untrue statement or omission of a "material fact" contained in a registration statement).

128. *See TSC Indus.*, 426 U.S. at 448 ("[I]f the standard of materiality is unnecessarily low, . . . the corporation and its management [may] be subjected to liability for insignificant omissions or misstatements . . . .").

129. *See* 1979 SEC Release, *supra* note 18, at 6 n.25 (noting that § 13(b) is "qualified by the terms 'in reasonable detail' and 'reasonable assurances,' as distinguished from the concept of materiality").

130. *See id.* at 6 (noting that § 13(b) provides liability regardless of whether the violation led to the dissemination of materially false information).

131. *See* S. REP NO. 95-114, at 7 (1977) (arguing that § 13(b) should deter corporate bribery by increasing the accuracy of corporate financials); Christian J. Mixter, *Individual Civil Liability Under the Federal Securities Laws for Misstatements in Corporate SEC Filings*, 56 BUS. LAW. 967, 985–86 (2001) (noting that the SEC frequently brings § 13(b) claims because they do not require proof of scienter).

132. 485 U.S. 224 (1988).

> an overabundance of information within its reach, and lead management "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking."[133]

The Court thus acknowledged that management will take greater precaution as the standard for liability decreases.[134] Because "in reasonable detail" is a lower standard than materiality, Congress anticipated that companies would be more diligent in complying with § 13(b).[135]

Second, the concern that a lower threshold would bury investors in an "avalanche of trivial information" is not present in § 13(b).[136] Section 13(b) applies to corporate books and records, which are not disclosed to investors in full.[137] Instead, companies only disclose material financial information.[138] But by setting a higher bar at the front end (during internal auditing) Congress ensures that companies disclose accurate, material information.[139] For these reasons, Congress concluded that "standards of reasonableness" should apply.[140]

3. Scienter

Scienter is a state-of-mind requirement in various provisions of federal securities law.[141] The seminal definition of scienter

133. *Id.* at 231 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976)).

134. *See id.* (noting that too low a standard of materiality may lead to overinclusive public disclosures).

135. *See* 1979 SEC Release, *supra* note 18, at 6 (noting that § 13(b) provides liability regardless of whether the violation led to the dissemination of materially false information).

136. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976).

137. *See* 15 U.S.C. § 78m(b)(2)(A) (2012) (applying the "in reasonable detail" standard to corporate "books, records, and accounts").

138. *See, e.g.*, *id.* § 77aa(a)(24) (requiring companies to disclose in the registration statement information regarding every "material contract" made outside the ordinary course of business).

139. *See* Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 466–68 (2002) (noting that Enron's accounting fraud heightened the need for more demanding internal audit controls and more precise SEC disclosures).

140. S. REP. NO. 95-114, at 8 (1977).

141. *See, e.g.*, Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341 (2005) (noting that Rule 10b–5 requires proof of scienter); 17 C.F.R. § 240.10b–5 (2014)

comes from the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*,[142] where the Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud."[143] This definition may be confusing given its circularity,[144] but courts have defined scienter in more identifiable terms: knowledge and recklessness.

In *Hochfelder*, the Supreme Court decided that negligence was insufficient to establish § 10(b) liability.[145] Section 10(b) imposes liability for "manipulative" or "deceptive" conduct.[146] According to the Court, these words contemplate a state of mind greater than negligence.[147] Instead, § 10(b) requires scienter.[148] In defining scienter, the Court cited favorably cases that described scienter as "conscious fault."[149] That is, defendants act with scienter when they have knowledge that their activities are fraudulent.[150]

The Court in *Hochfelder* also acknowledged that recklessness could constitute scienter in certain circumstances[151] but refused

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(providing liability for securities fraud).

142. 425 U.S. 185 (1976).

143. *Id.* at 193 n.12.

144. What's the requisite state of mind to commit fraud? It's the intent to commit fraud.

145. *See Hochfelder*, 425 U.S. at 187–88 (stating that the issue before the court was whether civil damages may lie for a § 10(b) violation in the absence of intent to deceive, manipulate, or defraud).

146. 15 U.S.C. § 78j(b) (2012).

147. *See Hochfelder*, 425 U.S. at 199 (arguing that the text of § 10(b) implied that Congress required more than mere negligence to establish liability).

148. *See id.* at 193 (concluding that § 10(b) requires more than mere negligence).

149. *See id.* at 193 n.12 (noting that scienter refers to "a mental state embracing intent to deceive, manipulate, or defraud"); Clegg v. Conk, 507 F.2d 1351, 1361 (10th Cir. 1974) (noting that Rule 10b–5 requires scienter or "conscious fault").

150. *See* Bradley J. Bondi, *Dangerous Liaisons: Collective Scienter in SEC Enforcement Actions*, 6 N.Y.U. J.L. & BUS. 1, 2 (2009) (noting that scienter generally refers to intent or knowledge of wrongdoing); William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 HOUS. L. REV. 121, 123 (1997) (noting that direct knowledge of falseness can constitute scienter under § 10(b)).

151. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976) ("In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act.").

to decide this issue.[152] While the Supreme Court has never ruled on this issue, all circuits agree that recklessness can constitute scienter.[153] In *Sundstrand Corp. v. Sun Chemical Corp.*,[154] the Seventh Circuit defined recklessness as an "extreme departure" from the standards of ordinary care to the point that the defendant "must have been aware" of the fraud.[155] Thus, scienter can constitute either direct knowledge of the fraud[156] or reckless disregard of the fraud.[157]

It is well established that Rule 10b–5 requires scienter[158] while § 11 does not.[159] But the circuit courts are currently spilt on whether § 13(b) and Rule 13b2–2 require scienter.[160] The next Part tackles this issue, arguing that neither of these provisions include a scienter requirement.

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152. *See id.* ("We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under [§] 10(b) and Rule 10b–5.").

153. *See* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568–69 (10th Cir. 1990) ("Our circuit, however, along with ten other circuits, has held that recklessness may satisfy the element of scienter in a civil action for damages under § 10(b) and Rule 10b–5."). Since the *Hollinger* decision, the Ninth Circuit has likewise held that recklessness can constitute scienter in the Rule 10b–5 context. *See In re* Software Toolworks, Inc., 50 F.3d 615, 626 (9th Cir. 1994) ("The plaintiffs may establish scienter by proving either actual knowledge or recklessness." (citing *Hollinger*, 914 F.2d at 1568–69)). As a result, all circuits include recklessness as a form of scienter.

154. 553 F.2d 1033 (7th Cir. 1977).

155. *Id.* at 1045 (citation omitted); *see also* Kuehnle, *supra* note 150, at 122 (noting that courts often rely on the *Sundstrand* court's definition of reckless scienter).

156. *See* Kuehnle, *supra* note 150, at 123 (noting that direct knowledge of falseness can constitute scienter under § 10(b)).

157. *See Hollinger*, 914 F.3d at 1568–69 (concluding that scienter includes recklessness).

158. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341 (2005) (noting that scienter is one of six requirements in a 10b–5 cause of action).

159. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) (noting that a plaintiff "need only show a material misstatement or omission to establish his *prima facie* case"). "Liability against the issuer of a security is virtually absolute, even for innocent mistakes." *Id.*

160. *See infra* Part III (arguing that § 13(b) does not require scienter).

III. The Circuit Split

As we have seen, § 13(b) sweeps broadly, reaching all aspects of corporate bookkeeping.[161] And yet Congress and the courts have placed strict limits on other provisions of securities law.[162] One way to limit the scope of § 13(b) would be to add a scienter requirement, and, currently, the federal circuits are split on this exact issue. Whereas the Ninth Circuit has found a scienter requirement in Rule 13b2–2,[163] the Second and Eighth Circuits have held the opposite.[164] This Part explores the circuit split, arguing that, as a matter of law (and policy), § 13(b) does not (and should not) contain a scienter requirement.

A. The Ninth Circuit's Decision in SEC v. Todd

In *SEC v. Todd*, the SEC brought a Rule 13b2–2 claim[165] against Jeffery Weitzen, former President and CEO of Gateway, and John Todd and Robert Manza, former financial officers at Gateway.[166] The SEC alleged that Gateway made a series of

161. *See supra* Part II.A–B (discussing the breadth of § 13(b) and Rule 13b2–2).

162. *See supra* Part II.C (comparing the scope of § 13(b) to Rule 10b–5 and § 11).

163. SEC v. Todd, 642 F.3d 1207, 1220 (9th Cir. 2011).

164. SEC v. Das, 723 F.3d 943, 955 (8th Cir. 2013); SEC v. McNulty, 137 F.3d 732, 740–41 (2d Cir. 1998).

165. *Todd*, 642 F.3d at 1212. The SEC also brought a Rule 10b–5 action against each defendant, and the issue before the court relating to Rule 10b–5 was whether the defendants acted with scienter. *Id.* at 1215–16. This raises a question regarding whether the court confused Rule 10b–5, which requires scienter, when deciding the Rule 13b2–2 issue. *See id.* at 1215 (noting that Rule 10b–5 requires evidence of four things, one of which is scienter). While the court reasoned that because the defendants acted with scienter regarding the 10b–5 claim, they likewise acted with scienter regarding the 13b2–2 claim, *id.* at 1220, this assumption does not resolve whether Rule 13b2–2 actually requires scienter. *See id.* at 1219 (noting that the SEC argued that the lower court "impermissibly grafted a scienter requirement" onto Rule 13b2–2). As discussed later in this subpart, the court relies entirely on precedent to resolve this issue. *See infra* notes 182–192 and accompanying text (noting that the Ninth Circuit relies exclusively on a single case to support its conclusion that Rule 13b2–2 requires scienter).

166. *Id.* at 1212. The district court dismissed the Rule 13b2–2 against Weitzen on summary judgment, and the Ninth Circuit affirmed this decision. *Id.*

misleading statements designed to meet analysts' quarterly earnings expectations.[167] In particular, the SEC claimed that Gateway misled the market by booking three transactions improperly: the Lockheed transaction, the VenServ transaction, and the AOL transaction.

In the Lockheed transaction, Gateway recorded $42.7 million in revenue from a sale of computer servers.[168] Following the sale, Lockheed leased the servers back to Gateway.[169] This transaction was odd because it was outside Gateway's ordinary course of business, which typically involves selling its own computers to individual customers.[170] The SEC claimed this transaction gave Gateway a one-time boost in revenue to meet quarterly expectations.[171]

In the VenServ transaction, Gateway booked $21 million in revenue from incomplete computer sales.[172] Under the sale agreement, Venserv agreed to pay Gateway only after Gateway referred a certain number of customers to Venserv.[173] Gateway did not reach the requisite number of referred customers but nevertheless booked the revenue from the sale.[174]

In the AOL transaction, Gateway changed the payment structure for its accounts receivable from AOL.[175] Rather than pay a fee when a customer registered for AOL on the Gateway computer, AOL agreed to pay a fee when Gateway shipped the computer to the customer.[176] This allowed Gateway to book $72 million in fees sooner.[177] While the transaction itself was not

167. *Id.* These misstatements masked a $110 million shortfall between actual earnings and market expectations. *Id.* at 1213.

168. *Id.*

169. *Id.*

170. *Id.*

171. *See id.* at 1213–14 ("[A]bsent the $47.2 million in revenue booked by Gateway from the Lockheed transaction, Gateway would not have met analysts' quarterly expectations.").

172. *Id.* at 1214.

173. *Id.*

174. *See id.* ("None of the parties presently disputes the fact that the VenServ sale was improperly booked.").

175. *Id.*

176. *Id.*

177. *Id.*

improper, Gateway misled analysts by referring to its revenue as "accelerated" when it was based on this one-time transaction.[178]

The jury found Todd and Manza liable under Rule 13b2–2, but the district court set aside the verdict.[179] On appeal, the SEC argued that the lower court improperly grafted a scienter requirement onto Rule 13b2–2 in setting aside the verdict.[180] While this rule does not create a strict liability regime, the SEC contended, it creates a standard closer to negligence or reasonableness.[181] Relying exclusively on *United States v. Goyal*,[182] the Ninth Circuit rejected this argument: "The district court properly applied a 'knowing' standard."[183]

In *Goyal*, the defendant faced criminal prosecution for making false statements to outside auditors.[184] Under §§ 13(b)(4) and 13(b)(5),[185] the Government had to show that the defendant "voluntarily made statements to [the outside auditor] that he knew were false."[186] Because §§ 13(b)(4) and 13(b)(5) contain a scienter requirement, "*[c]riminal liability* under Rule 13b2–2 therefore also requires that a false statement to an auditor be made knowingly."[187] Otherwise, Rule 13b2–2 would exceed the scope of §§ 13(b)(4) and 13(b)(5).[188]

In *Todd*, the SEC did not seek criminal liability against Gateway's officers;[189] nevertheless, the Ninth Circuit read its decision in *Goyal* to impose a scienter requirement even in civil actions.[190] Indeed, the court omitted the word "criminal" when

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178. *Id.*

179. *Id.*

180. *Id.* at 1219.

181. *See id.* (arguing that the district court improperly grafted a scienter requirement onto Rule 13b2–2).

182. 629 F.3d 912 (9th Cir. 2010).

183. *Todd*, 642 F.3d at 1219.

184. *Goyal*, 629 F.3d at 913.

185. *See* 15 U.S.C. § 13(b)(4)–(5) (2012) (imposing criminal liability for individuals who knowingly violate § 13(b)).

186. *Goyal*, 629 F.3d at 916.

187. *Id.* at 916 n.6 (emphasis added).

188. *See id.* (noting that the SEC cannot promulgate a rule that covers a "broader swath" than the authorizing statute).

189. *See* SEC v. Todd, 642 F.3d 1207, 1219 (9th Cir. 2011) (noting that the SEC brought claims under Rule 13b2–2 and not under §§ 13(b)(4) and 13(b)(5)).

190. *See id.* ("To be liable, one must 'knowingly' make false statements.").

citing *Goyal*, writing "liability under Rule 13b2–2 . . . requires that a false statement to an auditor be made knowingly."[191] And the court's analysis ended there. The court provided no other support for the proposition that Rule 13b2–2 requires scienter for civil liability. As discussed below, other sources, such as the text of Rule 13b2–2 and § 13(b)'s legislative history, confirm that the Ninth Circuit is plainly wrong.[192]

B. The Second Circuit's Decision in SEC v. McNulty *and the Eighth Circuit's Decision in* SEC v. Das

The Second and Eighth Circuits have reached the opposite conclusion, finding that Rule 13b2–2 does not require scienter.[193] This subpart discusses *SEC v. McNulty* (Second Circuit) and *SEC v. Das* (Eighth Circuit) in turn, highlighting the legislative history of § 13(b) and the administrative history of Rule 13b2–2, respectively.

1. SEC v. McNulty

Robert McNulty controlled several corporations, and from 1988–1990, he raised $78 million in public offerings.[194] The SEC brought a Rule 10b–5 claim against McNulty for diverting these

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191. *Compare Todd*, 642 F.3d at 1219 ("[L]iability under Rule 13b2–2 . . . requires that a false statement to an auditor be made knowingly." (quoting United States v. Goyal, 629 F.3d 912, 916 n.6 (9th Cir. 2010))), *with* United States v. Goyal, 629 F.3d 912, 916 n.6 (9th Cir. 2010) ("*Criminal* liability under Rule 13b2–2 . . . requires that a false statement to an auditor be made knowingly." (emphasis added)).

192. *See infra* Part III.B (arguing that the Second and Eighth Circuits concluded properly that Rule 13b2–2 does not contain a scienter requirement).

193. Two district courts in the Tenth Circuit have discussed the circuit split, and each agreed with the Second and Eighth Circuit that § 13(b) and Rule 13b2–2 do not require scienter. *See* SEC v. Kovzan, No. 11–2017–JWL, 2013 WL 5651401, at *15 (D. Kan. Oct. 15, 2013) ("The Court is persuaded by the reasoning of the Eighth Circuit in choosing a standard in *Das*."); SEC v. Goldstone, 952 F. Supp. 2d 1060, 1214 (D.N.M. 2013) ("The Court finds the Second Circuit's interpretation of [R]ule 13b2–2(a) and (c) persuasive . . . ."). Likewise, the United States District Court for the Southern District of New York has concluded that Rule 13b2–2 does not require scienter. SEC v. Espuelas, 908 F. Supp. 2d 402, 416 (S.D.N.Y. 2012).

194. SEC v. McNulty, 137 F.3d 732, 734 (2d Cir. 1998).

funds to himself and to other entities he controlled.[195] The SEC also brought a § 13(b) claim against John Shanklin, who controlled the books and records for two of McNulty's companies.[196] Shanklin did not file a response, and the district court entered a default judgment in September 1995.[197]

Shanklin sought to set aside the default judgment, arguing his lack of scienter constituted a defense to the Rule 13b2–2 claim.[198] The court denied Shanklin's motion, concluding that § 13(b) and Rule 13b2–2 do not require scienter.[199] The court observed that § 13(b)(2) contains no words indicating a scienter requirement.[200] The court bolstered this reading with §§ 13(b)(4) and 13(b)(5), which expressly require scienter for criminal liability.[201] This implied, the court concluded, that Congress did not intend to require scienter for civil liability.[202]

The legislative history of § 13(b) confirms this reading. Congress believed § 13(b)(2) would "operate in tandem with the criminalization provisions" of §§ 13(b)(4) and 13(b)(5).[203] Those provisions criminalize "conscious undertaking[s] to falsify records."[204] As Congress noted: "The inclusion of this [knowingly] standard is intended to be limited to matters arising under

195. *See id.* (noting that McNulty fraudulently concealed his intent to misappropriate the funds). McNulty was dismissed as a defendant in return for cooperating with the SEC's investigation. SEC v. McNulty, No. 94 CIV. 7114 (MBM), 1996 WL 422259, at *1 n.1 (S.D.N.Y. July 29, 1996).

196. *See McNulty*, 137 F.3d at 734 (claiming that Shanklin knew, or recklessly failed to know, of McNulty's fraudulent activities).

197. *See id.* at 734–35 (noting that the SEC reminded Shanklin to file an answer on numerous occasions).

198. *See id.* at 738 (arguing that his lack of scienter provided a conclusive defense necessary to overcome a default judgment).

199. *See id.* at 740–41 ("[S]cienter is not an element of civil claims under [§ 13(b) or Rule 13b2–2].").

200. *See id.* at 741 (arguing § 13(b)(2) does not require scienter); 1979 SEC Release, *supra* note 18, at 10 (noting that the SEC did not add a scienter requirement to Rule 13b2–2 because there is no scienter requirement in § 13(b)).

201. *See* SEC v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998) (noting that Congress amended § 13(b) to include criminal liability in 1988).

202. *See id.* (arguing that Congress could have included a scienter requirement in § 13(b)(2) in 1988 when it added the knowingly standard to §§ 13(b)(4) and 13(b)(5)).

203. S. REP. NO. 95-114, at 7 (1977).

204. *Id.* at 9.

[§§ 13(b)(4) and 13(b)(5)] and not to any other provisions of the securities laws."[205] Thus, the legislative history shows that scienter applies only to criminal actions under § 13(b).

2. SEC v. Das

Vinod Gupta "lived a life of luxury" while serving as CEO of infoUSA, Inc., a publicly traded company.[206] The founder and leader of infoUSA billed the company for numerous personal expenses, including private jet travel and upkeep on his eighty-foot yacht.[207] By billing the company, Gupta received additional benefits without paying additional income tax.[208] While management viewed this practice as acceptable,[209] the SEC viewed this practice as a violation of numerous provisions of securities law.[210]

The SEC asserted claims against Rajnish Das and Stormy Dean, former CFOs of infoUSA, under § 13(b)(2) and Rule 13b2–2 for failing to report the benefits given to Gupta.[211] The district court found in favor of the SEC on both counts.[212] On appeal, Dean challenged the jury instructions, which stated that Dean violated Rule 13b2–2 if he acted unreasonably.[213] Dean cited the Ninth Circuit's decision in *SEC v. Todd*, arguing that Rule 13b2–2 requires scienter.[214]

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205. *Id.*

206. SEC v. Das, 723 F.3d 943, 946 (8th Cir. 2013).

207. *Id.*

208. *Id.*

209. *See id.* (noting that management found this acceptable because Gupta was the driving force behind the company's success).

210. *See id.* at 946–47 (bringing seven causes of action against executives of infoUSA). The SEC brought claims under the following provisions of the '34 Act: § 10(b) (committing securities fraud); § 14(a) (filing false proxy statements); § 13(b)(5) (falsifying books and records); Rule 13a–14 (certifying false reports); Rule 13b2–2 (deceiving outside auditors); § 13(a) (aiding and abetting); and § 13(b)(2) (aiding and abetting). *Id.*

211. *Id.*

212. *See id.* at 947 (noting that jury needed only a "few hours" of deliberation to convict Das and Dean of all seven charges).

213. *See id.* at 954 (arguing that the SEC was required to prove that the defendants acted "knowingly").

214. *Id.*

The Eighth Circuit rejected this argument, relying on the text of § 13(b) and the administrative history of Rule 13b2–2. As to the text of § 13(b), the court noted that the knowingly standard applies exclusively to criminal liability under § 13(b)(5).[215] Accordingly, grafting scienter onto § 13(b)(2) would conflict with the plain language of the statute. As to the administrative history of Rule 13b2–2, the court noted that the SEC interprets Rule 13b2–2 to not require scienter,[216] and the court deferred to the SEC's interpretation of its own rule.[217]

The court also criticized the Ninth Circuit's decision in *Todd*.[218] The court noted that the Ninth Circuit relied on a criminal case for the proposition that § 13(b) requires scienter.[219] And reading the scienter requirement in § 13(b)(5) to apply to Rule 13b2–2 would destroy the dichotomy between criminal and civil liability.[220] Such an argument, the court highlighted, "ignores that Rule 13b2–2 was promulgated pursuant to section 13(b)(2), not (b)(5)."[221] According to the Eighth Circuit, the "plain language of the statute" is clear—criminal liability requires scienter but civil liability does not.[222]

C. The Policy Rationale for Excluding Scienter from Rule 13b2–2

The SEC had valid reasons for excluding scienter from Rule 13b2–2. First and foremost, the SEC recognized that

215. *See id.* (noting that any analysis of statutory interpretation should begin with the plain language of the statute).

216. *See id.* at 956 (noting that Rule 13b2–2 was promulgated under § 13(b)(2), which does not require scienter, and not under § 13(b)(5), which requires scienter); 1979 SEC Release, *supra* note 18, at 12 (interpreting Rule 13b2–2 to not include a scienter requirement).

217. *See Das*, 723 F.3d at 956 ("[I]t is well established that an agency's construction of its own regulations is entitled to substantial deference." (quoting Martin v. Occupational Safety & Health Review Comm'n, 499 U.S. 144, 150 (1991))).

218. *See id.* at 955 (arguing that the Ninth Circuit concluded improperly that § 13(b)(5)'s scienter requirement also applied to § 13(b)(2)).

219. *See id.* (noting that the Ninth Circuit misquoted *Goyal*).

220. *See id.* at 955–56 ("[C]riminal liability trigger's § 13(b)(5)'s 'knowing' requirement . . . indicating that it is otherwise not an element of a civil claim.").

221. *Id.* at 956.

222. *Id.* at 955.

including scienter in Rule 13b2–2 would be inconsistent with congressional intent.[223] According to the SEC, Congress excluded scienter from § 13(b)(2) by providing "no words indicating" an intent to include scienter while expressly providing a scienter requirement in § 13(b)(5).[224] Accordingly, including scienter in Rule 13b2–2 would frustrate congressional intent.[225]

In addition, the SEC believed that excluding scienter would facilitate the detection of corporate fraud and bribery.[226] Consultation with outside auditors frequently results in the detection of "material weaknesses" in auditing controls.[227] The SEC did not believe that these weaknesses were inadvertent; instead, the SEC noted that the presence of weak internal audit controls was "almost universal" in corporate fraud and bribery cases.[228] The SEC believed Rule 13b2–2 would help auditors detect flaws in accounting controls and thereby illuminate instances of corporate impropriety.[229] Thus, Rule 13b2–2 would further the primary goal of the FCPA by deterring corporate bribery.[230]

The SEC also concluded that Rule 13b2–2 would serve the FCPA's secondary goal of affirming investor confidence in corporate disclosures.[231] While outside auditors frequently detect flaws in the internal audit controls, their primary objective is to

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223. *See* 1979 SEC Release, *supra* note 18, at 10 (noting that including scienter "would be inconsistent with the language" of § 13(b)).

224. *Id.*

225. *See id.* ("It would be anomalous, under these circumstances, to include a 'scienter' requirement in the new Rule.").

226. *See id.* at 12 (arguing that officers and directors often mislead outside accounts to hide illegal or improper payments).

227. *Id.* at 11.

228. *Id.*

229. *See id.* at 6 (arguing that Rule 13b2–2 is necessary and appropriate to carrying out § 13(b)'s policy goals).

230. *See id.* at 4 ("The primary impetus for the enactment of the FCPA arose from disclosures of widespread corporate bribery."); Anupam Chander, *Googling Freedom*, 99 CALIF. L. REV. 1, 36 (2011) (noting that Congress expressed a "moral interest in condemning corruption" when passing the FCPA).

231. *See* S. REP. NO. 95-114, at 7 (1977) ("Public confidence in securities markets will be enhanced by assurance that corporate recordkeeping is honest."); Chander, *supra* note 230, at 36 (noting that the FCPA enhanced our "free enterprise system" by protecting the integrity of corporate disclosures).

verify corporate financials.[232] By encouraging honest communication between corporate actors and outside auditors, Rule 13b2–2 should increase the auditors' ability to detect inaccuracies.[233] As a result, the SEC concluded that Rule 13b2–2 would further both goals of the FCPA.

The SEC recognized, nonetheless, that excluding scienter from Rule 13b2–2 would impose significant costs on public companies. In particular, the SEC recognized that strict compliance with § 13(b) would be virtually impossible given the daily volume of transactions for large corporations.[234] As a result, officers and directors cannot guarantee that comments made to outside auditors are perfectly accurate.[235] This uncertainty could result in less candid communication as officers may shield themselves from unknowingly violating the rule.[236] In addition, the SEC acknowledged that this rule may subject certain good-faith actors to personal liability.[237]

Ultimately, the SEC concluded that the benefits of Rule 13b2–2 outweighed its costs.[238] The SEC downplayed the effect of excluding scienter, arguing that the "in reasonable detail" language would protect individuals who commit inadvertent or minor mistakes.[239] Even if Rule 13b2–2 was not so limited, the SEC concluded that the need to deter corporate impropriety was

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232. *See* 1979 SEC Release, *supra* note 18, at 11 (noting that auditors review a company's internal audit controls primarily to understand the scope and nature of the examination into the accuracy of the company's financials).

233. *See id.* (arguing that Rule 13b2–2 will deter inaccurate corporate financials).

234. *See id.* at 9 (discussing comments raised by concerned parties that large corporations would not be able to comply with Rule 13b2–2 without a scienter requirement).

235. *See id.* (noting that many commenters believed violations of Rule 13b2–2 would be "inevitable").

236. *See id.* at 12 (noting that many comments expressed concerns that chilling communication would impede an auditor's evaluation of the corporation).

237. *See id.* at 9 (noting that many comments argued that Rule 13b2–2 would impose liability unfairly on innocent actors).

238. *See id.* at 12 (deciding that the advantages of Rule 13b2–2 outweigh the disadvantages mentioned by several commenters).

239. *See id.* at 10 (noting that the rule does not require perfection in corporate recordkeeping).

important enough to justify exacting liability on innocent actors.[240] Relying conclusively on "its experience" in handling corporate accounting issues, the SEC's position is clear: "[T]he Commission has decided that the advantages of the new Rule outweigh the potential disadvantages suggested by certain commentators."[241]

But the SEC failed to consider an alternative—an alternative that would limit the scope of § 13(b) while advancing the SEC's policy goals. The next Part argues that the SEC can better protect corporate actors by including a due diligence defense in § 13(b) and Rule 13b2–2. Such protection would allay the concerns expressed by many commenters while better aligning the costs and benefits of these provisions with Congress's and the SEC's policy goals.

IV. Grafting a Due Diligence Defense onto § 13(b) and Rule 13b2–2

This Note has highlighted a single, basic tension: § 13(b) sweeps broadly to ensure accurate financial disclosures,[242] and yet concerns of overly broad prosecution permeate any analysis of federal securities law.[243] The question becomes how can we balance these two concerns? This Part argues that a due diligence defense would both limit § 13(b) and enhance the accuracy of financial disclosure. To understand this proposal fully, we must first analyze the due diligence defense under § 11[244] as well as highlight characteristics that make § 13(b) amenable to a due diligence defense.[245]

240. *See id.* at 12 (arguing that the benefits of Rule 13b2–2 outweigh its cost).

241. *Id.*

242. *See supra* Part II.A–B (discussing the breadth of § 13(b)).

243. *See supra* Part II.C (discussing the many ways in which Congress and the courts limit certain provisions of securities law).

244. *Infra* Part IV.A.

245. *Infra* Part IV.B.

A. The Due Diligence Defense Under § 11

Section 11 provides liability for material misstatements or omissions in a registration statement.[246] There are a few affirmative defenses,[247] the most significant of which is the due diligence defense. The due diligence defense allows defendants who act reasonably, as opposed to intentionally or recklessly, to escape liability.[248] This defense, however, is not available to the issuer.[249]

The due diligence defense is a composite of two defenses: the "reasonable reliance" defense and the "reasonable investigation" defense.[250] The applicability of these defenses depends on the portion of the registration statement at issue and the individual defendant.[251] The reasonable reliance defense is available only to nonexperts working with expertised portions of the registration statement.[252] In these circumstances, nonexperts can establish a due diligence defense by showing they had "no reasonable ground to believe and did not believe" that the expertised portion of the registration statement was misleading.[253] In essence, this defense allows nonexperts to rely on the work of experts.[254] The

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246. *See* 15 U.S.C. § 77k(a) (2012) (providing liability for materially misleading registration statements).

247. *See id.* (providing that liability will arise unless the purchaser of the security knew of the material misstatement or omission at the time of purchase); *id.* § 77k(e) (providing that damages may be reduced to the extent the defendant shows that the plaintiff's injury arose from causes other than a misleading registration statement).

248. *See* David I. Michaels, *No Fraud? No Problem: Outside Director Liability for Shelf Offerings Under Section 11 of the Securities Act of 1933*, 26 ANN. REV. BANKING & FIN. L. 345, 364 (2007) (arguing that the due diligence defense allows defendants to avoid liability by "(dis)proving scienter").

249. *See* 15 U.S.C. § 77k(b) (stating that no person "other than the issuer" who establishes a due diligence defense shall be liable under § 11).

250. Michaels, *supra* note 248, at 366.

251. *See* 15 U.S.C. § 77k(b)(3) (distinguishing between expertised and nonexpertised portions of the registration statement and between experts and nonexperts).

252. *See id.* § 77k(b)(3)(C) (applying the defense to any part of the registration statement "made on the authority of an expert").

253. *Id.*

254. *See* John Nuveen & Co. v. Sanders, 450 U.S. 1005, 1010 (1981) (Powell, J., dissenting) (noting that this defense is available because "by definition" it is reasonable to rely on the veracity of an expert's work).

reasonable investigation defense adds an additional requirement in two circumstances: (1) where an expert works with an expertised portion of the registration statement;[255] or (2) where a nonexpert works with a nonexpertised portion of the registration statement.[256] These individuals must conduct a reasonable investigation into the accuracy of the registration statement.[257]

This raises a question: what constitutes a "reasonable" investigation or belief? The statute provides some answer: "[T]he standard of reasonableness shall be that required of a prudent man in the management of his own property."[258] This provision provides little guidance because it is "exceedingly vague."[259] The SEC attempted to provide greater clarity with Rule 176, which lists eight factors relevant to determining the reasonableness of an investigation.[260] But this rule is essentially useless because most of the factors, such as the "type of issuer" or the "type of person," are so obvious that courts would likely consider these factors without the rule's guidance.[261]

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255. 15 U.S.C. § 77k(b)(3)(B) (2012).

256. *Id.* § 77k(b)(3)(A).

257. *Id.* § 77k(b)(3)(A)–(B). For example, an accountant compiling a company's audited financials is an expert working with an expertised portion of a registration statement. *See John Nuveen & Co.*, 450 U.S. at 1010 (Powell, J., dissenting) (noting that certified accountants are experts regarding the portions of the registration statement on which they work). Thus, the accountant would have to investigate the accuracy of the audited financials to qualify for a due diligence defense. A nonaccountant working with the same material would likely be a nonexpert working with an expertised portion of the registration statement. As such, the nonaccountant, relying on the accountant's expertise in compiling the audited financials, can establish a due diligence defense without investigating the accuracy of those financials.

258. *Id.* § 77k(c).

259. David I. Michaels, *An Empirical Study of Securities Litigation After Worldcom*, 40 RUTGERS L.J. 319, 331 (2009); *see* Stephen P. Ferris et al., *An Analysis and Recommendation for Prestigious Underwriter Participation in IPOs*, 17 J. CORP. L. 581, 588 (1992) (noting that companies prefer experienced underwriters given the vague reasonableness standard in the due diligence defense).

260. *See* 17 C.F.R. § 230.176 (2014) (listing, among others, "the type of issuer," "type of security," and "type of person" as relevant factors).

261. *See* Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters' Continuous Due Diligence After WorldCom*, 30 CARDOZO L. REV. 2001, 2022 (2009) (noting that Rule 176 does not provide underwriters with "iron-clad" steps to avoid § 11 liability); William K. Sjostrom Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS

The case law provides some help in this regard. The formative case involving the due diligence defense is *Escott v. BarChris Construction Corp.*[262] There, the court employed a case-by-case approach, assessing the validity of each defendant's due diligence claim based on the specific facts relating to each defendant.[263] Nevertheless, this case shows that senior managers are less likely to avoid liability because it is unreasonable to be ignorant of the misleading registration statement given their positions in the company.[264]

The Southern District of New York shed greater light on this analysis in *In re WorldCom, Inc. Securities Litigation*.[265] The court decided that individuals cannot claim due diligence where "red flags" give notice that the company may be engaged in "wrongdoing to the detriment of its investors."[266] Under this analysis, even nonexperts can be liable if expertised portions of the registration statement contain red flags.[267] The court's primary concern related to underwriters, who are nonexperts despite their financial sophistication. Worried that underwriters may turn a "blind" eye to inaccurate financials, the court stated that "mere reliance" on audited financials would not ward off liability.[268] Instead, underwriters, as nonexperts, must investigate red flags in expertised portions of the registration statement.[269]

L.J. 549, 571 (2006) (arguing that Rule 176 merely illustrated the SEC's opinion on the reasonableness of investigations).

262. 283 F. Supp. 643, 652 (S.D.N.Y. 1968).

263. *See id.* at 684–701 (noting that the plaintiffs brought § 11 claims against the corporation, one controller of the corporation, nine directors, eight underwriters, and the corporation's outside auditor).

264. *See id.* at 684 ("[The CEO] knew all the relevant facts. He could not have believed that there were no untrue statements or material omissions. . . . [He] has no due diligence defenses."); Sjostrom, *supra* note 261, at 575 ("[I]nside directors/management defendants will face a difficult task in meeting the reasonable investigation standard.").

265. *See* 346 F. Supp. 2d 628, 634 (S.D.N.Y. 2004) (addressing a due diligence defense advanced by WorldCom's underwriter).

266. *Id.* at 672.

267. *See id.* 671–72 (noting that the red flag analysis should apply to underwriters even though they are nonexperts when working with corporate books and records).

268. *Id.*

269. *See id.* (finding that an investigation is not reasonable where a

To summarize, the due diligence defense allows reasonable actors to avoid liability.[270] Some defendants must show that they had no reasonable grounds to believe that the registration statement was misleading;[271] other defendants must hold the same belief after a reasonable investigation into the veracity of the registration statement.[272] While case law provides some answers regarding the reasonableness of an investigation or belief,[273] "no bright lines can be drawn."[274] Instead, this is inherently a case-by-case determination.[275]

B. Similarities Between § 11 and § 13(b)

There are two similarities between § 11 and § 13(b) that make § 13(b) amenable to a due diligence defense: both are limited in scope;[276] and both are plaintiff friendly.[277] This subpart discusses these similarities in turn.

Section 11 and § 13(b) apply to a limited number of actors. There are only five potential defendants under § 11:

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defendant ignores red flags that indicate corporate fraud).

270. *See* Michaels, *supra* note 248, at 364 (noting that defendants may prove due diligence by "(dis)proving scienter").

271. *See* 15 U.S.C. § 77k(b)(3)(C) (2012) (applying this standard to nonexperts working with expertised portions of the registration statement).

272. *See id.* § 77k(b)(3)(A) (requiring nonexperts working with nonexpertised portions of the registration statement to conduct a reasonable investigation); *id.* § 77k(b)(3)(B) (requiring experts working with expertised portions of the registration statement to conduct a reasonable investigation).

273. *See In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 672 (S.D.N.Y. 2004) (requiring individuals to investigate "red flags" in the registration statement); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 684–701 (S.D.N.Y. 1968) (illustrating that it is more difficult for senior management to make out a due diligence defense).

274. Sjostrom, *supra* note 261, at 609.

275. *See Escott*, 283 F. Supp. at 684–701 (applying the due diligence defense to the facts relating to each individual defendant).

276. *See* 15 U.S.C. § 77k(a)(1)–(5) (limiting potential defendants under § 11 to five classes of persons); *id.* § 78m(b) (applying to misstatements or omissions in corporate books and records).

277. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) (noting that "liability against the issuer of a security [under Section 11] is virtually absolute, even for innocent mistakes"); 15 U.S.C. § 78m(b)(2)(A) (2012) (requiring companies to keep books and records accurate to a reasonable detail).

(1) signatories of the registration statement; (2) directors or partners at the time of filing; (3) persons named in the registration statement as being or about to become a director or partner; (4) certain experts who worked on the registration statement; and (5) underwriters.[278] Likewise, only the issuer and those who work with financial records can be liable under § 13(b).[279]

Nevertheless, there is a key difference between the underlying activities governed by these provisions. Section 11 governs registration statements, where the bulk of the work is done by a "working group" consisting of senior executives, outside counsel, outside auditors, and the underwriter.[280] It is more difficult for these high-level corporate actors to establish a due diligence defense because it is less reasonable for them to be ignorant of the misleading statements.[281] But because corporate bookkeepers must account for thousands of transactions a day,[282] compliance with § 13(b) requires the diligence of more junior employees.[283] That is, junior employees are more likely to work on corporate accounting than they are to work on a registration statement. As a result, the due diligence defense may provide a greater shield in the § 13(b) context.

A greater shield appears appropriate considering the causes of action under § 11 and § 13(b). While both provisions are plaintiff friendly,[284] § 11 requires materiality whereas individuals

278. 15 U.S.C. § 77k(a)(1)–(5).

279. *See id.* § 78m(b)(2) (noting that § 13(b) applies to every reporting issuer); *id.* § 78m(b)(4)–(5) (providing criminal liability for knowingly violating § 13(b)).

280. Sjostrom, *supra* note 261, at 556.

281. *See id.* at 575 ("[I]nside directors/management defendants will face a difficult task in meeting the reasonable investigation standard."); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 684 (1968) ("[The CEO] knew all the relevant facts. He could not have believed that there were no untrue statements or material omissions. . . . [He] has no due diligence defenses").

282. *See* 1979 SEC Release, *supra* note 18, at 9 (addressing the concern that the volume of daily transactions for large corporations would make compliance with § 13(b) nearly impossible).

283. *See* Joseph A. Franco, *Of Complicity and Compliance: A Rules-Based Anti-Complicity Strategy Under Federal Securities Law*, 14 U. PA. J. BUS. L. 1, 69 (2011) (noting that complying with § 13(b) "necessarily enlists a range of secondary participants, such as other employees and outside auditors").

284. *See supra* Part III.C.1 (comparing the scope of liability under § 11 and

can be liable under § 13(b) where their actions result in nonmaterial inaccuracies in corporate financials.[285] As a result, § 13(b) not only reaches more corporate employees but also is easier to prove than a § 11 violation. Thus, corporate employees may need greater protection from § 13(b) liability.

C. The Due Diligence Defense as Applied to § 13(b) and Rule 13b2–2

As discussed above, a due diligence defense protects reasonable actors from liability, and such a defense may be appropriate in the § 13(b) context as a violation by mid- and lower-level employees is relatively easy to prove. Now, this subpart provides specific language applying a due diligence defense to § 13(b) and Rule 13b2–2 before discussing the benefits of such a proposal.

The proposed language would be inserted as clauses (i) and (ii) to § 13(b)(2)(A) and read as follows:

> (i) No person, other than the issuer, shall be liable under subparagraph (A) of this paragraph who shall sustain the burden of proof that he had, after reasonable investigation, reasonable ground to believe and did believe that the books, records, and accounts accurately and fairly reflected, in reasonable detail, the transactions and dispositions of the assets of the issuer.
>
> (ii) A person does not have reasonable ground to believe that the books, records, and accounts accurately and fairly reflected, in reasonable detail, the assets and dispositions of the issuer solely by reason of the issuer having a system of internal accounting controls required by subparagraph (B) of this paragraph.

Clause (i) follows the format of § 11. The relevant portion of § 11 begins with the language of the due diligence defense: "[W]ho shall sustain the burden of proof that . . . he had, after reasonable investigation, reasonable ground to believe and did

§ 13(b)).

285. *See* 1979 SEC Release, *supra* note 18, at 6 (noting that § 13(b) provides liability regardless of whether the violation led to the dissemination of materially false information).

believe . . . ."[286] Section 11 then applies this language to the inverse of § 11's core prohibition:[287] "[T]hat the statements therein were true and that there was no omission . . . necessary to make the statements therein not misleading . . . ."[288] Likewise, this proposal applies the due diligence language to the inverse of § 13(b)(2)(A)'s prohibition:[289] "[T]hat the books, records, and accounts accurately and fairly reflected, in reasonable detail, the transactions and dispositions of the assets of the issuer." This should apply the same due diligence defense to both § 11 and § 13(b)(2)(A).

This proposal omits § 11's distinctions between experts and nonexperts and between expertised and nonexpertised portions of the registration statement. Presumably, bookkeepers have extensive experience in corporate accounting. As a result, this proposal uses the reasonable investigation defense under § 11, effectively treating bookkeepers as experts working with expertised material.[290] Nevertheless, corporate bookkeepers may rely on internal audit controls. Compared to § 11, therefore, bookkeepers may be the nonexperts and the internal audit controls may be the experts. As a result, it is possible to apply the reasonable reliance defense to § 13(b), allowing bookkeepers to rely on internal audit controls. Clause (ii) of the proposal forecloses this possibility because it could render the due diligence defense meaningless. Under clause (i), a defendant could argue that he had reasonable ground to believe the books and records were accurate because the issuer had internal audit controls designed to ensure accurate books and records. Because issuers are required to have these controls,[291] this could effectively remove the due diligence defense from § 13(b)(2)(A).

286. 15 U.S.C. § 77k(b)(3) (2012).

287. *See id.* § 77k(a) (prohibiting a registration statement from containing an "untrue statement of material fact or [an omission] . . . necessary to make the statements therein not misleading").

288. *Id.* § 77k(a)(b)(3).

289. *See id.* § 78m(b)(2)(A) (requiring reporting issuers to "make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect the transactions . . . of the issuer").

290. *See id.* § 77k(b)(3)(A) (requiring experts working with expertised portions to conduct a reasonable investigation into the veracity of that portion of the registration statement).

291. *See id.* § 78m(b)(2)(B) (requiring internal accounting controls).

While allowing this argument to bear some weight, clause (ii) would not allow this argument to serve as the sole basis of establishing a due diligence defense.

This proposal would also require the SEC to add language to Rule 13b2–2. Inserted as paragraph (3) of subsection (a),[292] the operative language would read as follows:

> No director or officer of an issuer shall be liable under this subsection who shall sustain the burden of proof that he had, after reasonable investigation, reasonable ground to believe and did believe that any statements made to an accountant in connection with any action listed under subparagraph (i) or (ii) of paragraph (2) of this subsection were true and did not omit any material fact required to be stated therein to make the statements not misleading.

This language follows the same formula discussed earlier: the due diligence language is applied to the inverse of Rule 13b2–2's core prohibition.[293]

To understand this proposal fully, it is useful to note what would not change under § 13(b). Similar to § 11, the issuer would not be able to claim due diligence.[294] The SEC could enforce a violation of § 13(b) against a company even if its employees acted reasonably in keeping the books and records. Likewise, this proposal would not affect §§ 13(b)(4) and 13(b)(5), which

292. Subsection (a) prohibits officers and directors from making materially misleading statements or omissions in connection with any outside audit or SEC filing. Subsection (b) prohibits officers and directors from taking any action to "coerce, manipulate, mislead, or fraudulently influence" outside auditors into rendering the issuer's financial statements materially misleading. A due diligence defense makes little sense here because the words "coerce, manipulate, mislead, or fraudulently influence" necessarily require intentional action. A violation of this subsection would never be reasonable under the due diligence defense. Subsection (c) imposes the same requirements of subsections (a) and (b) on specific categories of companies. *See* 17 C.F.R. § 240.13b2–2(c) (2014) (applying Rule 13b2–2 to investment companies and business development companies). Presumably, the proposal could apply to this subsection as well, but that is beyond the scope of this Note.

293. *See id.* § 240.13b2–2(a) (prohibiting officers and directors from making materially misleading misstatements or omissions to outside auditors). The language "no officer or director" is used here because Rule 13b2–2 uses the same language. *Id.*

294. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) ("Liability against the issuer of a security [under § 11] is virtually absolute, even for innocent misstatements.").

authorize civil and criminal actions against individuals who knowingly violate § 13(b).[295] Finally, the due diligence defense would not apply to the internal audit controls required by § 13(b)(2)(B).[296] As discussed in detail in the next Part, these retained aspects help justify the proposal on cost–benefit grounds.

D. Cost–Benefit Analysis: A Due Diligence Defense in § 13(b) and Rule 13b2–2

A cost–benefit analysis asks whether the costs of an action exceed its benefits.[297] This is the "basic tool" of regulation, which seeks to reduce the costs of harmful behavior.[298] Such analysis cannot be performed in a vacuum, however. It is important to note that an overriding goal of corporate law in general, and federal securities law in particular, is to deter corporate impropriety.[299] Thus, this subpart begins by discussing briefly some basic cost–benefit principles in the corporate context before analyzing how a due diligence defense would both decrease the costs and increase the benefits of corporate accounting regulation.

1. Cost–Benefit Principles in the Corporate Context

As stated earlier, corporate law seeks to deter corporate impropriety. Deterrence occurs where the perceived costs of an action exceed the perceived benefits.[300] That is, a person will not

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295. *See* 15 U.S.C. § 78m(b)(4)–(5) (2012) (imposing criminal liability for knowing violations of § 13(b)).

296. *See id.* § 78m(b)(2)(B) (requiring issuers to implement internal audit controls designed to protect the accuracy of its books and records).

297. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 13.8, at 402 (7th ed. 2007) (noting that a cost–benefit analysis is a method of determining whether a course of action is advisable).

298. *Id.*; *see* Cass R. Sunstein, *Cost–Benefit Default Principles*, 99 MICH. L. REV. 1651, 1656–67 (2001) (noting that there has been greater emphasis on cost–benefit principles in the regulatory context since the 1970s).

299. *See* S. REP. NO. 95-114, at 3 (1977) (noting that Congress intended § 13(b) to deter corporate bribery of foreign officials).

300. *See* POSNER, *supra* note 297, § 7.2, at 219 (discussing optimal criminal sentencing from a deterrence perspective).

perform an action if that person believes the costs outweigh the benefits.[301] Regulators can deter certain action by making its costs exceed its benefits.[302] To increase costs, regulators must consider two variables: the likelihood of apprehension and the penalty. Under the rational actor theory, an individual considering the cost of violating a regulation will discount the expected penalty by the probability of getting caught.[303] To deter violations, regulators must ensure that the expected punishment, when discounted by the likelihood of conviction, exceeds the benefit of noncompliance.[304] For instance, suppose a corporate officer would earn $1 million by sidestepping a regulation, and the officer believes there is a 50% chance that she will be fined for this action. The regulation would deter the officer if the fine exceeds $2 million because, in theory, only a fine over $2 million would negate the expected gain.

The corporate form adds a wrinkle to this equation. Because the corporation is a person only in the legal sense, the entity itself cannot be deterred.[305] Instead, regulators focus on deterring the corporation's agents.[306] But many of these agents, particularly at the highest level, are judgment proof due to liability insurance and exculpatory clauses.[307] Imposing liability on judgment-proof individuals provides little deterrence because these individuals expect little-to-no punishment.[308] As a result, regulators deter

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301. *See id.* (arguing that punishing crimes too severely is inefficient).

302. *See id.* § 13.8, at 402 (noting that regulators consider the cost and benefits of a given action when crafting regulations).

303. *See* John C. Coffee, *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 389 (1981) ("[T]he expected penalty must be discounted by the likelihood of apprehension and conviction in order to yield the expected punishment cost.").

304. *See id.* (noting that an actor will only be deterred from a given action where the expected punishment exceeds the expected benefit).

305. *See* V.S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477, 1494 (1996) (noting that this fact may make corporate liability appear incompatible with deterrence).

306. *See id.* ("In reality, the law aims to deter the unlawful acts or omissions of a corporation's agents.").

307. *See id.* at 1495 (arguing that regulation will deter judgment-proof individuals less than individuals who are not judgment proof).

308. *See* Coffee, *supra* note 303, at 389 (noting that greater punishments should have greater deterrent effect).

corporate agents indirectly by holding the corporation itself liable.[309]

The goal of § 13(b) and Rule 13b2–2 is to deter improper corporate accounting practices and to increase the accuracy of financial records. In drafting § 13(b) and in promulgating Rule 13b2–2, therefore, Congress and the SEC presumably concluded that the threat of liability exceeded the potential benefits of violating these provisions.[310] Assuming this is true, we arrive at the question at hand: Can we improve the regulation of corporate bookkeeping by reducing its costs and maintaining or increasing its deterrence? That is, can we deter at a lower cost? The due diligence defense would accomplish this goal.

2. Reducing the Costs of § 13(b) and Rule 13b2–2

This proposal would reduce the costs of § 13(b) and Rule 13b2–2 in two ways. First, it would reduce compliance costs.[311] Second, these provisions as currently constructed may impose overdeterrence costs—they may cause companies to take excessive precautions that add little marginal value to the accuracy of corporate records. This proposal would reduce such overdeterrence costs as well.[312]

a. Cost of Compliance

As Congress recognized,[313] § 13(b) imposes significant costs on public companies.[314] Compliance requires "elaborate and

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309. *See* Khanna, *supra* note 305, at 1495 ("Probably the best reason for relying on corporate liability over direct liability is that corporate agents are often judgment-proof.").

310. *See id.* at 3 (arguing that § 13(b) should deter corporate bribery of foreign officials).

311. *Infra* Part IV.D.2.a.

312. *Infra* Part IV.D.2.b.

313. *See* S. REP. NO. 95-114, at 8 (1977) (recognizing that the benefits of § 13(b) must be weighed against the cost of implementing internal audit controls).

314. *See* Note, *The Accounting Provisions of the Foreign Corrupt Practices Act: An Alternative Perspective on SEC Intervention in Corporate Governance*, 89 YALE L.J. 1573, 1576 (1980) (noting that § 13(b) forces management to construct

expensive" internal audit controls[315] as well as the work of numerous employees.[316] In addition, litigation and investigation expenses can be extensive given the complexity of evaluating a company's internal accounting procedures.[317] These costs have only increased with the expanded investigatory powers given to the SEC by the Sarbanes–Oxley Act.[318]

To put these costs in perspective, a helpful comparison can be drawn to the new internal auditing requirements implemented by Sarbanes–Oxley. Section 404 of the Act instructs the SEC to promulgate rules requiring companies to discuss the state of their internal auditing controls in their annual report.[319] Among other things, SEC rules require a statement concerning the general effectiveness of the internal audit controls.[320] Because these rules require an annual assessment of internal audit controls, section 404 imposes "substantial costs" on businesses.[321] According to a 2009 SEC Report, medium-sized companies, defined as those with a market capitalization between $75 million and $700 million, spent $1 million annually to comply with section 404.[322] Larger companies faced nearly four times the cost.[323] This comparison is

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"elaborate and expensive control systems").

315. *Id.*

316. *See* Franco, *supra* note 283, at 69 (noting that complying with § 13(b) "necessarily enlists a range of secondary participants, such as other employees and outside auditors").

317. *See* Tyco Int'l Ltd., Current Report (Form 8-K) (Dec. 30, 2002) (noting that Tyco's internal investigation of possible accounting violations required 25 lawyers and 100 accountants, totaling approximately 15,000 lawyer hours and 50,000 accountant hours).

318. *See* Pearson & Mark, *supra* note 6, at 53 ("Expansive internal investigations are often required to prepare for potential external investigations by the SEC . . . .").

319. *See* 15 U.S.C. § 7262 (2012) (requiring the SEC to promulgate rules governing annual reports of internal audit controls).

320. *See* 17 C.F.R. § 229.308(a)(3) (2014) (requiring "management's assessment" of the effectiveness of internal audit controls).

321. Peter Ferola, *Internal Controls in the Aftermath of Sarbanes–Oxley: One Size Doesn't Fit All*, 48 S. TEX. L. REV. 87, 96 (2006).

322. *See* OFFICE OF ECON. ANALYSIS, SEC, STUDY OF SARBANES–OXLEY ACT OF 2002 SECTION 404 INTERNAL CONTROL OVER FINANCIAL REPORTING REQUIREMENTS 46–47 tbl.9 (2009), http://www.sec.gov/news/studies/2009/sox-404_study.pdf (noting that internal labor was the greatest compliance cost followed closely by outside audit expenses).

323. *See id.* (noting that companies with a public float over $700 million

not exact; the cost of complying with section 404 may differ from the cost of complying with § 13(b). Nevertheless, the high cost associated with section 404 illustrates the expansive scope of internal audit controls. As a result, it likely that the cost of complying with § 13(b) is in the same ballpark.

This proposal should reduce compliance costs in two significant ways. First, this proposal should increase management's ability to adopt more cost-efficient means of compliance. Congress recognized that giving management flexibility was the most efficient way to reduce the costs of implementing § 13(b)'s requirements.[324] Congress included the "in reasonable detail" language to allow management flexibility in complying with § 13(b).[325] This proposal should increase flexibility because it provides additional protection by eliminating liability where bookkeepers act reasonably. As a result, managers and bookkeepers should be more comfortable in choosing less costly accounting procedures.

This argument bears directly on the second way this proposal would reduce business costs. As the Supreme Court noted in *Basic, Inc. v. Levinson*, increasing the scope of liability should increase the precaution corporations take to avoid liability.[326] Conversely, corporations should take less precaution where the scope of liability is lower. This makes sense from a deterrence standpoint. Providing additional protection from liability should decrease the perceived likelihood of conviction.[327] As a result, the proposal should lessen § 13(b)'s deterrent effect,[328] and corporate

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faced nearly $4 million in annual compliance costs).

324. *See* S. REP. NO. 95-114, at 8 (1977) (recognizing that "management must necessarily estimate and evaluate the cost/benefit" of implementing § 13(b)'s requirements).

325. *See id.* ("Here, standards of reasonableness must apply.").

326. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988) (arguing that setting the standard of materiality too low in the Rule 10b–5 context would result in companies flooding investors with an overabundance of trivial information in an attempt to avoid liability).

327. *See* Malcom E. Wheeler, *A Proposal for Further Common Law Development of the Use of Punitive Damages in Modern Product Liability Litigation*, 40 ALA. L. REV. 919, 929 (1989) (noting that the minimum punishment needed to deter a certain action depends on the actor's expected cost and benefits of committing that action).

328. *See* POSNER, *supra* note 297, § 7.2, at 219 (arguing that deterrence occurs where the perceived costs of a particular action surpass the perceived

actors should take less precaution (and thereby incur less cost) in ensuring accurate books and records.

A skeptic would argue that this proposal could lead to less accurate books and records. As corporations take less precaution in accounting procedures, the probability of inaccurate books and records should increase. Consequently, decreasing § 13(b)'s deterrent effect may result in more inaccurate bookkeeping. Such an argument fails in two ways.

First, this proposal should better enable outside auditors to detect flaws in internal auditing procedures by facilitating communication with corporate executives. As expressed by many commenters, Rule 13b2–2 may chill communication between auditors and corporate actors.[329] This also makes sense from a deterrence standpoint. Because individuals can be liable for unknowingly violating the rule, the chance of apprehension and conviction is high. In response, individuals may limit communication with outside auditors to limit liability exposure.[330]

Under this proposal, individuals could take reasonable steps at the front end to ensure that the information divulged to accountants is accurate. Individuals could then communicate this information without fear of liability. By facilitating communication, this proposal would better serve the two aims of the FCPA. First, it would better enable outside auditors to detect flaws in internal audit controls, thus increasing the efficiency of accounting procedures.[331] Second, it would better illuminate instances of corporate impropriety by increasing the auditor's ability to detect inaccuracies in corporate financials.[332]

Thus the first response to the skeptic's argument is that this proposal presents a trade-off. On one hand, the skeptic's concern

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benefits).

329. *See* 1979 SEC Release, *supra* note 18, at 12 (noting that many commenters believed that excluding scienter from Rule 13b2–2 would impede frank communication between auditors and the corporation).

330. *See id.* (noting that many commenters argued that including a scienter requirement in Rule 13b2–2 would also facilitate communication).

331. *See* S. REP. NO. 95-114, at 7 (1977) (arguing that § 13(b) should increase "public confidence in securities markets" by ensuring that "corporate recordkeeping is honest").

332. *See id.* at 3 (arguing that inaccurate books and records facilitate corporate impropriety by disguising the financial effect of fraud and bribery).

may be valid: as corporate actors take less precaution, corporate books and records may be less accurate. Put another way, this proposal may devalue § 13(b)'s books and records requirement. But on the other hand, this proposal would strengthen § 13(b)'s internal auditing requirements because it would better enable outside auditors to detect flaws in auditing controls. Stronger controls should yield more accurate books and records. Thus, even if devaluing the books and records requirement, this proposal should increase the accuracy of corporate financials by strengthening internal audit controls.

The second response to the skeptic's argument attacks a false assumption. The argument is only correct assuming § 13(b) currently achieves the optimal level of deterrence. If § 13(b) overdeters, the marginal value of additional accounting protections is low because the additional protections will cost more than their corresponding benefit. If this is the case, decreasing § 13(b)'s deterrent effect would enable management to reach the optimal cost–benefit balance. The next subsection argues that the current construction of § 13(b) actually overdeters bad accounting practices.

b. Cost of Overdeterrence

If society wished to deter all crime, it could employ all citizens as police officers and impose disproportionately high punishments.[333] Such a policy could deter crime entirely as both the likelihood of apprehension and the severity of the punishment would increase dramatically. But society does not do this because such a system would tax the entirety of our wealth. The cost of deterring all crime is simply too high. As a result, such a system of criminal enforcement is inefficient.[334] This hypothetical reflects the basic concept of overdeterrence. The purpose of deterrence is

333. *See* John T. Byam, Comment, *The Economic Inefficiency of Corporate Criminal Liability*, 73 J. CRIM. L. & CRIMINOLOGY 582, 588 (1982) (arguing that such enforcement of crime would be inefficient).

334. *See* Thomas C. Galligan Jr., *The Risks of and Reactions to Underdeterrence in Torts*, 70 MO. L. REV. 691, 696–97 (2005) (noting that overdeterrence leads to inefficient use of resources); W. David Slawson, *The Role of Reliance in Contract Damages,* 76 CORNELL L. REV. 197, 227 (1990) (indicating that both overdeterrence and underdeterrence are inefficient).

to reduce the effects of socially harmful behavior; law overdeters where the punishment for socially harmful behavior exceeds the harm caused by such behavior.[335]

For instance, assume a corporation could prevent $100,000 in harm to investors by implementing $50,000 worth of new internal audit controls. Assume further that the corporation would violate § 13(b) by failing to implement these new controls. If the fine was $100,000, the corporation would implement the new controls because it would cost less than the fine. Such action is socially optimal because $100,000 in harm is prevented at a cost of $50,000. But if the fine was $1 million dollars, the corporation may implement internal auditing controls worth well over $100,000 in light of the disproportionate liability. In this situation, the potential fine overdeters because the audit controls would cost more than the harm they prevented.[336]

Section 13(b)'s overdeterrence operates in a different fashion, however. Rather than affect the punishment variable in the deterrence equation, § 13(b) affects the perceived likelihood of apprehension. Section 3(b) increases the perceived likelihood of apprehension precisely because it does not require scienter. Regarding Rule 10b–5, which requires scienter, some scholars argue that overdeterrence is not an issue because parties can avoid liability at no additional cost by acting without knowledge or reckless disregard of the fraud.[337] Section 13(b) and Rule 13b2–2 do not require scienter; therefore, individuals cannot protect themselves fully. "Without a crystal ball," individuals face great uncertainty in these situations.[338] Individuals likely compensate

335. *See* A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 879–80 (1998) (arguing that such punishments are "socially wasteful"); Dan M. Kahan & Martha C. Nussbaum, *Two Conceptions of Emotion in Criminal Law*, 96 COLUM. L. REV. 269, 353–54 (1996) (indicating that society wastes limited enforcement resources by overdeterring certain actions).

336. *See* Polinsky & Shavell, *supra* note 335, at 879–80 (arguing that excessive punitive damages cause firms to take excessive steps to prevent potential liability).

337. *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 692 n.8 (1992) (arguing that parties can avoid Rule 10b–5 liability at no cost simply by acting in good-faith).

338. Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2185 (2010).

for this risk by taking excessive precaution even if that excessive precaution would not necessarily increase the accuracy of financial information.[339]

This proposal would resolve this problem by providing greater protection to corporate actors. Under this proposal, these corporate actors would perceive a lower risk of conviction because they could take concrete steps to avoid liability. Because the standard of reasonableness under the due diligence defense remains "exceedingly vague,"[340] this proposal would not eliminate all uncertainty. Nevertheless, this proposal should improve the current situation because it would provide at least *some* means to avoid liability. In doing so, the proposal would better allow corporate actors to reach the optimal cost–benefit approach to ensuring accurate financial records.

3. Maintaining the Benefits of § 13(b) and Rule 13b2–2

In addition to reducing costs, this proposal would maintain § 13(b)'s benefits through a system of dual liability. Under this proposal, the corporation itself could not claim due diligence. If the sanctions are large enough, the corporation should take internal action to deter its employees from violating the statute.[341] Internal sanctions could include a wide range of punishments, from dismissal to the denial of a promotion. To some extent, these sanctions may deter corporate employees more effectively than civil liability.[342] Because imposing civil liability

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339. *See id.* at 2184 (arguing that overdeterrence can increase capital costs by causing companies to overinvest in precautionary measures).

340. Michaels, *supra* note 259, at 331; *cf.* David G. Owen, *Toward a Proper Test for Design Defectiveness: "Micro-Balancing" Costs and Benefits*, 75 TEX. L. REV. 1661, 1680 (1997) (indicating that much of tort law also rests on "vague principles" of reasonableness); James A. Henderson Jr., *Process Constraints in Tort*, 67 CORNELL L. REV. 901, 922 (1982) (noting that any standard of reasonableness is inherently vague).

341. *See* Coffee, *supra* note 303, at 407–08 (noting that the Chicago School of legal scholars supports entity liability because it incentivizes senior management to take measures to avoid liability (citing RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 236 (2d ed. 1977))).

342. *See* Vikramaditya S. Khanna, *Should the Behavior of Top Management Matter?*, 91 GEO. L.J. 1215, 1248 (2003) (noting that formal corporate sanctions strengthen informal corporate sanctions, which also influence the behavior of

requires a trial, individuals view the likelihood of conviction as low.[343] Even though internal sanctions may be less severe than civil liability, the threat of internal sanctions is more palpable.[344] As a result, corporate employees may fear internal sanctions more than civil liability.

This argument assumes that management seeks to maximize corporate profits; otherwise, management would not police employees who threaten corporate profits.[345] In some circumstances, however, managers may benefit personally by disregarding corporate profits.[346] Entity liability would serve little purpose in these scenarios because it would pass the cost of the manager's illegal action onto the corporation.[347] Through entity liability, this proposal should incentivize management to police corporate employees, and, through individual liability, this proposal should deter individual managers from intentionally violating § 13(b) or Rule 13b2–2.[348]

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corporate employees).

343. *See* Coffee, *supra* note 303, at 410 (noting that the procedural requirements associated with a trial lessen the perceived likelihood of conviction).

344. *See id.* ("[T]he risk of punishment by the corporation may be much greater than the risk of punishment by the legal system.").

345. *See id.* at 393 (arguing that corporate deterrence must consider agency problems inherent in the corporate form); David S. Ruder, *Public Obligations of Private Corporations*, 114 U. PA. L. REV. 209, 213–14 (1965) (noting that corporate law traditionally placed fiduciary obligations on managers to ensure that managers considered the interest of shareholders in maximizing profit).

346. *See* Coffee, *supra* note 303, at 393 (noting that individual managers can benefit personally to the detriment of the corporation). For instance, the vice president of a company who seeks to become president may falsify corporate records to show that his division was incredibly profitable, thus increasing his chances of becoming president. *See id.* (arguing that lower-level employees may resort to the same tactics to avoid dismissal or demotion).

347. *See id.* (arguing that it is "extraordinarily difficult" to deter corporate impropriety solely by sanctioning the corporation). *But see* Meir Dan-Cohen, *Sanctioning Corporations*, 19 J.L. & POL'Y 15, 29–30 (2010) (arguing that sanctioning the corporation entices management, either out of loyalty or self-interest, to change harmful corporate practices).

348. *See* Coffee, *supra* note 303, at 393 (arguing that individual liability is necessary given the "fundamental incongruence" that can arise between the interests of management and the interests of the corporation); Ruder, *supra* note 345, at 213–14 (arguing that management's fiduciary duties serve to dampen this fundamental incongruence between the interests of management and shareholders).

This proposal would be particularly effective in light of "sweeping" liability insurance that shields management from personal liability.[349] Currently, individual liability is reserved for offenses unprotected by these policies, such as intentional violations of the law.[350] By maintaining individual liability for intentional violations and imposing entity liability for unintentional violations, this proposal should cause management to do two things. As discussed earlier, management could sanction employees who create unacceptable legal risks.[351] In addition, managers may delegate legally risky tasks to subordinates.[352] By allowing subordinates to claim due diligence, this proposal should provide greater protection to those who bear the risk of liability.

In addition to imposing risk on junior employees, liability protection also allocates risk to shareholders. This is due to corporate "overspill."[353] Put succinctly: "[W]hen the corporation catches a cold, someone else sneezes."[354] In particular, the cost of liability tends to fall on shareholders because liability decreases the value of their shares.[355] While this phenomenon occurs due to

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349. Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 858 (1984); *see* Mae Kuykendall, *Assessment and Evaluation: Retheorizing the Evolving Rules of Director Liability*, 8 J.L. & POL'Y 1, 2 (1999) (noting that corporations tend to grant directors blanket liability protection rather than indemnify directors on a case-by-case basis).

350. *See* Tom Baker, *Transforming Punishment into Compensation: In the Shadow of Punitive Damages*, 1998 WIS. L. REV. 211, 235 (noting that the standard liability insurance policy does not cover intentional harm); Kraakman, *supra* note 349, at 859 (arguing that liability insurance and indemnification policies make individual liability a less effective tool of deterrence).

351. *See* Dan-Cohen, *supra* note 347, at 29–30 (noting that management may change harmful corporate practices in response to entity liability); Kraakman, *supra* note 349, at 859 (arguing that corporations focus heavily on internal monitoring because the entity itself "bears the brunt" of legal liability).

352. *See* Kraakman, *supra* note 349, at 860 (arguing that management has an incentive to delegate legally risky practices to subordinates even without liability protection); *see also* Urska Velikonja, *Leverage, Sanctions, and Deterrence of Accounting Fraud*, 44 U.C. DAVIS L. REV. 1281, 1315 n.187 (2011) (noting that WorldCom CEO Bernie Ebbers was "very fond" of delegating "dirty work" to his subordinates); Kathleen F. Brickey, *Enron's Legacy*, 8 BUFF. CRIM. L. REV. 221, 270 (2004) (noting that Ebbers' penchant for delegating legally risky tasks made it difficult to connect him to WorldCom's fraud).

353. Coffee, *supra* note 303, at 387 n.4.

354. *Id.* at 401.

355. *See id.* (noting that bondholders, creditors, employees, and consumers

the corporate form itself,[356] liability protection exacerbates this problem by forcing the corporation to bear the costs of management's liability in addition to its own.[357]

In this context, however, shareholders are in a better position than management to bear the risk of liability.[358] Shareholders never risk more than the value of their investment in a corporation,[359] and shareholders can diversify this risk by investing in numerous companies over an active securities market.[360] In liability terms, shareholders can mitigate the risk that one company will incur liability by investing in fifty other companies that do not incur liability. As a result of decreasing their risk exposure, shareholders have a lower risk premium and are more willing to invest in other ventures.[361] Thus continues the diversification cycle.

Managers, on the other hand, cannot diversify risk because they invest their managerial skills in a single company.[362] And the consequences of their investment frequently flow beyond that single company. Managers invest their reputation in a company,

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may also bear the cost of corporate liability).

356. *See id.* at 387 n.4 (noting that the overspill problem is inherent in the corporate form).

357. *See* Kraakman, *supra* note 349, at 858 (arguing that the overspill problem is more prevalent if management enjoys "sweeping" liability protection).

358. *See id.* at 862–67 (arguing that placing the risk of liability on shareholders is a less costly means of deterring corporate impropriety).

359. *See id.* at 862 ("Limited liability assures that shareholders retain an unlimited claim to the profits of successful firms but never risk more than the value of their shares in unsuccessful ones.").

360. *See id.* at 862–63 (arguing that active security markets allow shareholders to diversify at low cost); Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 30 (1994) (noting that investors can plan for increased risk exposure, which makes them better risk bearers than tort victims as well).

361. *See* Kraakman, *supra* note 349, at 864 (arguing that undiversified risk bearers are more likely to forgo an investment opportunity because they are overly risk averse).

362. *See* Jeffrey N. Gordon, *Corporate Governance and Executive Compensation in Financial Firms: The Case for Convertible Equity-Based Pay*, 2012 COLUM. BUS. L. REV. 834, 838 (noting that managers typically hold "large undiversified equity stakes" in the company whereas shareholders typically diversify their holdings); Kraakman, *supra* note 349, at 864 (describing managers as "undiversified risk bearers").

and poor performance could adversely affect their ability to find future positions in other companies.[363] Acting in their own self-interest, therefore, managers may prefer actions that promise a lower return with less risk over actions that promise a higher return with more risk.[364] Because they are risk averse, managers may demand greater compensation for incurring risk than would shareholders. Thus, this proposal would efficiently allocate risk to parties who could bear the risk at a lower cost—shareholders.

Knowing that shareholders would bear any bad consequences, managers would not necessarily incur excessive risk because there are other incentives to comply with § 13(b). As mentioned earlier, managers invest their reputation in a company, and § 13(b) liability could limit a manger's future job prospects. Furthermore, shareholders could respond to a § 13(b) violation by policing management or by removing managers that expose the corporation to liability.[365] But such action would entail significant collective action problems, so shareholders would likely respond by selling their shares instead.[366] This response could also affect managers negatively if they are compensated in stock options.[367] These outside incentives should deter managers

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363. *See* Kraakman, *supra* note 349, at 863 (arguing that poor managerial performance damages a manager's reputation); Joshua Andrix, Note, *Negotiated Shame: An Inquiry into the Efficacy of Settlement in Imposing Publicity Sanctions on Corporations*, 28 CARDOZO L. REV. 1857, 1867–68 (2007) (arguing that public sanctioning can harm a manager's reputation, which should serve to deter illegal activity).

364. *See* John C. Coffee Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 13 (1986) (noting that undiversified managers have "good reason" to be risk averse and that diversified shareholders have "every reason" to be risk neutral).

365. *See* David Kerem, *Change We Can Believe In: Comparative Perspectives on the Criminalization of Corporate Negligence*, 14 TRANSACTIONS: TENN. J. BUS. L. 95, 97 (2012) (noting that proponents of entity liability argue that shareholders can police management effectively in response to bearing the cost of liability).

366. *See id.* (noting the "collective difficulty shareholders face" in holding management responsible for creating unnecessary legal risk).

367. *See* Shannon German, *What They Don't Know Can Hurt Them: Corporate Officer's Duty of Candor to Directors*, 34 DEL. J. CORP. L. 221, 235 (2009) (noting that stock options create an incentive to increase the value of the stock so that the recipient can exercise the option and realize a gain); Jan C. Nishizawa, *Ethical Conflicts Facing In-House Counsel: Dealing with Recent Trends and an Opportunity for Positive Change*, 20 GEO. J. LEGAL ETHICS 849, 851 (2007) (noting that corporations often use stock options to entice talented

from taking excessive risk even though shareholders would bear the brunt of the risk.

To summarize, this proposal would allow the SEC to impose individual liability for intentional violations of § 13(b). As a result, providing a due diligence defense to individuals who act reasonably would shift liability to the corporation. In response, management should monitor employees to limit liability exposure. While entity liability would transfer the risk of liability from management to shareholders, shareholders could bear the risk at a lower cost. In addition, this proposal would preserve many outside incentives to comply with § 13(b). All in all, this proposal should maintain § 13(b)'s ability to ensure accurate financial records.

V. Conclusion

The circuit split regarding whether § 13(b) and Rule 13b2–2 require scienter offers an opportunity to reevaluate these provisions. Such a reevaluation reveals that Congress and the SEC can decrease costs and maintain benefits by including a due diligence defense. This serves as a reminder that even cures have ill side-effects—sometimes, regulations impose costs beyond their benefits. Congress, the SEC, and policy-makers alike must occasionally revisit regulations, asking whether society can accomplish its regulatory goals at a lower cost.

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lawyers and executives to the company); Kraakman, *supra* note 349, at 863 (noting that stock options give management a financial incentive to increase the value of the company's stock).