March 21, 2012

Sciento Pleading and Rule 10b-5: Empirical Analysis and Behavioral Implications

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SCIENTER PLEADING AND RULE 10b-5: EMPIRICAL ANALYSIS AND BEHAVIORAL IMPLICATIONS

by

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ABSTRACT
Pleading requirements are the key to access to the courthouse. Nowhere is this more true than with Rule 10b-5 class action securities fraud claims where provisions of the Private Securities Litigation Reform Act of 1995 impose special pleading burdens upon plaintiffs regarding the scienter element and bar them from discovery when defendants file a motion to dismiss. This article begins with a doctrinal history of the scienter element of a Rule 10b-5 claim which indicates that many key legal questions remain unsettled and that application of legal rules to specific factual allegations regarding a particular type of defendant—external auditors—is extraordinarily muddled. To determine whether or not the impression arising from this extensive but nonsystematic examination of the case law is accurate, the authors also undertook a rigorous empirical examination of Rule 10b-5 claims against auditors and confirmed that few facts are consistently viewed by the courts as indicating the presence (or absence) of scienter by external auditors. This lack of clarity in the law and its application makes it difficult for either plaintiffs or defendants to evaluate the settlement value of claims. Furthermore, the law’s excessive vagueness affords judges virtually untrammeled discretion. The literature of behavioral psychology and related fields indicates that excessive discretion exacerbates problems that arise from unconscious judicial bias.
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Many important and contentious issues surround private class action securities fraud lawsuits under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Pleading requirements are the “key that opens access to courts” for these and other lawsuits, yet the law in this area has long been and continues to be best described as “muddled.” The confused state of the law is more than just theoretically important, because empirical studies of differential pleading standards among the circuits in Rule 10b-5 cases indicate that certain of these differences strongly affect both dismissal rates and claim amounts.

Similar confusion reigns in an important strand of these cases that is the primary focus of this article—those Section 10(b)/Rule 10b-5 claims brought against external auditors. Pervasive confusion is not terribly unusual in the case law generated by federal securities litigation, but neither is it a good thing. A doctrinal analysis of courts’ scienter decisions in these Rule 10b-5 auditor cases highlights the existence of these many important and contentious issues, but does little to resolve them. A primary purpose of this article is to determine whether or not empirical analysis can shed some light on these issues and, if so, help to clarify the pragmatic contours of the all-important scienter requirement in private federal securities fraud litigation.

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1 This article takes no position on the question of whether such lawsuits are overall good or bad. Certainly many believe that they are generally damaging to the economy while serving no good end. See, e.g., The “Liability for Aiding and Abetting Securities Violations Act of 2009,” Hearing on S. 1551 Before the S. Comm. on the Judiciary and the Subcomm. on Crime and Drugs, 111th Cong. 111-369 (2009) (statement of Adam Pritchard, Professor of Law, University of Michigan Law) (arguing that private class actions move a lot of money around, but add little to deterrence at the margin); Roberta Romano, The Shareholders Suit: Litigation without Foundation, 7 J. L. ECON. & ORG. 55, 84-85 (1991) (arguing that attorneys are the principal beneficiaries of this litigation).

Others have found evidence of benefits flowing from active private antifraud litigation. See, e.g., FRANK B. CROSS & ROBERT A. PRENTICE, LAW AND CORPORATE FINANCE 182 (2007) (reporting results of empirical study finding, among other things, that “in the securities law enforcement context, it is the private right of action and not government prosecution which has the greatest financial value.”); Justin Hopkins, Private Enforcement of Securities Laws and Financial Reporting Choices 4 (Nov. 1, 2011), available at http://ssrn.com/abstract=1872068 (finding that a court decision that reduced the risk of shareholder litigation led to more financial restatements and earnings management, especially among firms facing a higher risk of litigation); Howell E. Jackson & Mark J. Roe, Public and Private Enforcement of Securities Laws: Resource-Based Evidence, 93 J. FIN. ECON. 207, 237 (2009) (finding that key positive financial outcomes such as stock market capitalization, trading volumes, and number of IPOs correlate with private enforcement…but also with public enforcement…of securities laws); Rafael La Porta, Florencio Lopez-de Silanes & Andre Shleifer, What Works in Securities Laws?, 61 J. FIN. 1, 28 (2006) (finding various benefits flowing from active private enforcement of public securities laws).


4 See Michael A. Perino, Did the Private Securities Litigation Reform Act Work?, 2003 U. ILL. L. REV. 913, 937, 976 (2003) (finding that the PLSRA affected dismissal rates, and that the stringency of the pleading standard applied to a particular circuit was especially impactful); Adam Pritchard & Hillary Sale, What Counts as Fraud? An Empirical Study of Motions to Dismiss under the Private Securities Litigation Reform Act, 2 J. EMPIRICAL LEG. STUD. 125, 142 (2005) (finding that different pleading standards among circuits affected motion to dismiss outcomes).

5 Perino, supra note __, at 917 (noting that stricter pleading standards may cause plaintiffs’ attorneys to focus on cases with higher damages).

In a narrow but important area, this article addresses two of the most important balancing acts in the law. How can plaintiffs be granted adequate access to the courthouse without unduly burdening defendants with frivolous litigation? And, how judges be allowed adequate discretion to dispose quickly of unpromising claims without giving them untrammeled discretion to advance their own unconscious biases?

Part I of this article undertakes a traditional historical and doctrinal analysis of the statutory and case-based development of the law of scienter in Rule 10b-5 litigation. It provides background and context, addressing the scienter issue generally, but also focusing upon the case law involving auditor defendants specifically. Part II reports the methods and results of an empirical analysis of the scienter-related case law in Rule 10b-5 litigation against external auditors. Both the doctrinal and the empirical analyses indicate that the law of pleading scienter against external auditors in Rule 10b-5 cases is so vague and inconsistent that as a practical matter judges have virtually unfettered discretion to reach any conclusion they deem appropriate. Using the insights of behavioral psychology and related fields, Part III analyzes the unfortunate implications of such nearly limitless discretion. Part IV concludes.

I. A HISTORY OF THE SCIENTER REQUIREMENT, ESPECIALLY AS REGARDS AUDITOR DEFENDANTS

A. The Early Questions.

1. Is Section 10(b) a scienter-based or negligence-based statute?

Section 10(b)\(^7\) forbids securities fraud in violation of SEC rules, such as Rule 10b-5.\(^8\) The role of scienter in Rule 10b-5 cases has been filled with controversial questions over the

\(^7\) Section 10(b) reads, in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce of or of the mails, or of any facility of any national securities exchange--

\(\ldots\) (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement[,] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.


\(^8\) Rule 10b-5 reads:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

\(\ldots\) (a) To employ any device, scheme, or artifice to defraud,

\(\ldots\) (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

\(\ldots\) (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.
years and remains so. The initial question was whether Section 10(b) is a scienter-based or negligence-based statute. Some lower courts initially held that negligence alone could violate the statute,\(^9\) while other courts strongly disagreed.\(^10\) That issue, at least (and, perhaps, at most) is now firmly settled. In 1976, the Supreme Court established in *Ernst & Ernst v. Hochfelder* that Section 10(b) and Rule 10b-5 are intent-based liability provisions.\(^11\)

2. Is recklessness sufficient to satisfy the scienter standard?

*Hochfelder* left open an immediate, critical question that remains unsettled nearly 40 years later.\(^12\) The Supreme Court has at least thrice reserved without deciding the issue of whether recklessness suffices to satisfy the scienter standard.\(^13\)

If the Supreme Court ever rules on this issue, it should embrace the recklessness standard for at least three reasons. First, for more than three decades the lower courts have been virtually unanimous in holding that recklessness suffices.\(^14\) Second, the common law of fraud has long recognized recklessness as sufficient to satisfy the scienter requirement\(^15\) and Section 10(b) was enacted to strengthen, not weaken, investor protection as compared to the common law.\(^16\) Third, the doctrine of intentionality in fraud cases long ago held that recklessness suffices for at least three reasons. First, for more than three decades the lower courts have been virtually unanimous in holding that recklessness suffices.\(^14\) Second, the common law of fraud has long recognized recklessness as sufficient to satisfy the scienter requirement\(^15\) and Section 10(b) was enacted to strengthen, not weaken, investor protection as compared to the common law.\(^16\) Third, the doctrine of intentionality in fraud cases long ago held that recklessness suffices for at least three reasons. First, for more than three decades the lower courts have been virtually unanimous in holding that recklessness suffices.\(^14\) Second, the common law of fraud has long recognized recklessness as sufficient to satisfy the scienter requirement\(^15\) and Section 10(b) was enacted to strengthen, not weaken, investor protection as compared to the common law.\(^16\) Third, the doctrine of intentionality in fraud cases long ago held that recklessness suffices for at least three reasons. First, for more than three decades the lower courts have been virtually unanimous in holding that recklessness suffices.\(^14\) Second, the common law of fraud has long recognized recklessness as sufficient to satisfy the scienter requirement\(^15\) and Section 10(b) was enacted to strengthen, not weaken, investor protection as compared to the common law.\(^16\)

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\(^9\) See, e.g., Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963); Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961).


\(^11\) Relying upon legislative history and principles of statutory interpretation, the Court concluded in *Hochfelder*, a case involving an auditor defendant, that “[w]hen a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances - the commonly understood terminology of intentional wrongdoing - and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct,” 425 U.S. 185, 214 (1976).

\(^12\) *Hochfelder* also left unsettled the question of whether the scienter requirement applied in SEC actions as well. The Supreme Court quickly held that it did in *SEC v.Aaron*, 446 U.S. 680, 701-02 (1980).

\(^13\) See, e.g., Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1323-24 (2011); Tellabs, Inc. v. Makor & Rights Ltd., 551 U.S. 308, 319 n.3 (2007); 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. We need not address here the question whether in some circumstances reckless behavior is sufficient for civil liability under section 10(b) and Rule 10b-5.”).

\(^14\) Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action*, 40 ARIZ. L. REV. 1003, 1026 (1998) (“…all Circuits that have considered the issue have held that recklessness suffices”).

\(^15\) See, e.g., Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 n.30 (6th Cir. 1979) (“At common law, recklessness satisfied the scienter requirement for fraud.”) (*citing* Derry v. Peek, (L.R. 1889) 14 A.C. 337, 374; WILLIAM PROSSER, LAW OF TORTS § 107, at 700-01 (4th ed. 1971); Restatement of Torts § 526(b)).

\(^16\) Section 10(b) is based on the common law of fraud. P. Schoenfeld Asset Management LLC v. Cendant Corp., 142 F. Supp. 2d 589, 595 (D.N.J. 2001); Huddleston v. Herman & MacLean, 640 F.2d 534, 547 (5th Cir. 1981), *modified on other grounds*, 459 U.S. 375 (1983); Harris v. American Inv. Co., 523 F.2d 220, 224 (8th Cir. 1975) (“common law fraud concepts underlie the securities law” providing guidance regarding their reach an application; SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855 (2d Cir. 1968) (noting that Sec. 10(b) should be interpreted so as to liberalize the common law in order to effectuate its remedial purpose); In re Cendant Corp. Litig, 60 F. Supp. 2d 354, 368-69 (D.N.J 1999). The Supreme Court often accesses the common law for guidance regarding the meaning of Section 10(b). *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224, 231, 244 n.22 (1988); Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 290, 310 (1985); Chiarella v. United States, 445 U.S. 222, 227-28 (1980).

Significantly, Sec. 10(b) was meant to strengthen, not weaken that common law protection. *See, e.g.*, Texas Gulf Sulphur Co., 401 F.2d at 855 (noting that Sec. 10(b) should be interpreted so as to liberalize the common law in order to effectuate its remedial purpose), *cert denied*, 394 U.S. 976 (1969). The Supreme Court has agreed,
in 1995 Congress enacted the PSLRA that contains liability provisions premised upon the existence of recklessness-based Section 10(b) liability.\textsuperscript{17} Enactment of provisions that have no meaning without recklessness-based liability surely signals Congressional approval of that liability.\textsuperscript{18}

3. What form of recklessness is required to satisfy the scienter requirement?

Most lower courts concluded that for recklessness to suffice, it must be nearer true scienter than to gross negligence on the \textit{negligence}$$\rightarrow$$\textit{gross negligence}$$\rightarrow$$\textit{recklessness}$$\rightarrow$$\textit{scienter} continuum.\textsuperscript{19} Lower courts commonly require not just recklessness, but “severe” recklessness.\textsuperscript{20}

B. The PSLRA’s Role.

Although \textit{Hochfelder} and succeeding lower court cases established a high standard of liability, Silicon Valley high tech firms and large accounting firms believed that they were the victims of too many frivolous class action securities fraud lawsuits pursuant to Rule 10b-5 and other federal securities law provisions.\textsuperscript{21} Their lobbying procured the 1995 enactment of the

\textsuperscript{17} The PSLRA adopted proportionate, rather than joint and several, liability for defendants who are not found to have knowingly violated the securities laws. In other words, defendants guilty of true scienter remain jointly and severally liable while defendants who are only reckless benefit from being only proportionately liable (although this protection is limited by two exceptions involving “uncollectible shares” stemming from the existence of insolvent co-defendants). \textit{See} 15 \textit{U.S.C.} § 78u-4(f) (2006).


\textsuperscript{19} \textit{See}, \textit{e.g.}, Reiger v. Price Waterhouse Coopers LLP, 117 F. Supp. 2d 1003, 1011 (S.D. Cal. 2000) (“…no degree of negligence can satisfy the substantive element of scienter, or raise a strong inference of scienter”; Greebel v. FTP Software, Inc., 194 F.3d 185, 199 (1st Cir. 1999) (describing distinction between recklessness and negligence as “not just a difference in degree, but also in kind.”)).

\textsuperscript{20} \textit{See}, \textit{e.g.}, Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1281, 1282 n.18 (11th Cir. 1999) (holding that “severe recklessness” meets the scienter standards and stating that “[s]evere recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or so obvious that the defendant must have been aware of it.”).

According to some courts, this level of recklessness requires that defendants make statements that they know, or have access to information suggesting, are materially inaccurate. Ferris, Baker Watts, Inc. v. Ernst & Young, LLP, 395 F.3d 851 (8th Cir. 2005); In re Navarre Corp. Sec. Litig., 299 F.3d 735, 746 (8th Cir. 2002).

\textsuperscript{21} Other provisions targeted by the PSLRA include Sections 11 and 12 of the 1933 Securities Act. 15 \textit{U.S.C.} §§77k, 77l (2006).
Private Securities Litigation Reform Act (PSLRA), a massively pro-defendant reform provision. For current purposes, the most significant features of the PSLRA were its heightened pleading requirement, especially for the scienter element, and its provision that the filing of a motion to dismiss, on grounds of failure to adequately plead scienter (or other elements) stays discovery and therefore may prevent plaintiffs from procuring evidence to support their claims.

After the PSLRA, notice pleading was out, replaced by a requirement not only that any complaint pursuant to Rule 10b-5 “specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed,” but also that civil damage plaintiffs shall “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”

The PSLRA set a precedent. In 2007 and 2009, in the Twombly and Iqbal cases, the Supreme Court raised the pleading bar across all federal court cases by requiring plaintiffs to articulate a “plausible” basis for their claims, even before they can use discovery to seek support for them. The PSLRA also raised several questions.

1. How strict is the pleading standard under the PLSRA?

Because the facts that give rise to a strong inference of scienter must be alleged with particularity, many courts hold that plaintiffs must plead "the who, what, where, when, and how: the first paragraph of any newspaper story." Put another way, a complaint must (1) specify the statements that were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent. Other courts, however, hold that plaintiffs "need not plead the 'date, place or time' of the fraud, so long as they use an 'alternative means of injecting precision and some measure of substantiation into their allegations of fraud.'" And some of these courts have cautioned against requiring plaintiffs to plead with too much precision issues that may have been concealed by defendants.

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27 Id. at § 78u-4(b)(2)(A) (emphasis added). See generally Ferris, Baker Watts, Inc. v. Ernst & Young, LLP, 395 F.3d 851, 855 (8th Cir. 2005); Florida State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 654 (8th Cir. 2001) (both applying this standard).
30 Allegations of acts that are “merely consistent” with a defendant’s liability fails to cross the important threshold between possibility and plausibility. Twombly, 550 U.S. at 556.
31 In re Advanta Corp. Sec. Litig., 180 F.3d 525, 534 (3d Cir. 1999).
34 Rolo, 155 F.3d at 658; Schoenfeld, 142 F. Supp. 2d at 604.
These disagreements are critical because, as noted above, the PSLRA’s discovery stay that goes into effect upon the filing of any motion to dismiss can make it extremely difficult for plaintiffs to obtain the necessary factual details required by most courts in order to successfully plead scienter.\(^{35}\) A strict scienter pleading standard can create a very significant roadblock to a plaintiff’s prosecution of a Rule 10b-5 claim.

2. What is a “strong inference”?

The PSLRA requires plaintiffs to plead scienter with sufficient particularity to establish a “strong inference” that the intent requirement is met, but the lower courts could not agree on the meaning of a “strong inference.”\(^{36}\) The Supreme Court attempted to settle the issue in *Tellabs, Inc. v. Makor & Rights Ltd*,\(^{37}\) where it held that a court’s responsibility in applying the PSLRA pleading standard

...is not to scrutinize each allegation in isolation but to assess all the allegations *holistically*. In sum, the reviewing court must ask: When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter *at least as strong as any opposing inference*.\(^{38}\)

Given a potential range of competing inferences, the Court essentially ruled that a “tie goes to the plaintiff,” for an inference of scienter need not be *stronger* than competing inferences for the complaint to survive a motion to dismiss, it need only be just as strong. As indicated, the Court also demanded a holistic, rather than merely a piecemeal, examination of the evidence.\(^{39}\)

3. How does a plaintiff properly plead and prove scienter?

Another and more significant issue that pre-dated the PSLRA but became even more contentious after its passage regards how a plaintiff is to properly plead and prove scienter. Regarding how one goes about proving that a defendant acted with requisite scienter, many

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\(^{35}\) See Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ’33 and ’34 Act Claims*, 76 WASH. U. L. QU. 537, 578 (1998) (“when vigorously applied, the combination of a strict pleading standard with a stay of discovery creates a pleading barrier so high that few complaints will survive it.”).


\(^{38}\) *Id.* at 326 (citations omitted) (emphasis added) This strict approach is generally consistent with the Supreme Court’s holdings in *Iqbal* and *Twombly* that to survive motions to dismiss complaints must contain sufficient factual information that, if accepted as true (as they must be) they would state a claim “plausible on its face” and that facial plausibility is achieved when plaintiffs plead factual details that allow courts to draw reasonable inferences that defendant is liable for the alleged conduct. Ashcroft v. *Iqbal*, 129 S. Ct. 1937, 1940 (2009); Bell Atl. Corp. v. *Twombly*, 550 U.S. 544, 570 (2007).

\(^{39}\) Quintanilla argues that *Tellabs*, by “broaden[ing] the epistemic goal of decision-making by requiring federal courts to compare and contrast culpable and nonculpable explanations for behavior” will have laudable effects. Victor D. Quintanilla, Practitioner Note: *(Mis)Judging Intent: The Fundamental Attribution Error in Federal Securities Law*, 7 N.Y.U. J. L. & BUS. 195, 245 (2010). But Su surveys the case law and suggests that the “holistic” approach suggested by the Court in *Tellabs* simply gives the circuit courts sufficient latitude to simultaneously pretend to follow *Tellabs* yet retain their pre-*Tellabs* tests for scienter. *See* Victoria Su, Student Note, *Scienter After Tellabs*, 5 BROOK. J. CORP. FIN. & COM. L. 527, 547 (2011).
lower courts had previously developed two primary means. One involved proof of motive and opportunity while the other involved the use of circumstantial evidence. These remain the two primary ways of establishing scienter in the wake of the PSLRA, at least according to many courts.40


Motive and opportunity can be established by plaintiffs alleging facts indicating that defendant benefitted in a “concrete and personal way” from the alleged fraud.41 Motives that would be common to all actors in the defendants’ position will not suffice.42 Thus, if plaintiffs plead merely that corporate insiders manipulated the numbers because they wished to maintain a high market price for their company’s stock, that would not suffice even though it would certainly be reasonable to believe that defendants would wish to achieve that goal, because almost all insiders would have that same motivation.43 In other words, this allegation would not help distinguish the motives of fraudsters from the motives of all corporate insiders.

Insider trading by individual defendants is often deemed to satisfy the motive requirement, but only if it is unusual in amount or otherwise suspicious.44

b. Circumstantial Evidence.

The second primary means of alleging scienter involves circumstantial evidence that points to more than mere negligence by defendants.45 It is difficult to read a persons’ mind, so

40 In the Second Circuit, at least, a strong inference of scienter can be established by alleging facts either "(1) showing that the defendants had both motive and opportunity to commit the [alleged] fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness." In re Bear Stearns Sec. & Erisa Litigation, 2011 U.S. Dist. LEXIS 6026, at *171 (S.D.N.Y., Jan. 19, 2011). See also ATSI, Inc. v. The Shaar Fund, Ltd., 493 F.3d 87, 99 (2d Cir. 2007) (other courts agree); Shields v. Citytrust Bancorp, Inc. 25 F.3d 1124, 1128 (2d Cir. 1994); In re Agape Litigation, 2011 U.S. Dist. LEXIS 33587, at *21 (E.D.N.Y., Mar. 29, 2011).

41 Intent and motive are related, but separate. Intent refers to the state of mind with which an act is committed, whereas motive is what prompts the person to act. See Maurice E. Stucke, “Is Intent Relevant?,” (Jan. 26, 2012), available at http://www.ssrn.com/abstract=1991761, at 10 (citing sources).


45 Avon Pension Fund v. GlaxoSmithKline PLC, 343 Fed. Appx. 671 (2d Cir. 2009); Ganey v. PEC Solutions, Inc. 418 F.3d 379 (4th Cir. 2005); Acito v. IMCERA Group, Inc., 47 F.3d 47, 54 (2d Cir. 1995); Greebel v. FTP Software, Inc., 194 F.3d 185, 198 (1st Cir. 1999).

c. **Scienter and Outside Auditors.**

The focus of this paper is the scienter requirement as applied Rule 10b-5 claims against external auditors. It is clear that the scienter requirement does not demand that auditor defendants desire to injure people, only that they be able to foresee that certifying misleading financial statements that do not conform to GAAP can influence and thereby injure investors. Beyond that, not much is settled.

1. Should outside auditors receive special treatment in application of the scienter standard?

   a. Existence of special treatment for auditors.

To protect auditors from liability, lower courts are commonly especially demanding of plaintiffs attempting to plead fraud against such auditors. The Sixth Circuit, for example, has stated that “the meaning of recklessness in securities fraud cases is especially stringent when the claim is brought against an outside auditor.” Therefore, according to some courts, liability attaches in a Rule 10b-5 case only when the auditor acts with “at least deliberate recklessness.” Other courts say that auditors’ wrongdoing must “approximate actual intent” to aid the client’s fraud in order to satisfy the recklessness standard. Others require that the evidence clearly

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47 Clark v. United States, 132 F.2d 538, 540-41 (9th Cir. 1943) (“it is rare when direct proof of the devising of the scheme may be given. In most cases it must be inferred.”).
49 In re Navarre Corp. Sec. Litig., 299 F.3d 735, 742 (8th Cir. 2002); Florida State Bd. of Admin. v. Green Tree Fin.Corp., 270 F.3d 645, 660 (8th Cir. 2001).
50 AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 221 (2d Cir. 2000); In re WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 496 (S.D.N.Y. 2005).
52 PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 693 (6th Cir. 2004). Much more than a simple audit failure is required for the auditor to be liable. “It is well-settled that violations of GAAP and GAAS, standing alone, do not create an inference of scienter, much less a strong one.” Id. at 694.
53 See, e.g., In re Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 979 (9th Cir. 1999); Kelley v. Rambus, Inc., 384 Fed. Appx. 570, 573 (9th Cir. 2010); In re Verifone Holdings Sec. Litig., 2011 U.S. Dist. LEXIS 24964, at *20 (N.D. Cal., Mar. 8, 2011).
show that the auditor either aided the fraud or was so “egregiously irresponsible that no other accountant would have acted in the same manner.” Still other courts have held that when the recklessness standard for auditors is combined with the stringent PSLRA pleading provisions, “a simple rule emerges: to allege that an independent accountant or auditor acted with scienter, the complaint must allege specific facts showing that the deficiencies in the audit were so severe that they strongly suggest that the auditor must have been aware of the corporation's fraud.” These approaches nearly eliminate recklessness as a basis of liability for auditors, although it is unanimously recognized by lower courts as sufficient for all other Rule 10b-5 defendants.

The special treatment provided to auditors is generally accepted, with Professor Coffee going so far as to opine that auditors have “virtual immunity” under federal securities laws. Perhaps the strongest evidence that auditors are subject to special treatment is the fact that auditors are rarely named as defendants in securities class actions, even when their clients are accused of accounting fraud.

b. Rationale for special treatment for auditors.

This differential treatment of auditors is not justified by any language of Section 10(b) or Rule 10b-5. Nor is it supported by any policy considerations contained in the ’34 Act’s legislative history. The Supreme Court has not issued any rulings that would directly justify this differentiation. Nor do the PSLRA’s provisions or legislative history provide any clear

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58 For instance, Cornerstone Research finds that auditor were named are an annual rate of only 1%-6% of securities class action cases between 2006-10, while GAAP violations were alleged in between 26% and 57% of cases. STANFORD LAW SCHOOL SECURITIES CLASS ACTION CLEARINGHOUSE & CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS 2010: 2010 YEAR IN REVIEW 32 fig. 29 (2010), http://securities.stanford.edu/clearinghouse_research/2010_YIR/Cornerstone_Research_Filings_2010_YIR.pdf. Similar results obtain in earlier time periods as well. E.g., Ross D. Fuerman, Auditors and the Post-Litigation Reform Act Environment, 14 RES. ACC. REG. 199-218 (2000).
59 While the PSLRA’s scienter pleading requirements nowhere distinguish between corporate defendants and accountants, courts have imposed clear distinctions. Sherrie R. Savett, Securities Class Actions Since the 1995 Reform Act: A Plaintiff’s Perspective, in SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2005, at 17, 35-36 (PLI Corp. Law & Practice, Course Handbook Series No. 6746, 2005); Gideon Mark, Comment, Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA, 39 Conn. L. Rev. 1097, 1175 (2007). At least one court agrees. See In re AOL Time Warner, Inc. Sec. & ERISA Litig., 381 F. Supp. 2d 192, 239 n.49 (S.D.N.Y. 2004) (“…Ernst & Young's protestations notwithstanding, Rule 9(b) does not contemplate a higher standard for pleading fraud by an independent auditor than for pleading fraud by any other 10(b) defendant.”). Other courts have resisted creating a two-tiered standard that favored auditors. New Mexico State Investment Council v. Ernst & Young LLP, 2011 U.S. App. LEXIS 7680, at *10 (9th Cir., Apr., 2011) (citing South Ferry LP, No. 2 v. Killinger, 342 F.3d 776, 784 (9th Cir. 2008)) (advising against “developing "separate[ ] rules of thumb for each type of scienter allegation.")
support for a differential treatment of auditors regarding the pleading of scienter, although the impact of many of its provisions were very kind to them.\textsuperscript{60}

The grounds for being especially solicitous of external auditors are typically unexplained even in court opinions that explicitly grant this extra protection. One reason some courts have given to justify special treatment for auditors is the notion that "there are limits to the scope of liability for failure adequately to monitor the allegedly fraudulent behavior of others."\textsuperscript{61} Although these differential standards for outside auditors may be defended as generally consistent with a special solicitousness that the Supreme Court has exhibited for secondary actors in securities fraud cases, the rationale is also undermined by these same cases. While it might once have been seriously argued that auditors had to worry about facing liability for failing to adequately monitor their clients’ fraudulent conduct, today they can be liable for Rule 10b-5 civil damages only for making false statements themselves. The 1994 \textit{Central Bank} case eliminated any auditor civil damage liability for aiding and abetting clients’ fraud.\textsuperscript{62} The 2008 \textit{Stoneridge} case held that auditors cannot be liable even for their own fraudulent statements that helped fool third parties if investors did not rely directly upon those fraudulent statements.\textsuperscript{63} And, most recently, \textit{Janus Capital}\textsuperscript{64} held that a defendant’s (including presumably an outsider auditor’s) own fraudulent statements cannot be actionable unless that defendant’s fraudulent activities were known to investors at the time they made their investment decisions.\textsuperscript{65}

A second rationale for giving auditors special protection from securities liability is based primarily upon the assumptions that (a) auditors are rational actors, and (b) a short-term profit earned by looking the other way while a client commits a fraud would be outweighed by the...

\textsuperscript{60} Although GAAP violations are generally featured in a significant portion of securities fraud class actions (e.g., 44\% in 2005 and 68\% in 2006, from 1995 to 2006, auditors were named as defendants in just 8.4\% of such suits. \textit{See} Eric L. Talley, \textit{Cataclysmic Liability Risk Among Big Four Auditors}, 106 COLUM. L. REV. 1641, 1681-82 (2006) (and sources cited).

These developments occurred parallel with a diminished SEC emphasis on monitoring of accounting firms that lasted until Sarbanes-Oxley was enacted in 2002. \textit{See} John C. Coffee, Jr., \textit{What Caused Enron? A Capsule Social and Economic History of the 1990s}, 89 CORNELL L. REV. 269, 290 (2004) ("[F]rom some point in the 1980s until the late 1990s, the SEC shifted its enforcement focus away from actions against the Big Five accounting firms . . . ."); Jay M. Feinman, \textit{Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology}, 31 FLA. ST. L. REV. 17, 60 (2003) ("Although the [SEC] . . . has the formal authority to discipline accountants, that authority is rarely exercised."); Cassell Bryan-Low, \textit{SEC May Take Tougher Stance on Accountants in Audit Failures}, WALL ST. J., Dec. 13, 2002, at A2, available at LEXIS, News Library, WSJNL File ("During the past 25 years, the SEC has sued large accounting firms fewer than ten times for audit failures . . . ."). \textit{See also} Adam C. Pritchard, \textit{The Irrational Auditor and Irrational Liability}, 10 LEWIS & CLARK L. REV. 19, 54 (2006) ("Under the PSLRA, defendants who are only tangentially involved in the fraud will not face potentially bankrupting liability, so accountants do not have to serve as quasi-guarantors for the solvency of their clients.").

\textsuperscript{61} Novak v. Kasaks, 216 F.3d 300, 309 (2d Cir. 2000). Because \textit{Central Bank}, \textit{Stoneridge}, and \textit{Janus Capital} make it clear that auditors cannot be liable under Section 10(b)/Rule 10b-5 for simply failing to adequately monitor the frauds of others, this rationale is less persuasive.


\textsuperscript{64} \textit{Janus Capital, Inc.} v. First Derivative Traders, 131 S. Ct. 2296 (2011).

\textsuperscript{65} \textit{Id.} at 2309.

Between the Supreme Court and the PSLRA, external auditors are already receiving substantial protection from liability which mitigates against any need to accord them special scienter protection. On the other hand, the audit firms can respond that notwithstanding these cases, they still face SEC civil and Department of Justice criminal liability for aiding and abetting fraud and for making fraudulent statements from the shadows. They could argue that this is liability enough to motivate them to act properly, even though they are specially protected from liability in private damage actions. Whatever the merits of this debate, most courts grant auditors special protection when scienter is at issue.
profits auditors can gain by maintaining a good reputation. Although there are persuasive reasons to doubt both of these assumptions, courts have continued to apply them without ever addressing the substantial body of evidence that undermines them.

Class action attorneys argue that there are significant collateral consequences to application of an unreasonably high pleading standard regarding accountants... that “the corporation and corporate insiders can then blame the absentee accountants, using the classic ‘empty chair defense,’ a powerful jury argument for avoiding management liability.” But these pleas have failed to sway most courts.

c. Scope of special treatment for auditors.

Representative of the special protections accorded by most courts to external auditors when scienter pleading is at issue is the common, but arguably extreme, “no audit at all” test. This most pro-auditor formulation requires dismissal of a complaint unless it alleges that the defendant auditors’ actions amounted to “no audit at all” or, at most, to a “pretended audit.”

66 The most prominent proponent of this point of view is Judge Easterbrook. DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990) (Easterbrook, J.) (“An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses [defendant] would suffer from a perception that it would muffle a client's fraud.”). Many other courts have found these assumptions persuasive. See, e.g., In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1427 n.7 (9th Cir. 1994); In re Suprema Spec., Inc., 438 F.3d 256, 282 (3d Cir. 2006); Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994); Reiger v. Price Waterhouse Coopers LLP, 117 F. Supp. 2d 1003, 1008 (S.D. Cal. 2000) (“a large independent accountant will rarely, if ever, have any rational economic incentive to participate in its client's fraud.”).

67 See Max H. Bazerman et al., Why Good Accountants Do Bad Audits, HARV. BUS. REV., Nov. 2002, at 96, 99; Robert A. Prentice, The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation, 95 NW. U. L. REV. 133 (2000); Mark, supra note __, at 1174-1205. All of these articles mine the literature of behavioral psychology and related fields to argue that auditors and audit firms, like most individuals and organizations, do not act rationally much of the time. Even if they did, however, there are many very practical reasons, including the lack of real competition among audit firms, the tremendous costs to audit clients of switching firms, and the short-term advantages that individual auditors could gain by making decisions that might undermine the long-term reputation of their firms that make it rational for auditors to violate the rules. See Prentice, Irrational Auditor supra this note at 199-207.

As Kahn and Lawson have observed:

…it is hard to dispute the evidence of what actually happens. ‘Despite the clear logic of the gatekeeper rationale, experience over the 1990s suggests that professional gatekeepers do acquiesce in managerial fraud, even though the apparent reputational losses seem to dwarf the gains to be made from the individual client.’ Or, as King Arthur said to the Black Knight in Monty Python and the Holy Grail when the Black Knight refused to acknowledge that both of his arms had been cut off: ‘Look!’

68 The “reputation always outweighs fees” argument has been accepted even when the defendant firm was very small (allegedly “a couple of guys in a strip mall down in ... New Jersey.”) In re MRU Holdings Sec. Litig., 2011 U.S. Dist. LEXIS 15969, at *52 (S.D.N.Y., Feb. 17, 2011). One familiar with Bernard Madoff’s auditor, who collected healthy fees for years without ever doing a substantive audit, certainly might wonder about the strength of the reputational constraint upon small firms. DIANA B. HENRIQUES, THE WIZARD OF LIES 254-55 (2011)


70 See, e.g., Ferris, Baker Watts, Inc. v. Ernst & Young, LLP, 395 F.3d 851, 855 (8th Cir. 2005) (applying without necessarily adopting “no audit at all” standard); In re Refco, Inc. Sec. Litig., 2011 U.S. Dist. LEXIS 33554,
As most commonly phrased, this test, which might be called the *Price Waterhouse* test, provides that plaintiffs must plead and prove

…that accounting practices were so deficient that the audit amounted to *no audit at all*, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decision.

As phrased, this is an extremely malleable standard. Note that this formulation of the standard allows courts to apply anywhere from a nearly impossibly high bar ("no audit at all") to a standard that is arguably so low as to improperly require only negligence rather than scienter ("no reasonable accountant would have made the same decision").

2. How does the motive and opportunity test apply to external auditors?

As noted earlier, most courts allow plaintiffs pleading scienter to point to both the motive and opportunity of defendants and the circumstantial evidence indicating that they have acted fraudulently. Regarding the motive and opportunity test, auditors generally cannot profit by millions of dollars from corporate fraud like company insiders can, so their economic incentives to commit fraud are arguably not nearly as strong as those of their clients and their clients’ employees. Therefore, unless auditors take bribes or engage in insider trading, two presumably rare events (especially given professional independence strictures against an auditor’s owning stock in a client), it seems very difficult for plaintiffs to plead scienter by auditor defendants via the motive and opportunity test. This is particularly true because the courts reject as

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72 While the courts have applied the “no audit at all” standard primarily in class action cases for damages, they have also applied it to SEC actions. SEC v. KPMG LLP, 412 F. Supp. 2d 349, 379 (S.D.N.Y. 2006); SEC v. Gold, 2006 U.S. Dist. LEXIS 87042, at *4 (E.D.N.Y. 2006). Indeed, it apparently originated in just such a case, SEC v. *Price Waterhouse*, 797 F. Supp. 1217 (S.D.N.Y. 1992).

73 See also PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 693-694 (6th Cir. 2004); In re Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 627 (9th Cir. 1994).

74 When this standard is applied, courts may conclude that liability may arise if an auditor’s “judgment, at the moment exercised, was sufficiently egregious such that a reasonable accountant reviewing the facts and figures should have concluded” that they were erroneous and investors were likely to be misled. In re IKON Office Solutions, Inc. Sec. Litig., 277 F.3d 658, 666 (3d Cir. 2002); In re American Bus. Fin. Serv., Inc. Noteholders Litig., 2008 U.S. Dist. LEXIS 61450, at *24 (E.D.Pa., Aug. 11, 2008).

75 AICPA, CODEN OF PROFESSIONAL CONDUCT, Interpretation 101-1.

76 This is not to say that accountants never get into trouble for insider trading. Despite the seeming irrationality of risking their professional reputation, they do engage in insider trading from time to time. See, e.g., United States v. Ruggiero, 56 F.3d 647 (7th Cir. 1995); SEC v. Stephen V. Humphries, 1999 SEC LEXIS 2452.
insufficient the pleading of an auditor’s most obvious economic motive for intentionally overlooking an audit client’s fraud—they wish to keep the client as a client and retain the flow of audit-related and consulting-related revenue flowing from that client. Although at least one court seemed amenable to the notion that preserving the existence of an accountant-client relationship might provide evidence of motive, virtually all other courts view this as a “general motive” that would apply to all auditor defendants and therefore as worthless for pleading scienter against a specific auditor in a specific case.

3. How does the circumstantial evidence test apply to auditors?

As Professor Coffee has pointed out, with strict judicial assumptions that auditors do not act with reckless or fraudulent motives in place, “the plaintiff faces a 'Catch 22' dilemma in suing the auditor: it cannot plead fraud with particularity until it obtains discovery, and it cannot obtain discovery under the PSLRA until it pleads fraud with particularity.” This often makes it impossible for plaintiffs to collect the circumstantial evidence that is the only remaining route to pleading scienter against an auditor.

So, how does the circumstantial evidence test apply to auditors? Where motive is not alleged and plaintiffs rely entirely on circumstantial evidence to support allegations of


See, e.g., In re Leslie Fay Cos., Inc. Sec. Litig., 835 F. Supp. 167, 174 (S.D.N.Y. 1993) (holding that the existence of an accountant-client relationship, in addition to an “unlikely degree of mere carelessness” on the part of the accountant gives rise to an inference of motive).

Loss aversion, the fact that people dread losses more than they anticipate gains, provides psychological evidence for the conclusion that auditors might well be strongly motivated to please a current client to avoid losing it to another audit firm. See generally ROBIN M. HOGARTH, EDUCATING INTUITION 166-167 (2001). The Supreme Court has intuited accurately that an accountant would be more likely to commit fraud to keep a current client happy than to acquire a new client. Edenfield v. Fane, 507 U.S. 761, 774 (1993).

See, e.g., In re AOL Time Warner, Inc. Sec. & ERISA Litig., 381 F. Supp. 2d 192 (S.D.N.Y. 2004); Queen Uno Ltd. Partnership v. Coeur D’Alene Mines Corp., 2 F. Supp. 2d 1345, 1360 (D.Colo. 1998) (characterizing allegations that Ernst & Young was motivated to commit fraud to ensure continued receipt of audit fees from client as “absurd”); ICD Holdings S.A. v. Frankel, 976 F. Supp. 234, 245 n.51 (S.D.N.Y. 1997) ("the fact that the professional service firms like [defendant] receive fees for their services is insufficient to supply the motive essential to the motive-and-opportunity theory . . ."); In re Worlds of Wonder Securities Litigation, 35 F.3d 1407, 1427 n.7 (9th Cir. 1994) (rejecting this argument as "utterly without merit"); Dileo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990); Duncan v. Pencer, 1996 U.S. Dist. LEXIS 401, *33-34 (S.D.N.Y. 1996) (holding that it would be "economically irrational" for a large accounting firm to "condone a client's fraud in order to preserve a fee that, at best, is an infinitesimal percentage of its annual revenues and, by doing so, jeopardize its reputation and license, as well as subject itself to potential damages literally tens of thousands of times as large as its fee"). Shields v. Citytrust Bankcorp, Inc., 25 F.3d 1124, 1130 (2d Cir. 1994) ("In looking for a sufficient allegation of motive, we assume that the defendant is acting in his or her informed economic self-interest.").

Of course, the fact that all auditors generally would like to keep the clients and attendant income and individual auditor would all like to keep their jobs does not mean that sometimes audit firms and individual auditors do not commit fraud for these purposes. In re Crazy Eddie Sec. Litig., 812 F. Supp. 338, 344 (E.D.N.Y. 1993) (auditor Ferrara told client officer that he did not investigate a suspicious transaction because he might have had to leave account).

79 Coffee, Understanding Enron, supra note __, at 1410.
recklessness, the evidence presented must be proportionally greater, according to some courts, although most courts do not explicitly require this greater proportionality. In accounting cases, catch-all or blanket allegations often comprise mere claims of misreported numbers or GAAP and/or GAAS violations; courts nearly unanimously hold that such allegations, standing alone, will not suffice. “[T]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter.”

What “more” might suffice for plaintiffs attempting to plead scienter? Consider the following factors that are often raised by plaintiffs as circumstantial evidence of auditor scienter.

a. Size of mistakes.

Allegations of mere accounting errors are generally viewed as providing no evidence of scienter or recklessness by the external auditor. But what if those errors were really large? A fifty dollar error is one thing; a fifty million dollar error is arguably something else entirely. However, in any given case it is likely unclear ahead of time whether a court will decide that a large accounting error provides circumstantial evidence of scienter or not. Many courts hold that even large errors provide evidence of negligence, but not of scienter. The court said in DiLeo v. Ernst & Young, “[f]our billion dollars is a big number, but even a large column of big numbers need not add up to fraud.” However, other courts have held that a sufficiently large error can indeed provide evidence of at least recklessness.


81 See, e.g., Kushner v. Beverly Enters., Inc. 317 F.3d 820, 831 (8th Cir. 2003); In re K-Tel Int’l, Inc. Sec. Litig., 300 F.3d 881, 890 (8th Cir. 2002); In re Navarre Corp. Sec. Litig., 299 F.3d 735, 742 (8th Cir. 2002); Novak v. Kasaks, 216 F.3d 300, 309 (2d Cir. 2000) (“Allegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim.”); Stevelman v. Alias Research, Inc., 174 F.3d 79, 84 (2d Cir. 1999) (“Allegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient to state a securities fraud claim.”).

82 In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1426 (9th Cir. 1994) (emphasis added). See also In re Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 627 (9th Cir. 1994); The Limited, Inc. v. McCrory Corp., 645 F. Supp. 1038, 1045 (S.D.N.Y. 1986).

83 It is unsurprising that courts find that small errors are evidence of negligence rather than of fraud. Lewis v. Straka, 2007 U.S. Dist. LEXIS, 59054 at *8 (E.D. Wis., Aug. 13, 2007) (“The amount that was misreported was a very small amount; the most that can reasonably be inferred from the misreporting is mistake rather than fraud.”).

84 Id. at * 12 (“large losses” do not create an inference of scienter). Huge errors do not indicate scienter or raise a strong inference of scienter under the PSLRA, some courts hold, because “no degree of negligence” can create Rule 10b-5 liability. Reiger v. Price Waterhouse Coopers LLP, 117 F. Supp. 2d 1003, 1014 (S.D. Cal. 2000).

85 DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990).

86 Id. at 627.

87 See, e.g., Spiegel, Inc. Sec. Litig., 382 F. Supp. 2d 989, 1036 (N.D.Ill. 2004) (finding a strong inference of scienter where defendants missed an understatement of $3 million in debt and an overstatement of $325,000 weighs heavily in favor of finding recklessness disregard); New Mexico State Investment Council v. Ernst & Young LLP, 2011 U.S. App. LEXIS 7680, at *27-28 (9th Cir., Apr., 2011) (holding that “while magnitude alone is not sufficient to support a finding of scienter, large GAAP and GAAS violations can play a role in finding scienter”); Carley Capital Group v. Deloitte & Touche, 27 F.
A compromise approach is embodied in court opinions holding that the magnitude of a client’s fraud can support an inference of scienter regarding the external auditor, but only when the plaintiff pleads specific and detailed facts indicating that the magnitude should have either enhanced the suspiciousness of identified transactions or should have made the overall fraud glaringly obvious.88

b. Multiple GAAP and GAAS errors.

There are disagreements regarding the evidentiary import of multiple errors as well as of large errors. Again, a GAAP or GAAS error is one thing. Multiple such errors might well constitute something else. In some cases, courts hold that multiple GAAP and GAAS violations are simply evidence of careless auditing.89 But again, there is confusion. In other cases multiple GAAP or GAAS errors have been deemed evidence of actionable recklessness.90

c. Restatements.

Even when GAAP violations lead to a restatement of financial statements, most courts agree that “while … subsequent restatement[s] do indeed provide some circumstantial evidence from which to infer scienter, ‘GAAP violations without more, do not establish scienter.’”91 But, yet again, other courts hold that a large restatement can provide circumstantial evidence of scienter.92 They are more likely to so hold when the accounting issue involved was simple,93 than when it was complex.94 And if the fraud was well hidden from the auditor by the client, even a massive restatement will not necessarily signal auditor scienter.95

94 In re Acterna Corp. Sec. Litig., 378 F. Supp. 2d 561, 583 (D. Md. 2005) (holding that a large restatement is not evidence of auditor’s scienter where the accounting issue called for “complicated analysis”).
d. Auditor access, non-audit services, and alumni.

Many courts conclude that the fact that an auditor had full access to and detailed knowledge of its clients’ affairs and records also fails to give rise to an inference of scienter.\(^{96}\) However, it seems that if courts rely heavily on the fact that auditors have been fooled by clients or had information withheld by their clients to support a conclusion that there was a lack of scienter, as they often do,\(^ {97}\) then complete access should mitigate in favor of a scienter finding, at least where there are sizable errors.\(^ {98}\)

Similarly, plaintiffs sometimes allege that other ties between the auditor and client, including former employees of the auditor now employed by the client and the provision of non-audit services, help establish scienter. However, courts generally hold that the provision of non-audit services for a client with a failed audit is evidence only of negligence.\(^ {99}\) The Enron case appears to be an exception to this general rule, as it includes a detailed discussion of Andersen’s change in policies regarding both non-audit services and waiting periods for employees to become employees of the audit client.\(^ {100}\) While it is difficult to generalize from the Enron case due to its unique nature and the numerous alleged auditor improprieties, Congress notably restricted both non-audit services to public audit clients and movement by employees of auditors and their clients in the Sarbanes-Oxley Act of 2002.\(^ {101}\)

A case concerning an audit firm alumnus is emblematic of the difficulty in establishing scienter. In *AUSA Life Ins. Co. v. Ernst & Young*,\(^ {102}\) the court found not only numerous GAAP violations, but actual knowledge and acquiescence by the audit firm in the violations.\(^ {103}\) The court found that Ernst & Young acquiesced in the fraud due to the “close personal relationship” between the Ernst & Young lead audit partner and the client’s chief executive, his former

\(^{96}\) *See, e.g.*, Reiger v. Price Waterhouse Coopers LLP, 117 F. Supp. 2d 1003, 1009 (S.D.Cal. 2000) (“an independent accountant’s relationship and acquired familiarity with its client does not impute the accountant with knowledge of every idiosyncratic detail associated with the client’s business”); Queen Uno Ltd. Pship. v. Coeur D’Alene Mines Corp., 2 F. Supp. 2d 1345, 1360 (D. Colo. 1998) (“It is equally implausible to assert that because an accountant had access to a company’s internal data, it by implication was aware of any fraudulent scheme, no matter how far-reaching. Such a broad-based rule would, as other courts have noted, subject any accountant or high-ranking company official to liability for even the most obscure allegation of fraud.”); Queen Uno, 2 F. Supp. 2d at 1360 (“It is equally implausible to assert that because an accountant had access to a company’s internal data, it by implication was aware of any fraudulent scheme, no matter how far-reaching. Such a broad based rule would, as other courts have noted, subject any accountant or high-ranking company official to liability for even the most obscure allegation of fraud.”).

\(^ {97}\) *Dimplex*, 1993 U.S. Dist. LEXIS 11224, at *5 (agreeing that auditor Deloitte was as much a victim of the fraud as were plaintiffs).

\(^ {98}\) In *re Spiegel, Inc. Sec. Litig.*, 382 F. Supp. 2d 989, 1036 (N.D.Ill. 2004). In *In re WorldCom*, 352 F. Supp. 2d at 472, the court emphasized that Arthur Andersen had touted its approach as one where it understood in depth its clients’ business model and the court held that this made it difficult for Andersen to claim that it was not willfully blind to the host of accounting irregularities of its client WorldCom. *Id.* at 499.


\(^ {101}\) Sarbanes-Oxley §§ 201(a) & 209.


\(^ {103}\) AUSA Life Ins. Co. v. Ernst & Young 991 F. Supp. 234, 246 (S.D.N.Y. 1999) (stating that the “irregularities resulted in substantial overstatement of JWP’s income in each of the years 1988 through 1990, with E&Y’s knowledge and acquiescence. The annual no-default letters issued by E&Y were also false in that they certified that JWP’s books had been kept in accordance with GAAP, which E&Y knew was untrue.”).
partner. Despite the findings of both actual knowledge of the fraud and the personal relationship as reason for the acquiescence, the court stated (without actually resolving the issue) that the scienter issue was “a close question.” The case was initially dismissed on loss causation grounds, but the Second Circuit reversed and also found the facts presented to be sufficient to establish scienter. However, the fact that any judge could find the issue of scienter in such a case to be questionable exemplifies the inherent malleability of the standard.

e. Auditor resistance to client practices.

When auditors call clients’ attention to improper auditing practices, sometimes courts view this as evidence that they are trying to do a good job and indicative of an absence of scienter, even if the auditors proceed to certify that the financial statements accord with GAAP. However, in other cases courts have held that even threatening to issue a going concern opinion does not necessarily insulate an auditor from liability if the auditor has proceeded to certify the financial statements with knowledge of these issues, although it “cut[s] strongly in [the auditor’s] favor”.

f. Rapid discovery of fraud by third parties.

When a third party such as a new CFO or a successor audit firm quickly discovers a fraud that the external auditor has overlooked for years, many courts find evidence supporting scienter. However, other courts find this not to be persuasive evidence of scienter.

4. The importance of red flags.

Today no concept is more important to the scienter issue in auditor litigation than the red flag. Although a heightened pleading standard applied in auditor cases such as the “no audit at all” test often appears on its face to be nearly insurmountable, when so inclined courts have held

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104 Id. at 248. The court went on to state that “the record suggests that, in their confrontations with [the chief executive officer, the audit partner] and his associates exhibited a level of tolerance and timidity inappropriate for an independent auditor. The ‘watch dog’ behaved more like a lap dog.” Id.
105 Id.
106 AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 220 (2d Cir. 2000).
107 Notably, the facts of the case were part of the motivation for revising auditor independence standards. See Revision of the Commission’s Auditor Independence Requirements, 2000 SEC LEXIS 2717, *152 n. 262 (Nov. 21, 2000).
110 Drabkin, 905 F.3d at 455-56.
111 In re Bear Stearns Cos., Inc. Sec., Derivative, & ERISA Litig., 2011 U.S. Dist. LEXIS 6026, at *___ (S.D.N.Y., Jan. 19, 2011) (plaintiffs alleged that two parties discovered Bear Stearns’ financial statements’ overvaluation of assets and underestimation of risk exposure in a single weekend); In re New Century, 588 F. Supp. 2d 1206, 1231 (C.D. Cal. 2008) (holding that the fact that a new CEO discovered accounting violations within months of taking the position provided evidence for an inference that KPMG’s audit had been deliberately reckless).
that "[a] complaint might reach the 'no audit at all' threshold by alleging that the auditor disregarded specific 'red flags' that would place a reasonable auditor on notice that the audited company was engaged in wrongdoing to the detriment of its investors."\textsuperscript{113}

A reading of court opinions supports a hypothesis that when courts desire to dismiss a case, they often focus upon the "no audit at all" branch of the Price Waterhouse test, ignoring its other alternatives (egregious refusal to see, no reasonable accountant, etc.).\textsuperscript{114} And, in so doing, they are strict in how they define the notion of a red flag. Some cases hold that when auditors ignore red flags and uncritically accept their clients’ explanations on all accounting issues, their actions constitute "no audit at all."\textsuperscript{115} Courts refuse to find "fraud by hindsight,"\textsuperscript{116} but if red flags are present at the time of the audit and the defendant auditors ignore them or investigate them insufficiently, then plaintiffs may be held to be neither second-guessing nor alleging fraud by hindsight.\textsuperscript{117}

In applying the red flag approach to judging the adequacy of scienter pleading against auditors, courts tend to look for allegations of "in your face facts" that cry out "how could defendant auditor not have known that these financial statements were false?"\textsuperscript{118} Because red flags must be viewed in context and as a part of the totality of the situation, it is perhaps painting with too broad a brush to subject to side-by-side comparison courts’ treatments of specific types of red flags. Nonetheless, to do so seems to provide further evidence of the confusion in the case law and the need for empirical examination.

\textsuperscript{113} In re Bear Stearns, 2011 U.S. Dist. LEXIS 6026, at * 511. See also In re AOLTime Warner Sec. Litig., 381 F. Supp. 192, 240 (S.D.N.Y. 2004) ("[a]llegations of 'red flags,' when coupled with allegations of GAAP and GAAS violations, are sufficient to support a strong inference of scienter."); New Mexico State Investment Council v. Ernst & Young LLP, 2011 U.S. App. LEXIS 7680, at *32 (9th Cir., Apr., 2011); In re Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 279-80 (3d Cir. 2006) (citing cases); In re the Leslie Fay Cos., Inc., Sec. Litig., 871 F.Supp. 686, 699 (S.D.N.Y. 1995) ("Because [the accountant] was immersed in [the company's] operations while performing its audit, and because the "red flags" would clearly be evident to any auditor performing its duties, one could reasonably conclude that [the accountant] must have noticed the "red flags," but deliberately chose to disregard them to avoid antagonizing [the company] and incidentally frustrating its fraudulent scheme."); In re First Merchants Acceptance Corp. Sec. Litig., 1998 U.S. Dist. LEXIS 17760, at *32-33 (N.D.Ill., Nov. 4, 1998) ("The allegations in the complaint, including the magnitude of the misstatements, the specific GAAP and GAAS violations and the 'red flags' together support an inference that Deloitte’s audit amounted to no audit at all or an egregious refusal to see the obvious or investigate the doubtful.").

\textsuperscript{114} See, e.g., In re Refco, 2011 U.S. Dist. Lexis 33554, at *39-40 (noting that the “no audit at all” cases “do not hold that the plaintiff must show that the auditor’s conduct amounted to no audit at all”…they may also show “or an egregious refusal to see the obvious, or to investigate the doubtful, or that they accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts”), quoting In re Scottish Re Group Sec. Litig., 524 F. Supp. 2d 370, 385 (S.D.N.Y. 2007), quoting in turn SEC v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992); P. Schoenfeld, 142 F. Supp. 2d at 608 (noting that although the court was not willing to hold that the defendant had done no more than a pretended audit, the number and magnitude of red flags could lead to a finding of “an egregious failure to see the obvious or investigate the doubtful such that no reasonable accountant would have made the same decisions if confronted with the same facts”).


\textsuperscript{116} Maiden, U.S. Dist. LEXIS 84083, at *13; Higginbotham v. Baxter Intl, Inc., 495 F.3d 753, 759-60 (7th Cir. 2007) ("Hindsight is the only basis of the proposed inference - and, as the Court observed in Tellabs, citing a famous opinion by Judge Friendly, there is no 'fraud by hindsight'.").


\textsuperscript{118} New Mexico State Investment Council v. Ernst & Young LLP, 2011 U.S. App. LEXIS 7680, at *32 (9th Cir., Apr., 2011); In re Oxford Health Plans, 51 F. Supp. 2d at 290.
Red flags, say some courts, are the audit risks or “risk factors” that auditors are to consider under GAAS when performing an audit.\(^\text{119}\) As in other areas of scienter analysis, courts have considerable discretion in characterizing events as red flags and in drawing conclusions from them, meaning that results are often inconsistent.\(^\text{120}\)

a. Generally reliable red flags.

   i) Whistleblowers.

   Apparently reliable tips from knowledgeable whistleblowers are usually treated as a red flag that cannot be ignored by auditors. In re Sunbeam Securities Litigation\(^\text{121}\) is a case where plaintiffs satisfied pleading requirements by pointing to numerous red flags, including not only GAAP and GAAS violations, but also allegations that the auditor failed to properly investigate internal controls, was tipped off by a Sunbeam employee regarding accounting improprieties, and ignored a press article alleging Sunbeam had manipulated the financial statements. In In re Lehman Brothers Sec. & ERISA Litig.,\(^\text{122}\) the court threw out most claims for lack of red flags, but did allow one claim to proceed based on a Lehman insider telling auditor Ernst & Young (which then did nothing about it) that Lehman was using “Repo 105’s” (barely disguised loan transactions) to temporarily take $50 billion in debt off its books at the end of every quarter.\(^\text{123}\)

   ii) Resignation of previous auditor.

   Another red flag courts have naturally given weight is the mid-audit resignation of a previous external auditor, typically the defendant’s predecessor.\(^\text{124}\)

b. Not necessarily red flags.

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\(^{119}\) See, e.g., McCurdy v. SEC, 396 F.3d 1258, 1261 (D.C.Cir. 2005); In re Bear Stearns Cos., Inc. Sec., Deriv. & ERISA Litig., 763 F. Supp. 2d 423 (S.D.N.Y. 2011); AOL Time Warner, 381 F. Supp. 2d 192, 240 n. 51 (S.D.N.Y. 2004); In Re Sunterra, 199 F. Supp. 2d at 1333 (M.D. Fla. 2002). ("Red flags’ are those facts which come to the attention of an auditor which would place a reasonable auditor on notice that the audited company was engaged in wrongdoing to the detriment of its investors.").


\(^{121}\) 89 F. Supp. 2d 1326 (S.D. Fla. 1999).


\(^{123}\) See also In re Crazy Eddie Sec. Litig., 812 F. Supp. 338, 340 (E.D.N.Y. 1993) (ignoring an anonymous whistleblower’s tip was part of the evidence of scienter underlying securities fraud that was predicate to a RICO claim).


Most categories of red flags are treated inconsistently, sometimes viewed as red flags that should have put auditors on notice of fraud that they ignored at the peril. And sometimes not.

i) Knowledge of weak internal controls.

An auditor’s knowledge of a client’s poor internal controls usually carries little weight with courts.125 Like simple allegations of departures from GAAP, these allegations may well be deemed “boilerplate allegations” of red flags.126 When accounting firms notice poor controls and extend their normal auditor procedures in order to compensate, that is obviously evidence that mitigates against a finding of scienter.127 On the other hand, some courts do hold that knowledge of weak controls can, in tandem with other facts, support a finding of scienter.128

ii) End of quarter transactions.

Another seemingly obvious red flag is the presence of large end-of-quarter transactions,129 although not all courts agree. For instance, in one case the plaintiff alleged that the client recorded as “start-up fees” two revenue transactions, one for $250,000 and the other for $338,220 on the last day of the fiscal year, never previously having recorded a start-up fee exceeding $5,000. The plaintiffs also alleged that twelve other revenue transactions were questionable for a variety of reasons, including no signed agreement, no license fee specified, no payment required within twelve months, unexpired customer cancellation privileges, and incomplete performance by the software firm. Despite these questionable transactions, the auditor issued a clean opinion. Later the client admitted GAAP violations and issued a restatement.130 Even assuming the claims were true, however, the court stated that a failure to investigate in such a situation “established only negligence rather than scienter.”131

iii) Aggressive accounting practices.

Some courts have found red flags where a client’s accounting practices were arguably in violation of GAAP and/or more aggressive than their competitors’ practices.132 Other courts, however, have found this to be evidence only of negligence, unless the auditor was actively involving in advising the client regarding the overly aggressive accounting practices, in which

125 E.g., Ley v. Visteon Corp., 543 F.3d 801, 816 (6th Cir. 2008) (finding that knowledge of weak internal controls coupled with large GAAP errors was not sufficient to establish scienter).
127 In re IKON Office Solutions, Inc., 227 F.3d 658, 672 (3d Cir. 2002).
128 N.M. State Inv. Council v. Ernst & Young, 641 F.3d 1089, 1095 (9th Cir. 2011) (finding that in tandem with many other factors, evidence of auditor’s knowledge of weak internal controls helped plaintiffs get over the scienter pleading bar).
129 See, e.g., In re AOL Time Warner, Inc. Sec. & ERISA Litig., 381 F. Supp. 2d 192 (S.D.N.Y. 2004); In re Homestore.com, Inc. Sec. Litig., 252 F. Supp. 2d 1018, 1044 (C.D. Cal. 2003) (finding that "the most significant of these red flags was the fact that on numerous occasions, major transactions took place within the last few days of the quarter").
131 Id. at 390
case the courts are more likely to hold that the auditor was guilty of scienter for overlooking the aggressiveness.\textsuperscript{133}

iv) Unusual accounting practices.

When auditors find evidence of unusual accounting practices, sometimes courts view a failure to further investigate as mere negligence,\textsuperscript{134} but other times view it as a red flag that was ignored, signaling scienter.\textsuperscript{135}

v) Other sloppy auditing practices.

Courts have held that lack of evidential matter and numerous unsupported entries were “red flags” indicative of fraud when the auditor ignored them.\textsuperscript{136} Contrariwise, other courts have held that failure to gather evidential matter and otherwise comply with GAAS did not necessarily constitute evidence of misconduct beyond simple negligence.\textsuperscript{137}

This part concludes that courts are deeply divided regarding the scienter standard to be applied in auditor cases, which acts constitute circumstantial evidence of scienter, and which acts do or do not raise red flags that potentially convert auditor carelessness into auditor scienter. However, these conclusions are based on a reading of the case law that was extensive, but scarcely complete or systematic. Therefore, Part II undertakes a rigorous empirical analysis designed to either confirm or contradict the initial conclusion that the case law is so malleable that it can support most conclusions in most cases, granting judges nearly complete discretion in ruling on motions to dismiss.

II. AN EMPIRICAL ANALYSIS OF SCIENTER CASE LAW RELATED TO AUDITOR DEFENDANTS

A. Introduction and Sample Description.

Previous empirical studies have generally supported the conclusion reached in Part I, that there is great uncertainty in the law regarding scienter pleading under Rule 10b-5. Grundfest and Pritchard, in studying the early years of post-PSLRA pleading, found little predictability in court decisions and noted:

\textsuperscript{133} E.g., In re Imax Sec. Litig., 587 F. Supp. 2d 471, 484 (S.D.N.Y. 2008).
\textsuperscript{134} See, e.g., Dimplex v. Scovill, Inc., 1993 U.S. Dist. LEXIS 11224, at *5 (S.D.N.Y., Aug. 12, 1993) (holding that an auditor’s failure to pursue certain “smelly documents” and to follow up on discrepancies and exceptions” was only evidence of negligence).
\textsuperscript{135} See, e.g., In re WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 498 (S.D.N.Y. 2005).
\textsuperscript{136} See, e.g., P. Schoenfeld Asset Management LLC v. Cendant Corp., 142 F. Supp. 2d 589, 609 (D.N.J. 2001)
\textsuperscript{137} See In re Crocs, Inc. Sec. Litig., 774 F.2d 1124, 1154 (D. Colo. 2011) (allegations of failure to follow GAAS and secure adequate evidential material may constitute only negligence, with court emphasizing that plaintiffs did not allege that any Deloitte employee was present at any specific meeting in which fraudulent scheme was discussed); Montalvo v. Ernst & Young, LLP, 2005 U.S. Dist. LEXIS 22753, at *17 (E.D. Mo., Sept. 30, 2005) (similar).
Judges can also value ambiguity to the extent that it allows them greater latitude to exercise discretion, more room within which to compromise with colleagues, and increased opportunity to avoid resolutions that they view as unjust or incorrect by whatever metric they might apply. Judge Posner, for example, suggests that judges often vote "their policy preferences and personal convictions," within the confines of the "rules" of judging, as part of the judging "game."\(^{138}\)

Does an empirical study of Rule 10b-5 scienter cases involving auditors support or undermine this picture? To examine this issue, we collect data from securities class action complaints where the auditor is named. Our initial sample comes from the RiskMetrics Securities Class Actions Services database and includes cases naming auditors as defendants where the original case was filed between 1996 and 2005 and the auditor portion of the case was resolved by December 2011. We utilize this time period because all cases are under the same legal framework under the PSLRA, and cases against auditors often take numerous years to resolve. We then match cases involving auditors to complaints from the Stanford Securities Class Action Clearinghouse. In order to keep data collection manageable and to ensure that the defendant firms have reasonably similar resources, we limit our sample to cases against the Big 4 (formerly, Big 5 and Big 6) audit firms that involve claims under Rule 10b-5. The sample includes a total of 144 cases involving the major audit firms.

B. Variable Definitions.

Due to our limited sample size, we cannot code every possible allegation by plaintiffs and still maintain sufficient degrees of freedom to conduct analyses. However, we define numerous commonly used allegations, and utilize common themes (Notice, Risk, and Independence) to group certain variables and define other variables individually.

The Notice group variable includes allegations that the auditor was informed or had notice of the alleged fraud, from either the press (Press) or a firm employee (Employee), such as a whistleblower. The Risk group includes several variables that commonly imply that a client’s audit is higher risk than normal, including poor internal controls (Controls), financial distress (Distress), unusual or questionable transactions, particularly at the end of financial reporting periods (Transactions), and executive turnover (Turnover). The final group is Independence, which includes allegations that the auditor was “too close” to the client, including the provision of non-audit services (NAS), if there were alumni from the audit firm at the client, and if the auditor was alleged to have unlimited or unusually high access to the client (Access).\(^{139}\)

The individual variables are broken out separately for two reasons. First, the “Benchmark” variable, defined as the client firm displaying an unusual propensity to hit earnings/revenue benchmarks or debt covenants, does not fit well within another group. Second, other individual variables may have implications beyond simply being a red flag. For instance, in addition to providing the auditor notice that the client may have an incentive to commit fraud, the “Offering” variable indicates that Section 11 liability is likely also present.\(^{140}\) SEC” and

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\(^{139}\) Prior research finds that non-audit service fees result in a higher probability of settlement. Jaime J. Schmidt, *Perceived Auditor Independence and Audit Litigation: The Role of Nonaudit Services Fees*, ACCT. REV. (forthcoming 2012).

\(^{140}\) Section 11 of the 1933 Act is, of course, a negligence-based liability provision. 15 U.S.C. Sec. 77k.
“Restatement” can be viewed as providing relatively “hard evidence” that something was wrong in the client’s financial statements. In particular, the Restatement variable provides an admission of an accounting misstatement, although courts generally hold that a restatement by itself is not indicative of scienter. “High audit fees” may provide evidence of scienter, but the inference behind this variable is substantially crowded due to its mechanical relation with litigation risk. A vast accounting literature finds that auditing firms price litigation risk into engagements. Thus, relatively high audit fees could indicate not only the idea that the client “bought off” the auditor or that the auditor could not afford to lose the client, but also that the auditor was aware of potential litigation risk. The “GAAS” variable indicates that the plaintiff alleges that the audit process itself was deficient.

These variables are defined in detail in Table 1. Each variable is an indicator variable, equal to one if the definition is met, zero otherwise. The group heading variables are equal to one if any sub-variable is equal to one, zero otherwise. Table 1 also contains the relative frequency with which each type of allegation appears in the sample.

Table 1: Variable Definitions

<table>
<thead>
<tr>
<th>Group variables</th>
<th>Specific allegation</th>
<th>Definition</th>
<th>% of cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notice</td>
<td>Press</td>
<td>A press story questioned client accounting practices.</td>
<td>38.2%</td>
</tr>
<tr>
<td></td>
<td>Employee</td>
<td>A client firm employee told the auditor about fraud or questionable accounting practices.</td>
<td>29.2%</td>
</tr>
<tr>
<td>Risk</td>
<td>Controls</td>
<td>Internal controls were deficient or inadequate.</td>
<td>69.4%</td>
</tr>
<tr>
<td></td>
<td>Distress</td>
<td>The client was in financial distress/filed for bankruptcy.</td>
<td>38.2%</td>
</tr>
<tr>
<td></td>
<td>Transactions</td>
<td>Questionable, complex, or unusual client transactions should have alerted the auditor of suspicious activity.</td>
<td>70.1%</td>
</tr>
<tr>
<td></td>
<td>Turnover</td>
<td>A high level executive left the firm or was fired.</td>
<td>38.2%</td>
</tr>
<tr>
<td>Independence</td>
<td>NAS</td>
<td>Non-audit service (NAS) fees made the client very important to the audit firm.</td>
<td>59.0%</td>
</tr>
<tr>
<td></td>
<td>Alumni</td>
<td>Alumni of the audit firm are in prominent positions at the client, particularly in financial reporting.</td>
<td>36.8%</td>
</tr>
<tr>
<td></td>
<td>Access</td>
<td>The auditor had “unlimited” (or similar word) access to the client’s books and operations.</td>
<td>15.3%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Individual variables</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benchmark</td>
<td>The firm had unusual consistency meeting earnings or revenue benchmarks (year-to-year growth, analyst</td>
</tr>
</tbody>
</table>

141 Stephen J. Choi et al., The Screening Effect of the Private Securities Litigation Reform Act. 6 J. EMPIRICAL LEGAL STUD., 35 (2009).
142 E.g., Dsam Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 390 (9th Cir. 2002).
144 Note that the “Group” percentage will not necessarily be the sum of the specific allegation percentages because many complaints make multiple allegations in the same area.
<table>
<thead>
<tr>
<th>Offering</th>
<th>The client had an equity offering, debt offering, or engaged in a merger/acquisition during the class period.</th>
<th>79.9%</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC</td>
<td>The SEC investigated the firm’s accounting practices.</td>
<td>30.6%</td>
</tr>
<tr>
<td>Restatement</td>
<td>Financial statements from the alleged fraud period were later restated.</td>
<td>65.3%</td>
</tr>
<tr>
<td>High audit fees</td>
<td>Large audit fees made the client very important to the audit firm.</td>
<td>34.7%</td>
</tr>
<tr>
<td>GAAS</td>
<td>Violations of generally accepted auditing standards (GAAS) occurred during the audit.</td>
<td>70.1%</td>
</tr>
</tbody>
</table>

C. Univariate Correlations.

Table 2 contains univariate (Pearson) correlations between the primary independent variables (as defined above) and two outcome variables. The first outcome variable is “Settle,” indicating the case survived the motion to dismiss. The second outcome variable is “Merit,” indicating the auditor settled the case for at least $5 million, the approximate cost of taking an average case to trial. On a univariate basis, 118 (81.9%) of the cases survive the motion to dismiss and settle (Settle), while only 52 (36.1%) of the cases reach a settlement of at least $5 million (Merit). Prior studies use similar definitions of meritorious outcomes with respect to the primary defendants in securities class actions.  

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145 The audit firms disclosed that they spent an average of approximately $3.5 million defending a Rule 10b-5 securities class action case in 1991 dollars. J. Michael Cook et al., *The Liability Crisis in the United States: Impact on the Accounting Profession*, 174 J. ACCTCY. 18 (Nov. 1992). Adjusted for inflation, this is equivalent to roughly $5 million per case over our sample period.

**Table 2: Pearson Correlation Matrix**

<table>
<thead>
<tr>
<th></th>
<th>Merit</th>
<th>Notice</th>
<th>Risk</th>
<th>Indep.</th>
<th>Bench.</th>
<th>Offering</th>
<th>SEC</th>
<th>Restatement</th>
<th>High Fee</th>
<th>Audit Fee</th>
<th>GAAS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Settle</td>
<td>0.35</td>
<td>-0.04</td>
<td>-0.00</td>
<td>-0.02</td>
<td>0.17</td>
<td>-0.06</td>
<td>0.15</td>
<td>0.26</td>
<td>0.23</td>
<td>-0.11</td>
<td></td>
</tr>
<tr>
<td>Merit</td>
<td>0.21</td>
<td>0.14</td>
<td>0.28</td>
<td>0.04</td>
<td>-0.06</td>
<td>0.32</td>
<td>0.28</td>
<td>0.24</td>
<td>0.04</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notice</td>
<td>0.29</td>
<td>0.28</td>
<td>0.10</td>
<td>-0.03</td>
<td>0.19</td>
<td>0.09</td>
<td>0.24</td>
<td>0.33</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk</td>
<td>0.40</td>
<td>0.12</td>
<td>-0.02</td>
<td>0.15</td>
<td>0.09</td>
<td>0.27</td>
<td>0.47</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Independence</td>
<td>0.03</td>
<td>-0.03</td>
<td>0.34</td>
<td>0.25</td>
<td>0.61</td>
<td>0.72</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Benchmark</td>
<td>0.27</td>
<td>-0.01</td>
<td>-0.03</td>
<td>0.10</td>
<td>-0.06</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Offering</td>
<td></td>
<td>-0.04</td>
<td>-0.00</td>
<td>-0.11</td>
<td>-0.06</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SEC</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.29</td>
<td>0.43</td>
<td>0.27</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Restatement</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.29</td>
<td>0.10</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>High Audit Fee</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.48</td>
</tr>
</tbody>
</table>
The correlations in Table 2 reveal several interesting patterns. First, even on a univariate basis, the Settle variable is uncorrelated with many of the most common plaintiff allegations: Notice, Risk, Independence, Offering, and GAAS. The only independent variables significantly (at the 10% level, as noted by bold type) correlated with Settle are Benchmark, SEC, Restatement, and High Audit Fee. Second, the Merit variable is significantly correlated with more variables, indicating that settlement negotiations may take into account factors that do not appear to influence courts. While the Benchmark variable loses significance, the Notice and Risk variables become significant when correlated with Merit.

Among the independent variables, the correlations are as one would expect. For instance, SEC and Restatement are highly correlated (0.29), while all of the variables that relate to the auditor’s conduct (Independence, High Audit Fee and GAAS) are highly correlated.

D. Multivariate Analysis.

We now move to a multivariate setting to investigate which factors are most relevant to the court’s decision. We utilize logistic regression because we have a binary dependent variable. Our first model is as follows:

\[
\text{Prob (Settle = 1)} = F (\alpha + \beta_1 \text{Notice} + \beta_2 \text{Risk} + \beta_3 \text{Independence} + \beta_4 \text{Benchmark} + \beta_5 \text{Offering} + \beta_6 \text{SEC} + \beta_7 \text{Restatement} + \beta_8 \text{High Audit Fee} + \beta_9 \text{GAAS})
\] (1)

“Settle” is a dichotomous variable that is set to one if a lawsuit withstands the motion to dismiss, and to zero otherwise. F is the cumulative distribution function of the logistic distribution, and other variables are as defined above.

Model 2 is identical to model 1, but the dependent variable is “Merit,” which is set to one when the auditor settles for at least $5 million, zero otherwise. This model is provided to provide corroborating evidence regarding whether the factors that the court takes into account also affect the settlement negotiation. The second model is as follows:

\[
\text{Prob (Merit = 1)} = F (\alpha + \beta_1 \text{Notice} + \beta_2 \text{Risk} + \beta_3 \text{Independence} + \beta_4 \text{Benchmark} + \beta_5 \text{Offering} + \beta_6 \text{SEC} + \beta_7 \text{Restatement} + \beta_8 \text{High Audit Fee} + \beta_9 \text{GAAS})
\] (2)

Models 3 and 4 are very similar to models 1 and 2, respectively, but break the Notice, Risk, and Independence variables into their sub-components. Models 3 and 4 are as follows:

\[
\text{Prob (Settle = 1)} = F (\alpha + \beta_1 \text{Press} + \beta_2 \text{Employee} + \beta_3 \text{Controls} + \beta_4 \text{Distress} + \beta_5 \text{Transactions} + \beta_6 \text{Turnover} + \beta_7 \text{NAS} + \beta_8 \text{Alumni} + \beta_9 \text{Access} + \beta_{10} \text{Benchmark} + \beta_{11} \text{Offering} + \beta_{12} \text{SEC} + \beta_{13} \text{Restatement} + \beta_{14} \text{High Audit Fee} + \beta_{15} \text{GAAS})
\] (3)

\[
\text{Prob (Merit = 1)} = F (\alpha + \beta_1 \text{Press} + \beta_2 \text{Employee} + \beta_3 \text{Controls} + \beta_4 \text{Distress} + \beta_5 \text{Transactions} + \beta_6 \text{Turnover} + \beta_7 \text{NAS} + \beta_8 \text{Alumni} + \beta_9 \text{Access} + \beta_{10} \text{Benchmark} + \beta_{11} \text{Offering} + \beta_{12} \text{SEC} + \beta_{13} \text{Restatement} + \beta_{14} \text{High Audit Fee} + \beta_{15} \text{GAAS})
\] (4)

Table 3 presents results from estimating these regressions (*, **, and *** indicate statistical significance at the 10%, 5% and 1% levels, respectively, in two-tailed tests):
### Table 3: Logistic Regression Results

Panel A: Regressions utilizing group variables

<table>
<thead>
<tr>
<th>Model</th>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent Variable</td>
<td>Settle</td>
<td>t-stat</td>
</tr>
<tr>
<td>Intercept</td>
<td>1.30</td>
<td>1.34</td>
</tr>
<tr>
<td>Notice</td>
<td>-0.33</td>
<td>0.62</td>
</tr>
<tr>
<td>Risk</td>
<td>0.38</td>
<td>0.44</td>
</tr>
<tr>
<td>Independence</td>
<td>-0.79</td>
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</tr>
<tr>
<td>Benchmark</td>
<td>1.15*</td>
<td>1.85</td>
</tr>
<tr>
<td>Offering</td>
<td>-1.12</td>
<td>1.45</td>
</tr>
<tr>
<td>SEC</td>
<td>0.51</td>
<td>0.75</td>
</tr>
<tr>
<td>Restatement</td>
<td>1.39**</td>
<td>2.56</td>
</tr>
<tr>
<td>High Audit Fee</td>
<td>1.75**</td>
<td>2.38</td>
</tr>
<tr>
<td>GAAS</td>
<td>-1.09</td>
<td>1.40</td>
</tr>
<tr>
<td>n</td>
<td>144</td>
<td>144</td>
</tr>
<tr>
<td>Pseudo R$^2$</td>
<td>0.295</td>
<td>0.272</td>
</tr>
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</table>

Panel B: Regressions utilizing all individual variables

<table>
<thead>
<tr>
<th>Model</th>
<th>(3)</th>
<th>(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent Variable</td>
<td>Settle</td>
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<tr>
<td>Intercept</td>
<td>1.41</td>
<td>1.48</td>
</tr>
<tr>
<td>Press</td>
<td>0.20</td>
<td>0.33</td>
</tr>
<tr>
<td>Employee</td>
<td>-0.42</td>
<td>0.56</td>
</tr>
<tr>
<td>Controls</td>
<td>0.03</td>
<td>0.05</td>
</tr>
<tr>
<td>Distress</td>
<td>0.29</td>
<td>0.50</td>
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<tr>
<td>Transactions</td>
<td>-0.33</td>
<td>0.49</td>
</tr>
<tr>
<td>Turnover</td>
<td>-0.19</td>
<td>0.29</td>
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<tr>
<td>NAS</td>
<td>-0.66</td>
<td>0.85</td>
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<tr>
<td>Alumni</td>
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<td>Access</td>
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<td>Benchmark</td>
<td>1.28*</td>
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<tr>
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<td>1.42</td>
</tr>
<tr>
<td>SEC</td>
<td>0.37</td>
<td>0.52</td>
</tr>
<tr>
<td>Restatement</td>
<td>1.35**</td>
<td>2.30</td>
</tr>
<tr>
<td>High Audit Fee</td>
<td>2.16**</td>
<td>2.48</td>
</tr>
<tr>
<td>GAAS</td>
<td>-0.96</td>
<td>1.16</td>
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<tr>
<td>n</td>
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<td>144</td>
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<tr>
<td>Pseudo R$^2$</td>
<td>0.318</td>
<td>0.356</td>
</tr>
</tbody>
</table>
Models 1 and 3 produce consistent results, with only Benchmark, Restatement and High Audit Fee being significant. Thus, courts do not appear to be influenced by most of the allegations in plaintiffs’ complaints, and in particular there is little consistency in the treatment of red flags. Courts specifically state that restatements, without accompanying red flags, are not indicative of fraud.\textsuperscript{147} High Audit Fee is also consistent with increased litigation risk being correlated with auditors being sued,\textsuperscript{148} which is not particularly surprising. Thus, Benchmark is the only variable that could be interpreted as a red flag that is significant.

When examining which cases reach settlements that likely reflect a meritorious underlying case, the results from estimating models 2 and 4 suggest that other factors also play a role. For instance, in model 2, Notice and SEC are also significant. The results from estimating model 4 suggest that reports in the press (Press) are driving the relationship between Notice and Merit. The statistical significance of SEC and Notice/Press seem reasonable with respect to the meritorious outcome of cases. The fact that these are significant in reach a material settlement, but not in the dismissal decisions of courts lends some support to the view that court decisions are not systematic.

Similar to earlier results, Restate remains significant in all specifications, although High Audit Fee is significant only in Model 2. Interestingly, Independence is marginally significant in model 2, and the results from model 4 suggest that this is driven by a significantly negative relation between Access and Merit. While this relation is difficult to explain logically, it could be that cases where the plaintiff makes allegations consistent with the Access variable represent cases that are relatively weaker and other facts consistent with fraud do not exist.

E. Sensitivity Analysis.

It is of course possible that other factors affect case outcomes. For instance, professors Pritchard and Sale examine how case outcomes in securities class actions against the primary defendants vary by circuit, focusing on the Second and Ninth where the highest number of cases are filed. Again, our relatively small sample size does not lend itself to this type of within-circuit analysis as even the Second Circuit (29 cases) and Ninth Circuits (24 cases) have relatively few cases. However, we do examine whether the circuit in which the case is filed could affect the motion to dismiss decision by including indicator variables for the three circuits with at least 15 cases (in addition to the Second and Ninth, the Eleventh Circuit has a relatively high filing rate with 15 cases). None of these circuit indicator variables are significant, and the coefficients on other variables are not significantly affected.

In addition, as noted above, the Offering variable could be an imperfect proxy for Section 11 liability. We code a separate indicator variable for whether a case has a Section 11 claim, and re-examine the outcome of the motion to dismiss decision. We include this variable in lieu of the Offering variable. We find that this variable is marginally significant (p = 0.087) in the equivalent of model (1), but marginally insignificant the equivalent of model (3) (p = 0.120).

\textsuperscript{147} E.g., Dsam Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 390 (9\textsuperscript{th} Cir. 2002).
\textsuperscript{148} See, e.g., Simunic & Stein, supra note ___, at ___.

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III. IMPLICATIONS

Part I’s reading of numerous cases pursuant to a doctrinal analysis indicates that the courts largely agree that auditor defendants in Rule 10b-5 cases should receive special protection in the form of higher pleading standards, but also reveals that there is substantial court disagreement regarding what form that special protection should take, what facts provide circumstantial support for a claim of auditor scienter, and what facts might constitute red flags indicating that auditors who ignored them were more than merely negligent. These conclusions are reaffirmed by Part II’s empirical conclusions that few factors are consistently viewed by the courts as indicative (or not) of auditor scienter. What are the practical implications of these findings?

A. Uncertainty.

The uncertainty of Rule 10b-5 pleading doctrine and its application has greatly bothered auditors. Part of their complaint is overblown, for it is not as though auditors are saying: “Oh, we thought that ignoring red flags was okay” or “Oh, we thought it was okay to let our client book large, extraordinary transactions on the last day of the fiscal year.” Whether or not judges view these actions as indicative of scienter, they do indicate unsound (even if only negligent) auditing practices. Auditors are not saying: “We thought it was okay to do these things.” What they are saying is: “We know we shouldn’t do these things, but we would like to be more certain about the adverse consequences of doing things we know we shouldn’t.” This is a legitimate complaint, but not a terribly sympathetic one.\footnote{Auditors also complain that potential damages turn “on factors outside the auditor’s control. Center for Audit Quality, Report of the Major Public Company Audit Firms to the Department of the Treasury Advisory Committee on the Auditing Profession (2008), available at http://www.thecaq.org/publicpolicy/treasurydata.htm. that is a bit of an overstatement, at least regarding the topic of this paper. If auditors do good audits and do not make mistakes that are material, the excessive malleability of scienter pleading law is unlikely to cause them a significant problem.}

On the other hand, auditors are on firm ground when they complain that unpredictable scienter doctrine makes it very difficult for them to judge the settlement value of a case.\footnote{Id. at 35 (“...confronted with a lawsuit in which it faces an uncertain outcome at trial and potentially catastrophic liability if it loses. Settlement is therefore often viewed as the only sensible alternative, because no firm has the resources to take a case to trial when the downside risk is a multi-billion dollar or even a multi-hundred dollar, catastrophic judgment.”).} And this is obviously a very significant concern as well for plaintiffs and, of course, plaintiffs’ attorneys. Plaintiffs’ attorneys, in particular, make very substantial economic investments when they file Rule 10b-5 class actions lawsuits,\footnote{For class action plaintiffs’ attorneys, the filing of a lawsuit is an investment decision, and typically a very expensive one. John C. Coffee, Jr., Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 COLUM. L. REV. 669, 684-90 (1986); Ronald A. Dabrowski, Note, Proportionate Liability in Rule 10b-5 Reckless Fraud Cases, 44 DUKE L.J. 571, 591 (1994).} and it is difficult for them to gauge the wisdom of such a filing when it is unclear how courts will treat the known scienter evidence. For both plaintiffs and defendants, the uncertainty of scienter pleading doctrine has decidedly unsatisfactory consequences.

B. Judicial Discretion
When applicable legal rules are in great dispute and their application in specific cases is unconstrained, as both the doctrinal and empirical portions of this article indicate is the case for the Rule 10b-5 scienter pleading standard, judges enjoy plentiful discretion in deciding whether to dispose of Rule 10b-5 private suits for damages in their early stages.

This might be a good thing. Hart and Sacks have noted regarding the application of law that “[d]iscretion is a vehicle of good far more than of evil. It is the only means by which the intelligence and good will of a society can be brought to bear directly upon the solution of hitherto unsolved problems.”152 Arthur Miller has agreed: “I love judicial discretion….We have to give [district judges] some elbow room objectively, individually, and contextually.”153

An extraordinarily subjective scienter test with lots of play in the joints allows trial judges who have a gut feeling that an overall claim is nonmeritorious to dispose of the case very early on, at a savings of resources to society, to defendants, and even to plaintiffs. Allowing such discretion could lead to superior resolutions of disputes.154 One may read a bevy of these opinions and conclude that few of them seem plainly erroneous on their face. That is a good sign.

Of course, judges are lawyers and it would be a poor lawyer who, given the opportunity to select from a range of pliable legal rules and to pick and choose among factual allegations, could not cobble together a reasonably persuasive argument for whichever choice he or she made. After analyzing what seemed to be a particularly questionable pro-defendant decision by the Fourth Circuit in Public Employees’ Retirement Ass’n of Colorado v. Deloitte & Touche, LLP,155 Steinberg and Appel noted that the “no audit at all” standard “can be applied to shield virtually any decision requiring an auditor’s judgment or discretion in the performance of the audit, beyond purely technical accounting treatments.”156

Still, if federal judges are honest, objective, and rational, granting them great discretion, as current scienter pleading law does, seems largely unobjectionable. However, while few question federal judges’ subjective honesty, there are substantial grounds upon which to challenge their rationality and objectivity.

1. Judges’ bounded rationality.

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154 See Su, supra note __, at 546, noting that “…there are benefits to giving judges some sort of interpretive latitude. A determination of scienter sometimes requires judges to look beyond the facts to the nuances of the case. Proving the mental state of a defendant is already difficult; thus, by allowing judges to look holistically at all of the claims to get the bigger picture, they are able to come to a more equitable conclusion.”).  
155 551 F.3d 305 (4th Cir. 2009).
Although economists have traditionally modeled people as rational actors, this is only roughly accurate. Herbert Simon won a Nobel Prize in economics by establishing that people are rational, but only boundedly so. An important part of the new knowledge that undermines the rational actor model is the heuristics and biases literature created by Nobel Prize winner Daniel Kahneman and Amos Tversky and their intellectual progeny. There is now a vast amount of research in this field establishing a large number of related (and sometimes overlapping) heuristics, biases, and other cognitive errors that ensure that people generally fall short of full rationality when they make decisions.

Because judges are people, it makes sense to assume that they are subject to these forces. And, empirical studies demonstrate, they are. Professors Guthrie and Rachlinski, along with Federal Magistrate Andrew Wistrich found evidence that judges, being human beings like the rest of us, are subject to a range of heuristics, biases, and cognitive limitations, including anchoring and adjustment, framing, the representativeness heuristic, the egocentric (overconfidence) bias, and the hindsight bias. Hastie and Viscusi have also found evidence that judges are subject to the hindsight bias. And in a different study, Guthrie, Rachlinski, and Wistrich found that judges, like most everyone else, tend to jump to conclusions without adequate reflection. As these authors observe, “intuition is generally more likely than

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157 Quintanilla, supra note __, at 198-99 (“…our legal intuitions are shaped by the assumption that humans are self-interested beings who behave as free moral agents and who make rational choices. Woven throughout our jurisprudence is the theory that humans are motivated to act out of self-interest and that every individual is rational and selfish.”).

158 Robert Trivers recently wrote that the “alleged science called economics…has resolutely failed to ground itself in underlying knowledge, at a cost to all of us.” ROBERT TRIVERS, THE FOLLY OF FOOLS 8 (2011).

159 People have a tendency to focus on an initial number or position, even if it is completely irrelevant to the decision to be made, and then to fail to adjust adequately in the face of new information. See RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE 23-24 (2009).

160 People often change their decisions in completely inconsistent ways depending upon how the question put to them is framed. See Jeffrey J. Rachlinski, Heuristics and Biases in the Courts: Ignorance Or Adaptation?, 79 ORE. L. REV. 61, 99 (2000) (“Like anchoring, framing seems to lie beyond the ability of courts to identify, regardless of whether the issue involves a judge or a jury.”).

161 The representativeness heuristic is “reliance on the degree of apparent similarity between the features of the events to the features of the category in judgment whether an event is a member of a particular category,” Rachlinski, Heuristics and Biases in the Courts, supra note __, at 83. It causes problems “because people tend to rely on the representativeness heuristic to the exclusion of other information relevant to categorical judgments,” Id. at 83, such as base rate information. Judges are subject to the representativeness heuristic. Id. at 99 (gathering evidence suggesting that judges often fall prey to the representativeness heuristic).

162 The egocentric bias is another term for overconfidence; judges manifest it in various ways, including by being poorly calibrated regarding their chances of being overturned on appeal. Guthrie et al., Inside the Judicial Mind, 86 CORNELL L. REV. 777, 814 (2001). See also Guthrie et al., The “Hidden Judiciary”: An Empirical Examination of Executive Branch Justice, 58 DUKE L.J. 1477, 1518-20 (2009) (finding substantial evidence of judges’ overconfidence in their judging abilities).

163 The hindsight bias is the tendency to conclude that things that have happened were more foreseeable than they actually were. See Jeffrey J. Rachlinski et al., Inside the Bankruptcy Judge’s Mind, 86 B. U. L. REV. 777, 779-80 (2001); Guthrie et al., Inside the Judicial Mind, supra note __, at 784.


165 Chris Guthrie, et al., Blinking on the Bench: How Judges Decide Cases, 93 CORNELL L. REV. 1, 11-13, 27-28 (“These results suggest that judges tended to favor intuitive rather than deliberative faculties.”… “When awarding damages, assessing liability based on statistical evidence, and predicting outcomes on appeal, judges seemed inclined to make intuitive judgments.”).
deliberation to lead judges astray.” What is the impact of judges’ bounded rationality when they are called upon to rule upon the allegations of scienter in Rule 10b-5 cases?

2. The Impact of decisional heuristics and biases.

Different heuristics and biases in different contexts will nudge decision making in different directions. As it happens, most of the relevant heuristics and biases in the current context will probably benefit securities fraud defendants to the detriment of plaintiffs.

a. Overconfidence.

People’s minds are “overconfidence machine[s].” In impossibly high percentages, most people believe that they are above average drivers, above average auditors, above average eyewitnesses and pretty much above average everything else. People chronically overestimate their own knowledge and ability to make accurate judgments.

To the extent that judges are affected by the overconfidence bias, and they are, granting them excessive discretion to dispose of cases at the pleading stage could be detrimental to a search for justice. It will tend to cause judges to conclude that they can with some measure of prescience predict more accurately than is actually the case whether plaintiffs if given

This model was initially developed by Nobel Prize winner Daniel Kahneman and Shane Frederick. See id. at 7-9.

166 Guthrie et al., Blinking on the Bench, supra note 196, at 5. See also id. at 29 (“an excessive reliance on intuition will lead to erroneous judicial decisions.”). See also Amos Tversky & Daniel Kahneman, Judgment Under Uncertainty: Heuristics and Biases, 185 SCI. 1124, 1124 (1974) (arguing that intuitive thinking can “lead to severe and systematic errors.”).

167 DAVID BROOKS, THE SOCIAL ANIMAL 218 (1911).


171 See Lyle A. Brenner, et al., Overconfidence in Probability and Frequency Judgments: A Critical Examination, 65 ORG. BEHAV. & HUM. DECISION PROCESSES 212, 218 (1996) (reporting study finding overconfidence as well as poor use of base rate information and vulnerability to representativeness heuristic); Hillel J. Einhorn, Overconfidence in Judgment, 4 NEW DIRECTIONS FOR METHODOLOGY OF SOC. AND BEHAV. SCI. 1 (1980) (quoting Will Rogers: “It’s not what we don’t know that gives us trouble. It’s what we know that ain’t so.”).


173 See Piero Calamandrei, EULOGY OF JUDGES 21 (John Clarke Adams & C. Abbott Phillips, Jr., trans., 1942) (“I fear the judge who is too sure of himself, who reaches his decision quickly, jumping immediately to conclusions without deliberation or repentance.”).
the opportunity to engage in discovery could find evidence supporting their scienter allegations.\textsuperscript{174}

b. Self-serving bias.

One of the most influential of the heuristics and biases is the \textit{self-serving bias}, the tendency people have to gather information, process information, and even remember information in such a manner as to advance their own self-interests or their own pre-existing views.

Top Enron executives were paid huge bonuses based on \textit{projected} profits in deals they put together. Psychological studies show that they were prone to seek out information that would support the highest plausible valuations.\textsuperscript{175} This is called the confirmation bias,\textsuperscript{176} and it accounts for people with conservative political views being more likely to watch Fox News while liberals are more likely to watch MSNBC.\textsuperscript{177}

The self-serving bias also affects how people process information. Thus, supporters of competing political candidates watching the same debate each tend to conclude that “their guy” won.\textsuperscript{178} A study showed that when a pro-capital punishment group and an anti-capital punishment group were each shown the same document with arguments for and against capital punishment, members of both groups tended to construe the document as favoring their diametrically opposed positions and, indeed, felt more fervently about their point of view after reading the document than before.\textsuperscript{179}

The self-serving bias even affects how people remember information.\textsuperscript{180} Studies show people are more likely to recall evidence that supports their own point of view than evidence that opposes it.\textsuperscript{181}

\textsuperscript{176} The confirmation bias is the tendency to seek out information that supports a hypothesis and to ignore or downplay conflicting information. Mark W. Dirsmith, et al., \textit{Of Paradigms and Metaphors in Auditing Thought}, 2 \textit{Contemp. Acc. Res.} 46, 56-57 (1986) (citing Henry Mintzberg, et al., \textit{The Structure of ‘Unstructured’ Decision Processes}, 21 \textit{Admin. Sci. Q.} 246 (1976)). This is particularly the case when the hypothesis is one already adopted by a person or that is consistent with the person’s self-interest. \textbf{Scott PloS}, \textit{The Psychology of Judgment and Decision Making} 231-34, 238-40 (1993).
\textsuperscript{177} \textbf{Drew Westen}, \textit{The Political Brain} xiv, 100 (2007) (noting that the pleasure centers of people’s brains light up when they find information supporting their preexisting beliefs). \textit{See also id.} at 100 (neuroimaging suggests that “our brains have a remarkable capacity to find their way toward convenient truths—even if they’re not all that true.”).
\textsuperscript{178} See, e.g., Robert P. Vallone, et al., \textit{The Hostile Media Phenomenon: Biased Perception and Perceptions of Media Bias in Coverage of the Beirut Massacre}, 49 \textit{J. Personality & Soc. Psychol.} 577 (1985) (showing that opposing groups on political spectrum each thought that the media had been biased in favor of their opponent). And fans of opposing football teams who each watch a tape of the game are likely to think that their team got shafted by the referees. \textit{See Albert H. Hastorf & Hadley Cantril}, \textit{They Saw a Game: A Case Study}, 49 \textit{J. of Abnormal & Soc. Psychol.} 129, 131 (1954).
\textsuperscript{179} \textit{Westen, supra} note \__, at 101.
\textsuperscript{180} \textit{Trivers, supra} note \__, at 25 (noting how self-interest causes us to “continually create false personal narratives”).
\textsuperscript{181} \textit{See Ziva Kunda}, \textit{The Case for Motivated Reasoning}, 108 \textit{Psychol. Bull.} 480, 483, 493-94 (1990) (discussing how people are subject to motivated reasoning, but cannot just believe anything, so under the “illusion of
Because of the self-serving bias, doctors who own stakes in testing labs order significantly more tests than doctors who do not. And studies show that even auditors, who are trained to be independent, analytical and skeptical, are strongly affected by the self-serving bias.

The self-serving bias indicates that judges’ holdings will be influenced by their preexisting political and policy beliefs, and large numbers of empirical studies indicate that this is the case. Judges even misremember the facts of cases in ways that support their subconsciously endorsed racial stereotypes.

What this means for the current topic is that if judges are predisposed to believe that federal securities fraud lawsuits are often frivolous or that it would be irrational for auditors to audit recklessly, they will tend to search through complaints and supporting documents for objectivity” they search their memories in a selective fashion to construct justifications for their desired conclusions).

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182 Margaret Heffernan, Willful Blindness 185 (2011) (quoting physician David Ring).

183 See C. Bryan Cloyd & Brian C. Spilker, The Influence of Client Preferences on Tax Professionals’ Search for Judicial Precedents, Subsequent Judgments and Recommendations, 74 ACCT. REV. 299, 301 (1999) (finding that after studying certain provided precedents, one-half of accountant subjects recommended a position known to be favored by their clients, even though a panel of experts concluded that there was only a 14% chance that the position would be sustained if challenged). Andrew D. Cuccia, Karl Hackenbrack & Mark W. Nelson, The Ability of Professional Standards to Mitigate Aggressive Reporting, 70 ACCT. REV. 227, 243-44 (1995) (finding self-serving bias in tax context); Steve Salterio & Lisa Koonce, The Persuasiveness of Audit Evidence: The Case of Accounting Policy Decisions, 22 ACCT., ORGS. & SOC’Y 573, 583-85 (1997) (finding that if precedents all point in one direction, the auditor will go that way, but if they are conflicting auditors will tend strongly to favor client’s preferred position, and noting that the finding “does suggest that conflicting precedents provide the basis for the auditor to side with the client which, in turn, may give the appearance of a lack of independence.”).


185 Jeffrey J. Rachlinski et al., Does Unconscious Racial Bias Affect Trial Judges?, 84 NOTRE DAME L. REV. 1195, 1232 (2009) (finding that judges “like the rest of us, possess implicit [racial] biases but that they mostly managed to avoid its influence when they were told of the defendant’s race and actively guarded against their own prejudices”).
information that supports that point of view, to interpret the arguments and documents to support that point of view, and as they write their opinions even to remember that the arguments and documents supporting that point of view.186 And that is the leaning of most federal judges, who “routinely express concern that securities class actions are often lawyer-driven suits brought in the hope of settling for their nuisance value.”187 The more discretion judges have to dismiss cases early, the more likely they will do so. The increasing conservatism of the federal bench exacerbates this effect.188

c. Hindsight bias and fraud-by-hindsight doctrine.

Hindsight Bias. The hindsight bias is the tendency to regard things that have occurred as having been relatively predictable and obvious.189 Once people know of an outcome, they tend to systematically overestimate the likelihood that they could have anticipated that outcome in advance. The hindsight bias is exacerbated by the curse of knowledge effect (the difficulty people have in ignoring information that they have learned when they make decisions)190 and the

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186 Judges may well suffer from the same phenomenon that affected one of Prime Minister Tony Blair’s underlings as the Iraq War began. He later admitted:

The speeches I drafted for the Security Council and my telegrams back to London were composed of facts filtered from the stacks of reports and intelligence that daily hit my desk. As I read these reports, facts and judgments that contradicted the British version of events would almost literally fade into nothingness. Facts that reinforced our narrative would stand out to me almost as if highlighted, to be later deployed by me, my ambassador and my ministers like hand grenades in the diplomatic trench warfare. Details in otherwise complex reports would be extracted to be telegraphed back to London, where they would be inserted into ministerial briefings or press articles. A complicated picture was reduced to a selection of facts that became “factoids”, such as the suggestion that Hussein imported huge quantities of whisky or built a dozen palaces, validated by constant repetition: true, but not the whole truth.


188 Baruch Fischhoff is one of the first to have studied the hindsight bias, which he describes as:

In hindsight, people consistently exaggerate what could have been anticipated in foresight. They not only tend to view what has happened as having been inevitable but also view it as having appeared ‘relatively inevitable’ before it happened. People believe that others should have been able to anticipate events much better than was actually the case.

Baruch Fischhoff, For Those Condemned to Study the Past: Heuristics and Biases in Hindsight, in JUDGMENT UNDER UNCERTAINTY 335, 341. See also, Baruch Fischhoff & Ruth Beyth, I Knew It Would Happen—Remembered Probabilities of Once-Future Things, 13 ORG. BEHAV. & HUM. Perf. 1 (1975); Scott A. Hawkins & Reid Hastie, Hindsight: Biased Judgments of Past Events after the Outcomes are Known, 107 PSYCHOL. BULL. 311, 323 (1990) (noting that “research and theory on hindsight phenomena suggest that the decision maker is unlikely to even be aware of the influence of the to-be-disregarded information, much less able to undo its effects.”).
outcome bias (the tendency people have to judge a decision’s quality by its outcome). The hindsight bias is one of the most reliably replicated biases in existence, and there is little evidence that we can free judges or jurors from the effects of the bias simply by educating them regarding its existence and impact. Most people, including when they act as jurors, are subject to the hindsight bias.

In general, the hindsight bias “makes defendants appear more culpable than they really are.” If an auditor did not see something coming, but a judge pursuant to the hindsight bias concludes that he or she would have seen it coming and therefore that the auditor should have as well, the judge will be more likely to find recklessness where an innocent mistake occurred than if the hindsight bias did not exist. And there is evidence that auditor defendants may suffer at the hands of this bias.

Fraud-by-Hindsight Doctrine. However, while the hindsight bias will disadvantage defendants if courts do not compensate for it, in the context of securities fraud class actions there is substantial empirical evidence that courts have compensated. In fact, they have overcompensated. In 1978, Judge Henry Friendly promulgated the “fraud by hindsight” (FBH) doctrine, ruling that a complaint that does nothing more than allege fraud by hindsight will not pass muster. Judge Easterbrook then popularized the doctrine in DiLeo v. Ernst & Young in 1990, leading it to be cited in nearly one-third of all published Rule 10b-5 class action opinions and creating “a hurdle that plaintiffs in securities cases must overcome.” In an impressive study, Gulati, Rachlinski, and Langevoort studied a large number of these cases. On the one hand, it might appear that the FBH doctrine is the courts’ way of neutralizing the prejudicial effects of the hindsight bias. However, upon further contemplation, the authors suspected that it might actually be a means of disposing of cases quickly to manage dockets. They developed various markers and tested them empirically. All the evidence pointed

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192 Rachlinski, Heuristics and Biases in the Courts, supra note __, at 67 (noting that “[e]very published empirical test of the hindsight bias replicates the phenomenon.”).
194 Lee J. Gilbertson, et al, A Study of Hindsight Bias: The Rodney King Case in Retrospect, 74 PSYCHOL. REP. 383, 384 (1994) (studying verdict in first Rodney King case); Reid Hastie & W. Kip Viscusi, What Juries Can’t Do Well: The Jury’s Performance As a Risk Manager, 40 ARIZ. L. REV. 901, 906 (1998) (concluding that in “decisions involving evaluations of risk, especially where the judgment requires the decision maker to infer ex ante risk estimates from an ex post perspective, the typical juror appears to be subject to a massive hindsight bias.”). See Wray Herbert, On Second Thought: Outsmarting Your Mind’s HARD-WIRED HABITS 47-48 (2010) (explaining the bias and giving examples);
195 Rachlinski, Positive Psychological Theory of Judging, supra note __, at 572.
196 See Donald C. Langevoort, The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior, 63 BROOK. L. REV. 629, 661-62 (1997) (noting that the potential for hindsight bias in securities fraud cases is “severe”).
199 901 F.2d 624, 628 (7th Cir. 1990).
200 Gulati et al., supra note __, at 775.
201 Id.
to judges using the FBH to manage their dockets rather than to compensate for the adverse effects of the hindsight bias:

…our analysis reveals that the FBH doctrine is not an effort to control the influence of the hindsight bias in securities litigation, but is part of an effort to manage securities cases. Although case management can take many forms, from limiting discovery to facilitating settlement, in this context, judges are seeking to manage securities cases through a thinly disguised effort to screen securities cases at an early stage of the proceedings. 202

Part of the evidence of the pro-defendant application of the FBH is that it is used almost exclusively in situations where the hindsight bias might benefit plaintiffs and almost never in situations where the bias might benefit defendants. 203 In the study’s sample of cases, defendants won 70% of the time when the FBH was mentioned, versus only 47% of the time when it was not. 204 The authors concluded:

What is clear … is that judges are actively managing the entry and exist of cases at the pleading stage. In a sense, then, the PSLRA’s heightened pleading standards and the FBH doctrine are not just about raising the bar to entry into court, but also about granting the judges more discretion in deciding who gains entry and who does not. 205

d. Fundamental attribution error and motivated exculpation.

Fundamental Attribution Error. If there is one overarching finding from psychological research over the past several decades, it is that the situational tends to dominate the dispositional. 206 In other words, people’s decision making is heavily influenced by the context in which they make decisions. They don’t automatically make good decisions because they are good people or bad decisions because they are bad people. Rather, good people too often make bad decisions because of social or organizational pressures. 207

However, most people are not aware of the influence of these contextual factors and tend to attribute others’ actions to their character, not to situational influences. 208 “When observers

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202 Id. at 776-77.
203 Id. at 777.
204 Id. at 804.
205 Id. at 822.
208 For example, when people read an essay written by another person, they tend to attribute that position to the author even after being informed that the author was forced to take that position. Edward E. Jones & Victor A. Harris, The Attribution of Attitudes, 3 J. Experimental Soc. Psychol. 1 (1967) (finding a tendency to attribute attitudes to behavior even in no-choice situations). See also Kenworthey Bilz & Janice Nadler, “Law, Psychology & Morality,” in 50 Psychology of Learning and Motivation: Moral Cognition and Decision Making (D. Medin et al. eds, 2009) (“the cognitive processes of actors are opaque but their behavior is apparent, and so
draw inferences on the causes of another’s behavior, they systematically fail to take into account situational factors.”

This is called the fundamental attribution error (FAE) and it interacts with the hindsight bias to cause people tend to conclude not only that people should have made different judgments than they did, but also that they made the wrong decision for bad reasons, not because situational factors impacted their decisions. Yet, situational factors do tend to exert pervasive influence upon human decision making.

The fundamental attribution error is extremely persistent and in the present context, it can cause judges and jurors to conclude erroneously that a 10b-5 defendant acted with fraudulent intent. How does this happen? Quattrone noted that people have two judgment systems working at the same time when they make decisions. System I processes are spontaneous and intuitive. They are automatic and rely heavily upon heuristics, some of which are discussed in this paper. System II is more deliberative, requiring effort and concentration. This model was initially developed by Daniel Kahneman and Shane Frederick.

Quattrone developed a model of the mental processes behind the Fundamental Attribution Error based on the finding that people tend to spontaneously (using System I) attribute a connection between another’s dispositions and their behavior. To take another step and consider the situational factors surrounding the other’s decision is effortful, so System II processes are spontaneous and

people assume that the obvious explanation (people behave the way they do because that is the kind of people they are) governs, and they shape their own behavior and beliefs accordingly.”


In contrast, when people judge their own behavior, they do not hesitate to take situational factors into account. ROBIN M. HOGARTH, EDUCATION INTUITION 154 (2001) (“In other words, [we tend to believe] that personality drives the behavior of others, but situation drives our own.”). For that reason, people ascribe less variability to others’ behavior than to their own. See PLous, supra note 179, at 186-87 (citing studies).

Another factor relevant to scienter is the tendency of people to judge the same behavior as more intentional and therefore more deserving of severe punishment when it will be performed in the future than when it has been performed in the past. See Zachary Burns et al., “Predicting Premediation: Future Behavior is Seen as More Intentional than Past Behavior,” available at ssrn.com/abstract=1879558 (June 2011).

See PLous, supra note __, at 180-81 (describing studies where people not only attributed helping behavior to others’ religiosity, consistent with the fundamental attribution error, but continued to do so even after reading a study that found no such connection.


Guthrie, et al., Blinking on the Bench, supra note __, at 7-9.


According to Fritz Heider, “behavior engulfs the field,” meaning that when we view others their behavior is the most salient thing we perceive, while situational factors tend to be in the background. FRITZ HEIDER, THE PSYCHOLOGY OF INTERPERSONAL RELATIONS 54 (1958).
may not kick in. Gilbert found that people tend to draw System I dispositional inferences even when they are informed that behavior is influenced by situational factors.

**Motivated Exculpation.** The FAE leads people to tend to conclude that because X did a bad thing, X must be a bad person. Having evidence only of the bad act, and tending to ignore situational factors that may have affected X’s decisions, people will tend to conclude that X’s bad acts are representative of X’s character. However, when people believe that they know something about X’s character and are not relying solely upon X’s actions to draw inferences about X’s character, a different dynamic results that, interestingly, may in the present setting push judges in a *pro-defendant* direction.

Most courts presume that accountants would not do anything to endanger their reputations. The announced reason for this is a straightforward presumption of economic rationality—auditors’ reputations are the key to their prosperity and it would not be rational for them to recklessly aid their clients’ fraud and therefore undermine that reputation. As indicated elsewhere in this article, there are pervasive reasons to doubt this story. First, most people are at best boundedly rational, and that includes auditors. Second, there is sufficient empirical evidence of auditor misconduct to persuasively rebut this presumption as it applies to auditors of public companies specifically.

It may be simple intellectual laziness that induces judges to continue this presumption in face of so much contrary evidence, but it is also quite possible that more is at work here. Whereas stereotypes of attorneys tend to paint them as slimy and immoral, stereotypes of accountants picture them, at worst, as boring and timid. Immoral and dishonest character is

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217 *Id.*
219 *See supra* notes ___ to ___ and accompanying text.
220 DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990) ("An accountant's greatest asset is its reputation of honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses [the auditor] would suffer from a perception that it would muffle a client's fraud.").
221 *See supra* notes ___ to ___ and accompanying text.
222 *See supra* note ___ and accompanying text. *See also* Kahn & Lawson, *supra* note __, at 404:

There are many reasons to doubt the extent to which auditors will always, or even often, find it in their own best interests to challenge management. First, the financial benefits of complicity with management, in the form of audit fees, future engagements, favorable recommendations, and the like, are tangible and concrete, while the costs in terms of lost reputation are remote, speculative, and uncertain. Second, the incentives of the individual auditors reinforce the perverse incentives faced by their audit firms as a whole.

Third, auditors are subject to many of the same cognitive biases that plague all people, and many of those biases work in favor of complicity with management.

Fourth, and most importantly, it is hard to dispute the evidence of what actually happens.

224 As the vocational guidance counselor said in Monty Python’s *And Now for Something Completely Different*: "Our experts describe you as an appallingly dull fellow, unimaginative, timid, spineless, easily dominated,
not a part of society’s default vision of accountants. Indeed, in recent movies accountants are most commonly portrayed as heroes.\textsuperscript{225}

To the extent that judges presume that accountants generally have good character, they will have a tendency to find that whatever bad acts they are associated with were not performed intentionally. Whereas the law formally holds that a defendant’s character should have little to do with any legal conclusions regarding motive, intentionality or ultimate blameworthiness,\textsuperscript{226} blaming is a social process and it is heavily influenced by psychological factors.\textsuperscript{227}

In two recent articles,\textsuperscript{228} one with Mary-Hunter McDonnell, Professor Janice Nadler has reported a series of experiments indicating that judgments regarding moral character affect people’s attributions of motive and intentionality. In other words, if people believe that Joe is a bad person, they will believe that he is acting with more intentionality than if they see Joe perform the exact same acts in the exact same context but believe that he is a good person.

In a series of three experiments they performed providing evidence of a process they call \textit{motivated inculpation}, Nadler and McDonnell report experiments producing

\ldots evidence that when people judge a harmful action performed by a bad person or performed with a bad motive, they are more likely to perceive that person as more responsible, and the act as more causal \textit{and intentional}, than when they judge an identical harmful action performed by a good person or performed with a good motive.\textsuperscript{229}

For current purposes, it is important to note that the process works both ways. In other words, there is also \textit{motivated exculpation}. If people see a defendant as “good,” they are generally motivated to interpret the defendant’s wrongdoing as less intentional and less blameworthy.\textsuperscript{230}

In a second set of experiments, Nadler explored the mechanism behind motivated inculpation. Again, her experiments supported the conclusion that “psychological blame is influenced by perceptions of the actor’s overall virtue or lack thereof, even apart from the actor’s reason for acting in the specific instance.”\textsuperscript{231} At least part of the mechanism at work stems from

no sense of humor, tedious company, and irrepressibly drab and awful. And whereas in most professions these would be considered drawbacks, in accountancy, they’re a positive boon.” Monty Python’s “And Now for Something Completely Different” (Kettleidrum/Lownes 1971). \textit{See also} Howard Darmstader, The “Best of” Series: Explaining with Examples, 10 SCRIBES J. LEG. WRITING 137, 141 (2005/2006) (noting that accountants are stereotyped as “dull, dry, meticulous bean counters”); Ian E. Scott, \textit{Fair Value Accounting: Friend or Foe}, 1 WM. & MARY BUS. L. REV. 489, 541 (2010) (noting that an accountant “is stereotypically rigid, rule-based, bookish, and has his calculator ready.”).\textsuperscript{225}

\textsuperscript{225} Tony Dimnik & Sandra Felton, \textit{Accountant Stereotypes in Movies Distributed in North America in the Twentieth Century}, 31 ACCT’G, ORG. & SOC’Y 129 (2006) (“Characters with CPAs or CAs are more likely to be Heroes than any other stereotype.”).

\textsuperscript{226} \textit{FED. R. EVID.} 404(a)(1) (“Evidence of a person's character or character trait is not admissible to prove that on a particular occasion the person acted in accordance with the character or trait.”).

\textsuperscript{227} \textit{CHARLES TILLY, CREDIT & BLAME} 52008 (“...crediting and blaming are fundamentally social acts.”).


\textsuperscript{229} Nadler & McDonnell, \textit{supra} note \_\_, at \_\_ (emphasis added).

\textsuperscript{230} \textit{Id.} at \_\_.

\textsuperscript{231} Nadler, \textit{supra} note \_, at \_ [2].
moral emotions that people feel. Nadler proposed that “compared to an otherwise virtuous person who causes harm, an otherwise bad person who causes harm makes us feel angrier and more disgusted, which in turn leads to more punitive attributions of blame.” Her experiments generally confirmed the supposition that when an actor’s character is thought to be good, people will judge him as having acted less intentionally in doing a bad act than when his character is perceived to be bad (and vice versa, of course). Overall, “[w]e give the benefit of the doubt to a person with a virtuous character who causes harm; we perceive his actions as less intentional and perhaps even less causal, and the harm less foreseeable than if his character is flawed.”

To the extent that courts irrationally credit auditors with being economically rational and buy into the common stereotype of accountants as boring but generally honest, they may have a tendency to underestimate the intentionality behind auditors’ acts that contribute to flawed audits.

C. Exacerbating Judicial Bias.

The conflicting heuristics and biases mentioned above are most likely to favor defendants in the current context, given the strength of the self-serving bias, the vigor with which courts apply the FBH doctrine, the impact of moral exculpation, the current conservatism of the federal judiciary, and the foundational (and erroneous) operative assumption that auditors would not sacrifice their reputations just to please a client and therefore deserve a special level of protection in 10b-5 scienter pleading. Professor Bone has argued that given judges’ bounded rationality, it is not necessarily a good idea to give courts significant discretion. The key point to stress is not so much which side is favored by judges’ unconscious biases, but the fact that whatever prejudices are in play are exacerbated by both the structure of the decision making process and the vagueness of the law that we document.

First, Rachlinsky recently pointed out that the Supreme Court’s recent decisions in Twombly and Iqbal require judges to decide cases based largely upon their first impression of the lawsuit without knowing which facts discovery will uncover. This has the impact of “encouraging judges to rely too heavily on their intuition, elevates the importance of potentially misleading pleading practices, and encourages overconfidence among judges.” The PSLRA preceded Ashcroft and Twombly in encouraging judges to resolve Rule 10b-5 cases before discovery, exacerbating the impact of judges’ psychological biases and cognitive distortions.

Second, the current muddled state of the law exacerbates whatever prejudices happen to apply whereas an ideal legal regime would instead minimize them. As Droske has pointed out, confusion or ambiguity in a doctrine increases the likelihood that the self-serving bias and other behavioral and cognitive effects will lead to judges following their own preferences:

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232 Emotions seem to play a significant role in guiding people to moral conclusions. See generally, JONATHAN HAIDT, THE HAPPINESS HYPOTHESIS: FINDING MODERN TRUTH IN ANCIENT WISDOM 20-22, 50-51, 54-55 (2006). Among the most important morality-tinged emotions are guilt, shame, anger, and disgust. Id.

233 Nadler, supra note __, at __ [6] Nadler cites work by Mark D. Alicke which also supports the view that people’s initial emotional reactions to a harm situation directly affect perceptions of harm and intent. See generally, Mark D. Alicke, Culpable Control and the Psychology of Blame, 126 PSYCHOL. BULL. 556, 557 (2000).

234 Nadler, supra note __, at __ [28]. The effect disappeared if study participants were asked to make judgments about BOTH “good Nathan” and “bad Nathan” side by side. Id. at 34.

235 Nadler, supra note __, at __ [38] (emphasis added).

236 Bone, supra note __, at 1965.

237 Rachlinski, Processing Pleadings, supra note __, at 413.

238 Id. at 414.
The lack of clarity with respect to whether statutory language is ambiguous provides judges an opportunity to exercise discretion so as to maximize their own personal political preferences. Professors Frank B. Cross and Emerson H. Tiller documented this phenomenon in an essay that empirically showed that judges selectively employed the *Chevron* doctrine—only triggered in cases of statutory ambiguity—so that cases would come out in accord with their political preferences.\(^{239}\)

Legal indeterminancy fosters unfettered judicial discretion which, in turn, creates more likelihood for judgment error.\(^ {240}\) Discretion has advantages, but should never be unconstrained.\(^ {241}\) Decisionmakers are more likely to be influenced by factors that they themselves view as unjustifiable, when a situation is elastic and there is more wiggle room to choose an outcome.\(^ {242}\) Judicial discretion, while absolutely necessary in some measure, also embodies the “right to be wrong.”\(^ {243}\)

### IV. CONCLUSION

Pleading rules are of central concern to securities antifraud litigation. “Determining who is allowed to invoke the machinery of the civil justice system and under what circumstances they may do so, lies at the core of how a system of law defines itself.”\(^ {244}\) Extraordinarily high stakes are involved when Rule 10b-5 class action litigation is filed, so it is important to get it right, and it appears that we are not getting it right. Part I of this article contains a doctrinal analysis that indicates that both general rules of pleading scienter in auditor fraud cases and the practical application of those rules are hopelessly muddled. Part II confirmed this conclusion through empirical study, demonstrating with some rigor that neither plaintiffs nor defendants can predict

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\(^{242}\) Nadler & McDonnell, supra note __, at ___ [13] (“We are also influenced by factors that we ourselves regard as unjustifiable, though we may not be aware of such influence. This is especially true when the legitimate evidence is ‘elastic’—that is, when there is more wiggle room to come out either way in their conclusion.”).

\(^{243}\) Charles M. Yablon, *Justifying the Judge’s Hunch: An Essay on Discretion*, 41 HAST. L. J. 231, 236 (1990). And substantive discretion, which is what is at stake here, is more worrisome than procedural discretion. Marcus, supra note ___ at 1605.

with any certainty how courts will react to specific factual allegations of auditor scienter in any given case. This is unlikely to be a satisfactory state of affairs, and Part III used the insights of behavioral psychology and related fields to explain why significant doctrinal ambiguity tends to create excessive judicial discretion which, in turn, is a recipe for bias that can disadvantage both plaintiffs and defendants. In the current state of affairs, it seems more likely that plaintiffs will be disadvantaged, but whatever the case regarding the direction of bias, unfettered discretion is likely to lead to more judicial errors of judgment than would occur under a regime of clearer and more settled law.245

245 Spelling out such a clearer state of the law is a task beyond the scope of this article, but others have tried and their efforts deserve some consideration. See, e.g., Olazabal & Abril, supra note __.