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Iv. Rule 10B-5

IV. RULE 10b-5

In *Blue Chip Stamps v. Manor Drug Stores,*[1] the Supreme Court reaffirmed the rule that only purchasers and sellers of securities have standing to sue under section 10(b) of the Securities Exchange Act ('34 Act)[2] and SEC Rule 10b-5.[3] The Supreme Court held in *Blue Chip* that an individual who was fraudulently induced *not* to purchase stock could not bring an action under Rule 10b-5.[4] Despite the *Blue Chip* implication that only actual purchasers or sellers of securities have standing to sue under Rule 10b-5, lower federal courts generally have applied the purchaser-seller requirement liberally to grant standing to defrauded plaintiffs.[5] In recent decisions, lower federal courts have both expanded and contracted Rule 10b-5 availability to defrauded investors. Courts have applied the *Blue*

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[1] 421 U.S. 723 (1975).

[2] 15 U.S.C. § 78j(b) (1976). Section 10(b) states:

> 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—
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> . . . .
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> (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, 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.

[3] 421 U.S. at 754-55. Rule 10b-5, promulgated by the Securities and Exchange Commission, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (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 (1978).

[4] 421 U.S. at 754-55. *See generally* Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings,* 65 GEO. L.J. 891 (1977); Gallagher, *10b-5 After* Blue Chip Stamps: *How Stands the Judicial Oak?,* 80 DICK. L. REV. 1 (1975) [hereinafter cited as Gallagher]; 1976-1977 *Securities Law Developments: Rule 10b-5,* 34 WASH. & LEE L. REV. 882 (1977) [hereinafter cited as 1976-1977 *Developments*].

[5] *See, e.g.,* Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978), *cert. denied,* 99 S.Ct. 1289 (1979) (capital call pursuant to limited partnership agreement constitutes purchase or sale of a security); Mallis v. FDIC, 568 F.2d 824 (2d Cir.), *cert. dismissed sub nom.* Bankers Trust Co. v. Mallis, 435 U.S. 381 (1977) (collateral pledge of securities is a purchase or sale); McCloskey v. McCloskey, 450 F. Supp. 991 (E.D. Pa. 1978) (granting right of first refusal to issuing corporation is a purchase or sale). *But see* Sacks v. Reynolds Sec. Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,715 (D.C. Cir. Dec. 19, 1978) (failure to transfer securities account not a purchase or sale); National Bank of Commerce v. All American Assurance Corp., 583 F.2d 1295 (5th Cir. 1978) (collateral pledge of securities not a purchase or sale).

Chip mandate during the past year in considering whether limited partnership agreements,[6] voting trust agreements,[7] corporate reorganizations,[8] and pledges of stock[9] constitute a purchase or sale of a security.

Investment Decision Under Partnership Agreements

The Supreme Court in *Blue Chip* stated that a contractual agreement to purchase or sell a security constitutes a purchase or sale within the meaning of section 10(b) of the '34 Act.[10] In *Goodman v. Epstein,*[11] the Seventh Circuit was presented with the issue of whether a purchase of an interest in a limited partnership[12] occurs only at the time the defrauded plaintiff becomes contractually committed to make subsequent cash contributions to the partnership or whether a purchase occurs each time a subsequent contribution to the partnership is made. The court rejected the argument that the only purchase occurs at the time of the original commitment to invest, instead holding that each subsequent capital contribution constitutes a separate purchase and sale.[13] The court reasoned that because an investment decision remained to be made at the time of each capital call, the response to the call constituted a purchase of a security.[14] Thus, material misrepresentations or omissions made at the time of the call were "in connection with the purchase or sale" of a security.[15]

In *Goodman,* the plaintiffs were limited partners in the D-E Westmont Limited Partnership, a real estate development venture.[16] The partnership agreement obligated the limited partners to furnish total capital of three million dollars in response to calls for capital which were made from time to time by the general partners.[17] During the course of negotiations for the sale of the development venture, the general partners encountered substantial financial difficulties.[18] Despite these difficulties, the general part-

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[6] Goodman v. Epstein, 582 F.2d 388, 414 (7th Cir. 1978); *see* text accompanying notes 11-23 *infra.*

[7] McCloskey v. McCloskey, 450 F. Supp. 991, 994-95 (E.D. Pa. 1978); *see* text accompanying notes 66-80 *infra.*

[8] Canadian Javelin Ltd. v. Brooks, 462 F. Supp. 190, 195-97 (S.D.N.Y. 1978); *see* text accompanying notes 48-58 *infra.*

[9] National Bank of Commerce v. All American Assurance Corp., 583 F.2d 1295, 1298-1300 (5th Cir. 1978); *see* text accompanying notes 31-39 *infra.*

[10] 421 U.S. 750-51; *see* 15 U.S.C. § 78c(a) (1976).

[11] 582 F.2d 388 (7th Cir. 1978), *cert. denied,* 99 S. Ct. 1289 (1979).

[12] A limited partnership is a "security" within the meaning of section 2(1) of the '33 Act, 15 U.S.C. § 77b(1) (1976). *See* Hirsh v. duPont, 396 F. Supp. 1214, 1220 (S.D.N.Y. 1975); Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities,* 37 Mo. L. Rev. 581 (1972).

[13] 582 F.2d at 410-14.

[14] *Id.* at 413.

[15] *Id.* at 414; *see* 15 U.S.C. § 78j(b) (1976). Section 10(b) only reaches fraud which occurs "in connection with the purchase or sale of any security." *See* note 2 *supra;* note 76 *infra.*

[16] 582 F.2d at 391-92.

[17] *Id.* at 391 n.9.

[18] *Id.* at 392-94. After signing the partnership agreement, the general partners initiated

ners continued to request capital from the limited partners without disclosing the financial decline of the Westmont project.[19] The plaintiffs sued the general partners under Rule 10b-5, alleging that the general partners misrepresented the financial status of the partnership when calling for additional funds.[20]

The limited partners asserted that failure to disclose the declining prospects of the Westmont project when calling for additional capital constituted a violation of Rule 10b-5.[21] The defendants argued that their failure to disclose material information to the limited partners did not violate Rule 10b-5 because the limited partners were contractually obligated to respond to calls by the partnership agreement.[22] The court, disagreeing

negotiations with Larwin Corporation, a real estate developer, for the sale of the Westmont project. *Id.* at 392. Problems arose, however, when the Illinois Environmental Protection Agency and local authorities refused to issue sewer permits to the Westmont partners. *Id.* at 392-93. In addition, the development itself ran into long and costly delays. *Id.* at 393.

[19] *Id.* After requesting return of funds invested to secure a building permit, the general partners made a $500,000 capital call. On the advice of counsel, the general partners did not state the purpose of the call. *Id.* at 394. One final call was made by the general partners. *Id.*

[20] *Id.* at 390.

[21] *Id.* at 398. In arguing that the defendants' fraud occurred in connection with the purchase of a security, the plaintiffs urged that the original commitment to the partnership was not the final investment decision to be made. They asserted that even after signing the partnership agreement, several options remained open to them upon receiving a call for a capital contribution. *Id.* Among these were: abandoning the project, filing for a declaratory judgment ending the partnership, and, in the case of fraud on the part of the general partners, refusing to comply with the call. *Id.* Thus, the plaintiffs argued that the presence of these options at the time of receipt of a call for a capital contribution rendered the decision to invest more capital an "investment decision" and made receipt of accurate information from the general partners vital in reaching an informed decision. *Id.*

[22] *Id.* at 401. The defendants relied on *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876 (2d Cir. 1972), to support their assertion that a purchase or sale of a security occurs only when the buyer originally commits himself to purchase that security. 582 F.2d at 401. In *Radiation Dynamics*, the respondent corporation sold stock of TRG, Inc. to the defendant. 464 F.2d at 879. Subsequent to this sale, TRG merged with another corporation, and the value of TRG stock increased greatly. *Id.* Radiation Dynamics brought suit, alleging that defendant's failure to disclose the existence of the impending merger violated Rule 10b-5. *Id.* The *Radiation Dynamics* court, in affirming trial court verdicts in favor of the defendant, stated that Radiation Dynamics was contractually committed to sell the securities *before* the merger became formalized. 464 F.2d at 888. Therefore, the court held that any material misstatements or omissions occurring after that commitment date were not in connection with the purchase or sale. *Id.* Applying this standard, the *Goodman* defendants asserted that since the allegedly fraudulent acts occurred after the limited partners were committed to enter the partnership, no misrepresentation or omission in connection with the purchase or sale of a security occurred. 582 F.2d at 401; *see* 15 U.S.C. § 78j(b) (1976); 17 C.F.R. § 240.10b-5 (1978); notes 2-3 *supra*.

The *Goodman* court stated that at the time Radiation Dynamics became contractually committed to sell the TRG stock, the merger was still in doubt, and therefore the information was not material and could not be relied upon in making an investment decision. *Id.* at 412. The *Goodman* court then stated that *Radiation Dynamics* should not be read to apply to an ongoing relationship, but only to a "one-shot deal." *Id.* at 412-13. Instead, the court stated, both the general and limited partners in the case at hand contemplated an ongoing relation-with the defendants' assertion, stated that the fact that the plaintiffs were empowered to dissolve the partnership, should its operation prove unprofitable, militated against the conclusion that the limited partners had irrevocably committed themselves to the partnership.[23]

The Seventh Circuit's decision in *Goodman* comports with other decisions focusing on the economic reality of the transaction instead of relying on strict contractual theories.[24] Had the *Goodman* plaintiffs known of the partnership's reversals, they would not have responded to the calls. They would have ended the partnership and sought recovery of their invested funds. Because the plaintiffs retained these options, the *Goodman* court correctly realized that the plaintiffs were actual purchasers within the meaning of Rule 10b-5 when they supplied funds pursuant to the capital calls.[25]

Pledgor-Pledgee

Courts have had difficulty applying the *Blue Chip* purchaser-seller requirement to pledges of stock. The question whether a pledge of stock is a transaction within the scope of section 10(b) and Rule 10b-5 is an important one because the purview of those laws would be greatly broadened if stock-pledge fraud is actionable under federal law. The Second and Fifth Circuits have split on this issue.[26] The Second Circuit, in *Mallis v. FDIC,*[27]

ship, and therefore the limited partners were left with "the possibility of an investment decision each time a call was made." *Id.* at 413.

[23] 582 F.2d at 410-13; *see* note 20 *supra.*

[24] *See, e.g.,* Mallis v. FDIC, 568 F.2d 824, 828-30 (2d Cir. 1977) (pledge of securities is a purchase or sale because risk undertaken by pledgee is no different than risk undertaken by ordinary investor); McCloskey v. McCloskey, 450 F. Supp. 991, 994-95 (E.D. Pa. 1978) (court must look to economic reality of transaction to determine whether purchase or sale has occurred).

[25] 582 F.2d at 410-13. In support of its decision that a purchase of a security occurred each time a capital contribution was made, the *Goodman* court relied on the Supreme Court's broad interpretation of the "in connection with" requirement in *Superintendent of Ins. v. Banker's Life & Cas. Co.,* 404 U.S. 6 (1971), and several lower court decisions broadly construing the terms "in connection with." 582 F.2d at 410 n.64; *see* Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied sub nom,* Bard v. Dasho, 389 U.S. 977 (1967); Devine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied,* 389 U.S. 970 (1967). The *Goodman* court, however, made no attempt to square its decision with the *Blue Chip* decision. Other courts, like *Goodman,* have realized that *Blue Chip* is of little aid in analyzing whether a purchase or sale has occurred in certain transactions. *See, e.g.,* McCloskey v. McCloskey, 450 F. Supp. 991, 994-95 (E.D. Pa. 1970); text accompanying notes 66-80 *infra.* Although *Blue Chip* stated that a purchase or sale must have occurred in order for a plaintiff to have standing to sue under section 10(b), the decision gave little guidance in determining whether a purchase or sale actually occurred.

[26] *Compare* Mallis v. FDIC, 568 F.2d 824 (2d Cir. 1977) *with* National Bank v. All American Assurance Corp., 583 F.2d 1295 (5th Cir. 1978) *and* Reid v. Hughes, 578 F.2d 634 (5th Cir. 1978).

[27] 568 F.2d 824 (2d Cir.), *cert. dismissed sub nom.* Bankers Trust Co. v. Mallis, 435 U.S. 381 (1977).

held that a pledge of stock is a purchase or sale under Rule 10b-5.[28] The basis for this holding was the court's opinion that a pledge transaction involves an investment risk for the pledgee which is indistinguishable from the risk undertaken by an ordinary investor.[29]

In the past year, the Fifth Circuit has twice rejected the argument that a pledge of stock is a purchase or sale of a security.[30] In *National Bank of Commerce v. All American Assurance Corp.*,[31] the court expressly declined to follow *Mallis* and held that a pledgee-bank did not have standing to sue under Rule 10b-5.[32] In *All American,* the pledgee-bank received worthless stock as pledge for a commercial loan.[33] After default the bank brought suit, alleging violations of section 17(a) of the Securities Act of 1933 ('33 Act) and section 10(b) of the '34 Act.[34] The district court dismissed the

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[28] *Id.* at 829-30; *see generally* 1976-1977 *Developments, supra* note 4, at 886-87.

[29] 568 F.2d at 829. The *Mallis* court refused to follow the Fifth Circuit's holding in McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied,* 420 U.S. 930 (1975). 568 F.2d at 829. In *McClure,* the Fifth Circuit stated that a pledgee might have standing to sue under § 10(b) after the pledgor defaulted on his obligation, but the pledge alone does not necessarily constitute a purchase or sale of a security. 497 F.2d at 495-96; *cf.* Bosse v. Crowell Collier & MacMillan, 565 F.2d 602, 611 (9th Cir. 1977) (plaintiff whose pledged stock was foreclosed upon by pledgee has standing to sue under §10(b) if pledge was induced by material misstatements or omissions). The *Mallis* court instead relied on United States v. Gentile, 530 F.2d 461 (2d Cir.), *cert. denied,* 426 U.S. 936 (1976), where the Second Circuit held that a pledge of stock was a purchase or sale for the purpose of the Securities Exchange Act's criminal enforcement provision, 15 U.S.C. § 77g(a) (1976). 568 F.2d at 829; *see* 530 F.2d at 566-67; 1976-1977 *Developments, supra* note 4, at 886-87. The *Mallis* court, in determining that a pledge of stock satisfies the *Blue Chip* purchaser-seller requirement, stated that a pledge of stock is no different and no less concrete than a normal transfer of title. 568 F.2d at 829. The court stated that the risks undertaken by a pledgee, including the possibility that the pledged securities have no value, entitled the pledgee to the protection of the federal securities laws. *Id.*

[30] *See* National Bank of Commerce v. All American Assurance Corp., 583 F.2d 1295, 1298-1300 (5th Cir. 1978); Reid v. Hughes, 578 F.2d 634, 638 (5th Cir. 1978).

[31] 583 F.2d 1295 (5th Cir. 1978).

[32] *Id.* at 1298-1300.

[33] *Id.* at 1297. The defendant wished to purchase a Texas insurance firm. In order to make the purchase, All American devised a stock pledge in which National Bank transferred $2.5 million to the insurance firm in consideration for the purchase price of the pledged stock. *Id.* at 1296-97. The pledged stock, however, had not been authorized by the insurance firm's Board of Directors, and was therefore worthless. *Id.* The Texas Insurance Board, unaware of the fraud, approved the sale of the insurance firm to All American. *Id.*

[34] *Id.* Section 17(a) of the '33 Act, 15 U.S.C. § 77q(a) (1976), states:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
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> (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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
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> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

bank's claim on the grounds that a commercial loan secured by a pledge of securities is not a protected transaction under Rule 10b-5.[35] On appeal, the Fifth Circuit affirmed, stating that the difference between the risk undertaken by a pledgee and the risk undertaken by an ordinary investor was clear. The pledgee, stated the court, does not benefit from any appreciation in value of the stock, has none of the rights usually held by shareholders, and has no right to sell the stock for its own account.[36] In addition, the pledgee has no general property right in the collateral, but only a right to sell in satisfaction of the pledgor's obligation should default occur.[37] The *All American* court also noted that the pledgee, unlike an ordinary investor, has a remedy against the pledgor on the note.[38] Thus, if Congress had desired to protect collateral pledges against fraud, it could have done so expressly.[39] Absent such congressional coverage, the *All American* court declined to extend section 10(b) protection to pledge transactions.

The differences between the Second and Fifth Circuit's analysis of a pledge transaction centers on each court's perception of the scope of the federal securities laws. The *Mallis* court recognized that if pledgees have standing as purchasers the number of section 10(b) plaintiffs would increase. The court nonetheless construed section 10(b) expansively and concluded that such a result would not undermine the policy objectives of section 10(b) and *Blue Chip*.[40] The *All American* court, using a more restrictive construction of section 10(b) and *Blue Chip*, refused to grant standing to a defrauded pledgee without express statutory authorization.[41]

Although the language of Rule 10b-5 and section 17(a) of the '33 Act are virtually identical, only *purchasers* of securities have standing to sue under section 17(a).

[35] 583 F.2d at 1302. Although the district court opinion was unreported, the court dismissing National Bank's claim was undoubtedly influenced by both McClure v. First National Bank, 497 F.2d 490 (5th Cir. 1974) and Reid v. Hughes, 578 F.2d 634 (5th Cir. 1978). *See* note 28 *supra*. In *Reid*, the Fifth Circuit, relying on *McClure*, held that a mere pledge of securities cannot constitute a purchase or sale within the meaning of § 10(b) and Rule 10b-5. 578 F.2d at 638. The Fifth Circuit in *All American*, however, did not rely heavily on *Reid*, stating that the *Reid* court failed to develop the pledge question. 583 F.2d at 1298.

[36] *Id.* at 1300.

[37] *Id.* (*citing* Pauly v. State Loan & Trust Co., 165 U.S. 606, 622 (1897)).

[38] *Id.* at 1300.

[39] *Id.* In addition to the argument that courts should not legislate, the *All American* court, quoting Professor Loss, stated that federal legislation was not needed to protect pledge transactions. *Id.* (*citing* 1 L. Loss, SECURITIES REGULATION 649 (2d ed. 1961)) [hereinafter cited as 1 L. Loss]. Neither Professor Loss nor the *All American* court, however, state the reasoning behind the conclusion that a pledge transaction does not need the protection of the federal securities laws. *See* 583 F.2d at 1300; 1 L. Loss, *supra*, at 649.

[40] 568 F.2d at 829; *see* 1976-1977 *Developments*, *supra* note 4, at 886-87; note 29 *supra*.

[41] 583 F.2d at 1300. The *All American* court stated that although *Mallis* held that the federal securities laws ought to encompass pledge transactions, *Mallis* did little to support the conclusion that those laws do in fact cover pledge transactions. The *All American* court implied that *Mallis* should not have held that section 10(b) covers pledge transactions without a clear expression of such an intent from Congress. *See id.*; note 39 *supra*. The *All American* court distinguished several cases on the ground that, in those cases, a purchase or sale occurred because the secured party foreclosed on the stock in question. 583 F.2d at 1299;

"Change in the Nature of the Investment" Test: The Forced Seller Exception

Prior to *Blue Chip,* several circuit courts had adopted the "forced seller" doctrine to avoid an overly strict application of the purchaser-seller requirement.[42] This doctrine, a judicially-created exception to the purchaser-seller requirement,[43] has survived the *Blue Chip* decision in at least two circuits.[44] The forced seller doctrine holds that an involuntary and fundamental change in the nature of a plaintiff's investment will be treated as a purchase or sale of securities for the purposes of standing under Rule 10b-5.[45] Under the forced seller doctrine, no actual purchase or sale of a security is necessary to confer section 10(b) standing.[46] A recent decision has reexamined the degree of change in the nature of the investment required to apply the forced seller doctrine.[47]

In *Canadian Javelin Ltd. v. Brooks,*[48] the district court for the Southern District of New York considered whether a corporation, whose controlling interest in two other corporations was eliminated by a stock exchange between the two latter corporations, was a forced seller and therefore had standing to sue under Rule 10b-5. The court refused to characterize the plaintiff corporation as a forced seller and dismissed the section 10(b) claim.[49]

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see SEC v. Guild Films Co., 279 F.2d 485 (2d Cir.), *cert. denied,* 364 U.S. 819 (1960); SEC v. Pig'n Whistle Corp., 359 F. Supp. 219 (N.D. Ill. 1973); SEC v. National Bankers Life Ins. Co., 334 F. Supp. 444 (W.D. Tex. 1971), *aff'd,* 477 F.2d 920 (5th Cir. 1973). These three cases held that a bank, as a pledgee, becomes an underwriter for the purposes of section 4(1) of the '33 Act when it forecloses and sells pledged unregistered stock. The *All American* court stated that foreclosure and sale in the circumstances of those cases placed the stock in the "public arena protected by the Securities Acts." 583 F.2d at 1299. Although the cases are distinguishable, the *All American* court did not state the ramifications of possible foreclosure by a bank such as the plaintiff in *All American.* Such a foreclosure should have no effect on the purchaser-seller question because, as the *All American* court recognized, foreclosure upon worthless stock would be fruitless. *See id.* at 1297.

[42] *See* Gallagher, *supra* note 4, at 8-12. The term "forced seller" refers to a plaintiff who has neither purchased nor sold securities, but who nevertheless has standing to sue under § 10(b) because the defendant's fraudulent conduct will force him to sell at some later time. *Id.* at 8-9 n.39. Requiring the plaintiff to postpone his suit until he actually exchanges his stock for cash is "a needless formality." Vine v. Beneficial Fin. Co., 374 F.2d 627, 634 (2d Cir.), *cert. denied,* 389 U.S. 970 (1967).

[43] *See* Gallagher, *supra* note 4, at 8-10.

[44] *See* Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977), *cert. denied,* 98 S. Ct. 2253 (1978); Houlihan v. Anderson-Stokes, Inc., 434 F. Supp. 330 (D.D.C. 1977). Commentators are divided on the issue whether the forced seller exception should survive Blue Chip. *Compare* Gallagher, *supra* note 4, at 8-12 *with* Note, *Standing Under Rule 10b-5 After* Blue Chip Stamps, 75 MICH. L. REV. 413, 431-32 (1976) [hereinafter cited as *Standing Under Rule 10b-5*].

[45] *See, e.g.,* Abrahamson v. Fleschner, 568 F.2d 862, 868 (2d Cir. 1977).

[46] *See* note 42 *supra.*

[47] *See* Canadian Javelin Ltd. v. Brooks, 462 F. Supp. 190 (S.D.N.Y. 1978).

[48] 462 F. Supp. 190 (S.D.N.Y. 1978).

[49] *Id.* at 197.

Canadian Javelin held a controlling interest of stock in two other Canadian corporations, Bison and Jubilee.[50] In order to eliminate Canadian Javelin's control over their respective corporations, Bison and Jubilee agreed to an exchange of stock between the two corporations.[51] As a result of this freeze-out, Canadian Javelin's interest in both Bison and Jubilee was substantially reduced.[52] Canadian Javelin argued that the freeze-out was fraudulent and therefore violated Rule 10b-5.[53] The plaintiff asserted standing as a forced seller of securities.[54] In dismissing the complaint, the court held that the freeze-out of Canadian Javelin did not significantly change the nature of its investment, but merely reduced it.[55] The court held that, in order to establish standing as a forced seller, the plaintiff must show that the change in the nature of his investment was significant enough to qualify the investment as a new security.[56] The plaintiff failed to meet this test because its investment had not been completely eliminated.[57] In so holding, the *Canadian Javelin* court strongly implied that only a "cashed-out" stockholder could satisfy the "significant investment change" test.[58]

In another case examining a change in the nature of an investment, the federal district court for the Eastern District of Pennsylvania held that an exchange of stock for voting trust certificates is not a purchase or sale

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[50] *Id.* at 192.

[51] *Id.*

[52] *Id.* at 192 n.1. In the stock exchange, Bison gave Jubilee 3.3 million shares of Bison stock in exchange for 2.1 million shares of Jubilee stock. *Id.* As a result of this exchange, Javelin's control interest in Bison was reduced to 34.5 percent, and Javelin's control interest in Jubilee was reduced to 23.9 percent. *Id.* Through the exchange, the defendants obtained a control interest in each corporation. *Id.*

[53] *Id.* at 192. Canadian Javelin did not state why the exchange was fraudulent.

[54] *Id.* at 195. Canadian Javelin asserted that the forced seller doctrine had survived *Blue Chip,* and that the proper test to determine whether a plaintiff is a forced seller is whether his interest has been converted from one in a going enterprise into a right solely to a payment of money for his shares. *Id.; see* Houlihan v. Anderson-Stokes, Inc., 434 F. Supp. 1330, 1337 (D.D.C. 1977).

[55] 462 F. Supp. at 196; *see* note 52 *supra.*

[56] 462 F. Supp. at 196.

[57] *Id. Houlihan,* as the *Canadian Javelin* court recognized, clearly requires that the plaintiff have only a right to a payment of cash for his frozen-out stock. *See* Houlihan v. Anderson-Stokes, Inc., 434 F. Supp. 1330, 1337 (D.D.C. 1977); note 54 *supra.*

[58] *See* 463 F. Supp. at 195-97; Abrahamson v. Fleschner, 568 F.2d 862, 868 (2d Cir. 1977) (change in nature of investment must be so significant as to qualify as a new investment); Houlihan v. Anderson-Stokes, Inc., 434 F. Supp. 1330, 1337 (D.D.C. 1977); 1976-1977 *Developments, supra* note 4, at 894. After determining that Javelin could not assert standing as a forced seller, the *Canadian Javelin* court stated that there was serious doubt that, even if Javelin could be granted standing under the forced seller doctrine a § 10(b) cause of action existed. 462 F. Supp. at 196. Relying on Piper v. Chris-Craft, 430 U.S. 1 (1977) and Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), the *Javelin* court stated that once full and fair disclosure has taken place in a transaction, the fairness of the transaction is, at most, a tangential concern under § 10(b). *Id.* (*citing* Santa Fe Indus., Inc., v. Green, 430 U.S. 462, 478 (1977)). Characterizing Javelins' allegations as claims of a breach of fiduciary duties, the *Javelin* court stated that such a claim belonged in the Canadian courts. *Id.* at 197.

under section 10(b). In *McCloskey v. McCloskey,*[59] the shareholders of a corporation exchanged all their stock for voting trust certificates reflecting the number of shares held in trust.[60] Eight years later the voting trust terminated and all stock was returned except stock held in trust for the plaintiff and defendant.[61] The reason for the retention of this stock was that a second voting trust had been executed between plaintiff and defendant.[62] After the execution of the second voting trust, the defendant proposed a stockholders' agreement in which the corporation would be granted a right of first refusal on all currently outstanding and subsequently issued stock.[63] This agreement was adopted and the defendant voted and signed on behalf of the plaintiff.[64] Upon discovering the right of first refusal agreement, the plaintiff brought suit against the voting trustee, alleging that she was induced to sign the voting trust agreement by material misrepresentations and omissions made by the voting trustee.[65]

The defendant moved for dismissal on the grounds that the plaintiff was neither a purchaser nor seller within the meaning of section 10(b) and Rule 10b-5.[66] The *McCloskey* court agreed, stating that although *Birnbaum* and *Blue Chip* firmly establish the purchaser-seller requirement, those cases did not purport to provide an exclusive definition of a purchase or sale.[67] In order to determine whether the plaintiff became a purchaser or seller by depositing her shares in the voting trust, the court used the two-step analysis employed by courts before the *Blue Chip* decision.[68] First, the court focused on the economic reality of the transaction by comparing the rights the plaintiff kept with those she relinquished in entering the voting trust agreement.[69] The court reasoned that since the plaintiff retained the right to dividends on her stock, the right to subscribe to any class of stock issued to shareholders, and the right to receive a pro rata distribution of corporate assets in the event of liquidiation, she retained every right normally held by a stockholder save one—the right to vote.[70] The court then considered whether the changes in the plaintiff's

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[59] 450 F. Supp. 991 (E.D. Pa. 1978).
[60] *Id.* at 993.
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.* at 994.
[66] *Id.*
[67] *Id.*
[68] *Id.*
[69] *Id.* at 995. In establishing the first part of the two part test, the court relied on United Housing Foundation, Inc. v. Foreman, 421 U.S. 837 (1975). In *Foreman,* the Supreme Court disregarded the fact that the plaintiffs held "shares" of a cooperative housing development and held that, because their shares had none of the attributes of ordinary investment securities, the shares were not securities within the meaning of section 2(1) of the '33 Act. 421 U.S. at 848-58; *see* 15 U.S.C. § 77b(1) (1976).
[70] 450 F. Supp. at 995.

investment were significant enough to qualify as a purchase or sale.[71] The court stated that the voting trust agreement, instead of resembling a purchase or sale, reflected an internal management decision to provide the plaintiff with a continuing interest in a corporation run by the voting trustee.[72] The court concluded that plaintiff's interest was not transformed or terminated in any real sense, and that her situation was distinguishable from true forced seller cases.[73]

The *McCloskey* court decided, however, that the right of first refusal granted by the trustee to the corporation did constitute a purchase or sale.[74] The court reasoned that the plaintiff, as beneficial owner of the stock, had standing to sue under section 10(b).[75] The defendant argued that even if the granting of the right of first refusal constituted a purchase or sale of a security, the plaintiff failed to establish the "in connection with" requirement of a section 10(b) claim because the alleged fraud could only have occurred at the time the voting trust was executed, a full four months before the right of first refusal contract was entered into.[76] The *McCloskey* court rejected this argument, stating that plaintiff's allegation of defendant's continuing scheme to drain the corporation's assets was

[71] *Id.;* see Murphey v. Hillwood Villa Assoc., 411 F. Supp. 287, 292 (S.D.N.Y. 1976) (in order to qualify as forced seller, plaintiff must prove significant change in nature of investment); text accompanying note 45 *supra.*

[72] 450 F. Supp. at 995.

[73] *Id.* After determining that a purchase or sale had not occurred, the *McCloskey* court, like the *Canadian Javelin* court, stated that the purposes of § 10(b) would not be served by finding that McCloskey had standing since Congress, in creating section 10(b), did not intend to "regulate transactions which constitute no more than *internal corporate mismanagement.*" (emphasis in original) *Id.* (*citing* Superintendent of Ins. v. Bankers Life & Cas Co., 404 U.S. 6, 12 (1971)); *see* note 58 *supra.* The *McCloskey* court implied that the plaintiff's claim should be resolved under state law.

[74] 450 F. Supp. at 996; *see* text accompanying notes 63-64 *supra.* The *McCloskey* court held that the right of first refusal contract was a statutory sale under § 3(a)(14) of the '34 Act. 450 F. Supp. at 996; *see* 15 U.S.C. § 78c(a)(14) (1976).

[75] 450 F. Supp. at 996. The court held that the plaintiff's status as beneficial owner of the stock conferred standing to sue under § 10(b) even though she did not sign the shareholder agreement which created the right of first refusal. *Id.* Without doing so explicitly, the court adopted the de facto seller exception to the purchaser-seller requirement. The de facto seller exception holds that the party whose economic interests are harmed or benefitted by the transaction has standing to sue under § 10(b) even though he is not the legal titleholder of the securities at the time of the sale and is not, therefore, the actual seller. *See* James v. Gerber Prod. Co., 483 F.2d 944 (6th Cir. 1973); Heyman v. Heyman, 356 F. Supp. 958 (S.D.N.Y. 1973); 1977-1978 *Securities Law Developments: Rule 10b-5,* 35 WASH. & LEE L. REV. 799, 802 n.5 (1978). The *McCloskey* court granted standing to the plaintiff, stating that "she was the one who stood to gain or lose by the sale." 450 F. Supp. at 996. Several decisions have held that the de facto seller exception has survived *Blue Chip. E.g.,* Klamberg v. Roth, 425 F. Supp. 440, 442 (S.D.N.Y. 1976). Commentators are divided on whether the exception has any vitality after *Blue Chip. Compare* Gallagher, *supra* note 4, at 12-15, 37-38 *and Standing Under Rule 10b-5, supra* note 44, at 430 n.104 *with* Comment, Blue Chip Stamps v. Manor Drug Stores: *Failure to Solve the Purchaser-Seller Problem,* 70 NW. U.L. REV. 965, 993 (1976).

[76] 450 F. Supp. at 996-97; *see* note 15 *supra.*

enough to survive defendant's motion to dismiss.[77]

The *McCloskey* case illustrates a current dilemma in the purchaser-seller area: the extent to which the *Blue Chip* decision establishes the sole criteria for determining whether a purchase or sale of securities has occurred. Although most courts profess to use *Blue Chip* as a guideline, it is clear the *Blue Chip* decision is of little help in many standing cases.[78] The pledge cases and the forced seller cases illustrate this problem most dramatically. The '33 and '34 Acts do not address either situation expressly, but some courts have readily granted standing to defrauded investors in the absence of an actual purchase or sale.[79] Eschewing a too-literal reading of the "purchase or sale" language of section 10(b), courts have looked instead to the realities of the transaction to determine whether such a transaction should be protected under a flexible construction of the federal securities laws.[80]

B. *Aiding and Abetting*

The concept of aiding and abetting in federal securities law, which derives from the common law concept of aiding and abetting, is designed to impute liability to those on the periphery of illegal securities transactions.[81] Individuals or corporate entities which directly violate section 10(b) are termed primary violators, while those on the periphery of the illegal

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[77] 450 F. Supp. at 997.

[78] *See, e.g.,* Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978); McCloskey v. McCloskey, 450 F. Supp. 991 (E.D. Pa. 1978); note 25 *supra;* text accompanying note 68 *supra.*

[79] *See, e.g.,* Mallis v. FDIC, 568 F.2d 824 (2d Cir. 1977); McCloskey v. McCloskey, 450 F. Supp. 991, 996-97 (E.D. Pa. 1978); notes 29 & 75 *supra.*

[80] *See* notes 29 & 60 *supra. But see* notes 39 & 41 *supra.*

[81] *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification and Contribution,* 120 U. PA. L. REV. 597, 602-28 (1972) [hereinafter cited as Ruder]; Comment, *Rule 10b-5 Liability after* Hochfelder: *Abandoning the Concept of Aiding and Abetting,* 45 U. CHI. L. REV. 218, 221-25, 246 (1977) [hereinafter cited as *Rule 10b-5 After* Hochfelder]. Several cases have stated that § 876 of the Restatement of Torts provides the basic standard for aiding and abetting liability under section 10(b) and Rule 10b-5. *See* Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 800 (3d Cir.) *cert. denied,* 99 S. Ct. 318 (1978); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966), *aff'd,* 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970). Section 876 states:

> Persons Acting in Concert.
> For harm resulting to a third person from the tortious conduct of another, a person is liable if he
> (a) orders or induces such conduct, knowing of the conditions under which the act is done or intending the consequences which ensue, or
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

RESTATEMENT OF TORTS § 876 (1939). Section 876 of the Restatement (Second) is substantially identical to the original.

transaction are labelled aiders and abettors.[82] Although some courts and commentators have advocated abandoning this distinction,[83] recent decisions indicate that the aiding and abetting concept, instead of fading away, is growing in popularity among imaginative pleaders.[84]

The Elements of Aiding and Abetting

The traditional elements of a section 10(b) aiding and abetting violation are: existence of an independent section 10(b) violation, the aider-abettor's knowledge of the independent violations, and the aider-abettor's substantial assistance in effecting that violation.[85] The requirement that all three elements be proven to establish a section 10(b) aiding and abetting violation has been reaffirmed in a number of recent cases.[86] In particular, courts in the past year have considered what type of knowledge must be shown to prove knowledge of the primary violation, and what type of conduct is sufficient to establish substantial assistance on the part of the alleged aider-abettor.[87]

In *Monsen v. Consolidated Dressed Beef Co.,*[88] the Third Circuit was presented with the question whether a bank should be held liable as an aider-abettor of its borrower's section 10(b) violations. The court, in reinstating the jury verdict against the bank, found that the bank knew of the primary violation and substantially assisted that violation.[89] In *Monsen,* Consolidated maintained a voluntary payroll borrowing program in which the company made deductions from the salaries of its employees in exchange for promissory notes.[90] The note program was not registered with the SEC and the noteholders received no financial information about Con-

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[82] *See* Ruder, *supra* note 81, at 600; *Rule 10b-5 After* Hochfelder, *supra* note 81, at 219-20.

[83] *See* White v. Abrams, 495 F.2d 724 (9th Cir. 1974); *Rule 10b-5 After* Hochfelder, *supra* note 81, at 248-54.

[84] *See, e.g.,* SEC v. Arthur Young & Co. [Current] FED. SEC. L. REP. (CCH) ¶ 96,766 (9th Cir. Feb. 1, 1979); Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793 (3d Cir. 1978); *In re.* Gap Stores, [Current] FED. SEC. L. REP. (CCH) ¶ 96,709 (N.D. Cal. Aug. 29, 1978); SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978).

[85] *See* Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 799-800 (3d Cir. 1978); SEC v. National Student Mktg. Corp., 457 F. Supp. 682, 712 (D.D.C. 1978); Ruder, *supra* note 81, at 630-38.

[86] *See* note 84 *supra.*

[87] *See, e.g.,* SEC v. Arthur Young & Co.,[Current] FED. SEC. L. REP. (CCH) ¶ 96,766 (9th Cir. Feb. 1, 1979) (substantial assistance); Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793 (3d Cir. 1978) (knowledge and substantial assistance); SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978) (knowledge and substantial assistance).

[88] 579 F.2d 793 (3d Cir.), *cert. denied,* 99 S. Ct. 318 (1978).

[89] *Id.* at 799-804. The district court jury found the bank liable as an aider-abettor of Consolidated's violations of section 12(2) of the '33 Act and section 10(b) of the '34 Act. *Id.* at 798-99; *see* 15 U.S.C. §§ 77l(2); 78j(b) (1976); note 2 *supra.* The jury exonerated the bank of any direct liability under section 10(b). 579 F.2d at 799.

[90] *Id.* at 796-97. The notes were issued at three month intervals and paid interest at 7% until maturity, five years later. *Id.* at 797.

solidated.[91] To secure additional financing, Consolidated and a Pennsylvania bank entered into a loan agreement which subordinated the priority rights of the noteholders.[92] Although the noteholders were never informed that their investment had been subordinated to the bank's secured interest, the bank encouraged Consolidated to continue raising funds by issuing unsecured promissory notes through the payroll program.[93] When Consolidated's financial condition became critical, the bank seized and liquidated the company's assets.[94] The bank applied the proceeds from liquidation to the company's outstanding debt to the bank.[95] The noteholders received nothing.[96]

The Third Circuit analyzed the bank's participation in the Rule 10b-5 violation in terms of the three elements of aiding and abetting liability.[97] First, the court recognized that Consolidated committed independent violations of section 12 of the '33 Act and section 10(b) of the '34 Act.[98] Consolidated violated section 10(b) by making misleading statements and omissions in connection with the note program.[99] Second, the court found that the bank had knowledge of the primary violation.[100] The court stated that to sustain an aiding and abetting charge, evidence must be adduced showing that the alleged aider-abettor "had a general awareness that his role was part of an overall activity that [was] improper."[101] In concluding that the bank had knowledge of the independent section 10(b) violation, the court found that the bank knew that no financial information had been given to the noteholders, and that the bank acquiesced in Consolidated's decision not to disclose its financial difficulties and the bank's priority position to the noteholders.[102]

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[91] *Id.* The investors, in making their investment, relied on the reputation of the Silverbergs, owners of Consolidated. *Id.* The noteholders should have received detailed financial information about Consolidated. SEC v. Ralston Purina Co., 346 U.S. 179 (1953); 15 U.S.C. §§ 77d(2); 77e; 77l(2) (1976); 17 C.F.R. § 239.146 (1978).

[92] 579 F.2d at 797-98.

[93] *Id.* at 798.

[94] *Id.*

[95] *Id.*

[96] *Id.*

[97] *Id.* at 799-800; *see* text accompanying note 85 *supra.*

[98] 579 F.2d at 798.

[99] *Id.*; *see* note 91 *supra.* The trial court also found as a matter of law that Consolidated violated section 12(1) of the '33 Act by its failure to register the notes. *Id.*; *see* 15 U.S.C. § 77l(1) (1976).

[100] 579 F.2d at 801-02.

[101] *Id.* at 799-800 (*citing* SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974)). The *Monsen* court stated tht the aider-abettor's knowledge of the fraud must be actual knowledge, but that a less strict requirement may be applied where the aider-abettor derives benefit from his wrongdoing. 579 F.2d at 799; *see* Gould v. American-Hawaiian Steamship Co., 535 F.2d 761, 780 (3d Cir. 1976); Landy v. FDIC, 486 F.2d 139, 162-63 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974).

[102] 579 F.2d at 801-02. The *Monsen* court, in finding that the bank had knowledge of Consolidated's independent fraud, relied upon the fact that the bank, as a major metropolitan lending institution, knew or should have known that Consolidated's notes were unregistered

Third, the court found that the bank substantially assisted Consolidated's independent fraud.[103] The court considered four factors in determining the bank's substantial assistance: the amount of assistance given by the aider-abettor, his presence or absence at the time of the independent violation, his relation to the primary violator, and the aider-abettor's state of mind.[104] The *Monsen* court stated that the bank's insistence that the note program be subordinated to its own secured interest, when combined with the bank's encouragement of Consolidated to continue the note program, was sufficient to establish the bank's substantial assistance.[105] The court concluded by stating that the bank's knowledge of the note program alone would not have established its aiding and abetting liability.[106] Conversely, the court noted that had the bank required the continuation and subordination of the note program without knowledge of the noteholder's lack of financial information and Consolidated's decision not to disclose, the bank's liability would not have been established.[107] Thus, the bank's knowledge of Consolidated's nondisclosure, plus the bank's rendering of substantial assistance, was sufficient to establish the bank's aiding and abetting liability.[108]

The Third Circuit's decision in *Monsen* illustrates some of the problems the concepts of "knowledge" and "substantial assistance" raise in analyzing aiding and abetting liability. Although it is often stated that banks, brokerage houses, accountants and attorneys should not be held as "insurers" of their customers' and clients' compliance with the securities laws, decisions such as *Monsen* inevitably tend to increase the investigative responsibilities of these institutions.[109] As the *Monsen* court realized, the task of ascertaining when a "legitimate business relationship between a lender and a borrower leaves the realm of propriety and enters the domain of proscribed conduct" is a difficult one.[110] In the absence of evidence showing self-aggrandizement on the part of the aider-abettor, such as existed in *Monsen*, the courts should remain reluctant to impose too high an investigative duty on lending institutions.[111]

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securities, and that the issuance of those notes without adequate financial information violated section 12(2) of the '33 Act. *Id.* at 802; *see* notes 91 & 99 *supra*.

[103] 579 F.2d at 802-03.

[104] *Id.* at 800. The four factors relied upon by the *Monsen* court in establishing its substantial assistance standard were taken from § 876 of the Restatement of Torts. *Id.*; *see* note 81 *supra*.

[105] 579 F.2d at 802.

[106] *Id.*

[107] *Id.*

[108] *Id.* The court stated that although it might not have held the bank liable, the evidence was sufficient to support a jury verdict. *Id.* at 803.

[109] The *Monsen* decision seems to place a greater burden upon lending institutions to investigate the financial position of its borrower's creditors before lending. *See* note 102 *supra*.

[110] *See* 579 F.2d at 795.

[111] The *Monsen* court's decision regarding the bank's knowledge of Consolidated's fraud is somewhat troubling because the court assumed, without proof, that the bank knew or

Substantial Assistance: The Duty to Disclose

Courts often establish an aider-abettor's substantial assistance by imposing upon the alleged aider-abettor a duty to disclose material information.[112] This duty to disclose flows from the alleged aider-abettor to the defrauded plaintiff.[113] Either action or inaction on the part of the aider-abettor can constitute a breach of the duty to disclose.[114] Breach of a judicially established duty to disclose material information, according to several recent decisions, is sufficient to establish the substantial assistance element of an aiding and abetting charge.[115]

In *SEC v. National Student Marketing Corp.*[116] (NSMC), the federal district court for the District of Columbia was presented with the issue whether two attorneys could be held liable as aiders and abettors. The SEC alleged that the attorneys aided and abetted a section 10(b) violation by failing to disclose to their client's shareholders adverse financial information acquired just before a merger closing.[117] The court, agreeing with the

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should have known that the note program was illegal. *See* note 102 *supra.* The court's statement that a court can impose a low scienter requirement when the defendant derives benefit from his wrongdoing, however, may provide a clue as to why the *Monsen* court reinstated the jury verdict. By assuming a priority position in relation to the noteholders, the bank derived benefit from its wrongdoing. *See* 579 F.2d at 798-99, 803 n.17. The court, realizing that the bank did benefit, may have relaxed its knowledge requirement. Absent justification for such a relaxed standard, however, imposition of aiding and abetting liability on a lending institution would seem to broaden peripheral liability beyond acceptable limits.

[112] *See, e.g.,* Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (3d Cir. 1978) (duty of loyalty owed by stockbroker to customer); SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978) (duty of disclosure owed by attorney to his client's shareholders). *See generally* Parker, *Attorney Liability Under the Securities Laws After* Ernst & Ernst v. Hochfelder, 10 Loy. L.A. L. Rev. 521, 536-53 (1977) [hereinafter cited as Parker].

[113] *See* note 114 *infra.*

[114] *See* Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46-47 (2d Cir. 1978); Ruder, *supra* note 83, at 641-44. Commentators generally have been hesitant to regard inaction or silence as substantial assistance. One commentator concluded that inaction should give rise to an aiding and abetting charge only if the alleged aider-abettor owed the defrauded party a duty of disclosure. Ruder, *supra* note 83, at 644 & n.211. Given such a duty, however, that commentator stated that liability should be primary, not secondary. *Id.* at 644.

[115] *See* Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46-47 (2d Cir. 1978); SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978). In *Rolf,* the Second Circuit upheld a trial court verdict in favor of an investor who sued his broker for aiding and abetting the independent fraud of the plaintiff's investment manager. 570 F.2d at 41-47. The court stated that the broker owed the plaintiff a duty of loyalty, and that the broker breached this duty by repeatedly assuring the plaintiff of the investment manager's competence. *Id.* at 47. Breach of this duty of loyalty, according to the court, amounted to substantial assistance. *Id.*; *see* text accompanying notes 172-90 *infra.*

[116] 457 F. Supp. 682 (D.D.C. 1978).

[117] *Id.* at 687, 700. The *National Student Marketing* case is the last act of a civil proceeding instituted by the SEC against NSMC and several other defendants. *Id.* at 686. The original defendants included NSMC and some of its officers and directors; Peat, Marwick, Mitchell & Co., an accounting firm, and several of its partners; various officers and directors of Interstate National Corp. the merged corporation; the law firm of White & Case and one of its partners; and the law firm of Lord, Bissell & Brook and two of its partners. *Id.* at 686-87.

SEC's allegations, held that the attorneys aided and abetted a section 10(b) violation.[118]

NSMC, a supplier of products for distribution on college campuses, sought to acquire Interstate, an insurance firm, so that NSMC could sell insurance to college students.[119] A merger agreement was prepared, requiring that a "comfort letter"—an accountant's representation as to the current financial position of a corporation—be presented by each corporation's accountant to the other corporation.[120] The comfort letter was to state that the accountants had no reason to believe that any material change had occurred in the corporations' financial position since the earlier issuance of interim financial statements.[121] During the merger closing, NSMC's counsel called NSMC's accountant who recited the comfort letter to counsel.[122] The orally reported comfort letter, later transcribed by NSMC's counsel, revealed that NSMC's previously-reported annual profit of $700,000 was nonexistent.[123] NSMC's counsel then delivered a copy of the comfort letter to Interstate's directors and Interstate's attorneys, the defendants in *NSMC*.[124] The Interstate directors and attorneys, after receiving the comfort letter, weighed their various alternatives.[125] Calling off the merger just prior to consummation would have been expensive for the Interstate group because of the short-term profits expected from quick resale of the newly-acquired NSMC stock.[126] In addition, the Interstate

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[118] *Id.* at 715.

[119] *Id.* at 688.

[120] *Id.* at 690.

[121] *Id.* The comfort letters were to state in full that (1) the auditors had no reason to believe that the audited interim financial statements of their clients were not prepared in accordance with accounting and auditing principles consistent with previous audits, (2) the auditors had no reason to believe that any material adjustments were required to present fairly the financial position of each company, and (3) each company had experienced no material adverse change in its financial position since the issuance of the interim financial statement. *Id.* Receipt of satisfactory comfort letters from both auditors was a condition precedent to the merger. *Id.*

[122] *Id.* at 691-92.

[123] *Id.* at 691. The reason for the disappearance of NSMC's profit was that Peat, Marwick adjusted amortization cash downward by $500,000, and further wrote off $300,000 of receivables. *Id.* at 692 & n.18.

[124] *Id.* at 693.

[125] *Id.* at 693-94. Schauer, one of Interstate's attorneys, read the letter first. He then passed the letter to the other Interstate representatives. *Id.* at 692. The Interstate group then inquired of NSMC as to the nature and effect of the adjustments. *Id.* The NSMC group responded that the adjustments were not material, and merely reflected Peat, Marwick's desire to "clean up" NSMC's books. Unbeknownst to the Interstate group was the fact that NSMC was in poor financial condition. *See generally* J. GOULDEN, THE MILLION DOLLAR LAWYERS 159-61 (1978).

[126] 457 F. Supp. at 693-94. The merger agreement provided that Interstate's shareholders would receive two shares of NSMC stock for every three shares of Interstate stock they owned. *Id.* at 688. This amounted to a 100 percent premium for the surrendered Interstate shares, based on their market value at the time. *Id.* at 689 n.7. The officers and directors of Interstate planned to sell their newly-acquired NSMC stock after the merger. *Id.* at 688-89.

directors and attorneys worried that postponing or cancelling the merger would push down the price of NSMC stock.[127] Finally, the Interstate group was concerned about possible stockholders suits for failure to carry out a favorable merger.[128] These economic concerns prevailed, and Interstate agreed to close the merger.[129] Shortly after the closing, NSMC's true financial position became known generally, and the SEC sought injunctions against all parties involved.[130]

The district court stated that two of Interstate's directors committed primary violations of section 10(b) by closing the merger without resoliciting Interstate's shareholders with corrected financial statements, and that Interstate's counsel, by failing to interfere with the merger closing after receipt of the comfort letter, aided and abetted the directors' primary violation.[131] In discussing the issue whether Interstate's counsel had sufficient knowledge of the primary violation to be liable as aiders-abettors, the court stated that Interstate's counsel knew the contents of the comfort letter and the materiality of the financial adjustments.[132] Interstate's counsel also knew that Interstate's shareholders, and the investing public generally, were unaware of the adjustments contained in the comfort letter.[133] Thus, the court concluded that the attorney-defendants had knowledge of the primary section 10(b) violation, satisfying the second element of the aiding and abetting charge.[134]

[127] *Id.* at 694.

[128] *Id.*

[129] *Id.* While the Interstate group was deciding whether to close the merger, NSMC's counsel was conferring with Peat, Marwick. *Id.* at 695. Peat, Marwick, by this time, had added two paragraphs to its comfort letter. *Id.* The first paragraph stated that the adjustments made earlier would result in a net loss for NSMC for the first nine months of 1969, and that the corporation would break even for the year. *Id.; see* text accompanying note 123 *supra.* The second stated Peat, Marwick's recommendation that Interstate shareholders be resolicited with corrected financial statements. *Id.* NSMC's attorney responded that the merger had been closed and therefore the letter was unnecessary. *Id.*

[130] *Id.* at 699.

[131] *Id.* at 712. The court first stated that Interstate's directors violated section 10(b) by failing to disclose the financial information to their shareholders. *Id.* at 711. The court emphasized that the fact that the directors expected to profit from the merger strongly supported a finding of scienter. *Id.* The court further stated that should actual intent to deceive, manipulate or defraud be absent, the defendant's conduct was clearly reckless and therefore tantamount to willful fraud. *Id.; see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring).

[132] 457 F. Supp. at 712-13. The court applied the same scienter requirement to the aiders-abettors as it imposed on the primary defendants. *Id.* at 712. The court stated that each defendant knew the information contained in the comfort letter had not been disclosed prior to the merger, and that the information was material. *Id.* at 713. The court distinguished this situation from one in which the alleged aiders-abettors either merely failed to discover the fraud or reasonably believed that the victims already knew of the undisclosed information. *Id.; see* Rolf v. Blythe, Eastman Dillon & Co., 570 F.2d 38, 52 (2d Cir. 1978) (Mansfield, J., dissenting); Hirsh v. duPont, 553 F.2d 750, 759 (2d Cir. 1977).

[133] 457 F. Supp. at 713.

[134] *Id.* at 713; *see* Ruder, *supra* note 83, at 630-31.

The court stated that to substantially assist a section 10(b) violation, the alleged aider-abettor must be aware that he is assisting a section 10(b) violation.[135] The court stated that inaction, as well as action, is sufficient to support the substantial assistance element of an aiding and abetting charge when the alleged aider-abettor owes a duty to disclose to the defruaded party.[136] To impute liability to the attorneys, therefore, the court had to impose a duty to disclose running from Interstate's counsel to Interstate's shareholders.[137] In establishing a disclosure duty, the *NSMC* court reasoned that when it became apparent that the merger was about to be closed on the basis of materially misleading information, the attorneys' obligation to their client, Interstate, required the attorneys to take steps to ensure that the information was disclosed to the shareholders.[138] The court did not delineate the parameters of this duty to disclose, but did state that the duty minimally required the attorneys to speak out at the closing about the materiality of the newly provided financial information and to make clear that the merger should not be closed until Interstate's shareholders were resolicited.[139] The court concluded that the attorneys, by not speaking out, lent an air of legitimacy to the merger closing, and substantially assisted the primary violation.[140] Confronted with the argument that the duty to disclose would conflict with the attorney-client privilege and inhibit client's business judgment, the court responded that it would not lightly overrule an attorney's conclusions regarding the materiality of the information involved and its need for disclosure.[141] The *NSMC* court stated, however, that on the facts before it the need for disclosure of material information clearly outweighed any need for confidentiality.[142]

[135] 457 F. Supp. at 713; *see* Ruder, *supra* note 83, at 630-38. The imposition of this test allows an alleged aider and abettor who knows of the independent fraud and who substantially assists that fraud to escape liability should the plaintiff fail to prove that the aider and abettor was aware that he was substantially assisting the fraud.

[136] 457 F. Supp. at 713; *see* text accompanying note 114 *supra*.

[137] *See* 457 F. Supp. at 713.

[138] *Id.* The court, in establishing a duty to disclose material information between an attorney and his client's shareholders, relied on several cases which had imposed similar duties. *Id.; see* Rolf v. Blythe, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir. 1978); Woodward v. Metro Bank, 522 F.2d 84, 97 & n.28 (5th Cir. 1975); Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147, 154-55 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970). Although realizing that the duties established in those cases contemplated disclosure to an opposing party and not to one's client, the court stated that the cases were "sufficiently analogous to provide support for a duty here." 457 F. Supp. at 713.

[139] *Id.* at 713. In establishing the duty between the attorneys and the shareholders, the *NSMC* court placed some weight upon the fact that the attorneys were learned in securities law. *Id.; see* note 158 *infra; cf.* Escott v. Bar Chris Constr. Corp., 238 F. Supp. 643, 686-90 (S.D.N.Y. 1968) (securities attorney who is director of corporation in order to establish due diligence defense under § 11(b)(3)(C) of the '33 Act, must satisfy a higher standard of investigation than must a non-attorney defendant).

[140] 457 F. Supp. at 713.

[141] *Id.*

[142] *Id.* The imposition of the duty on a corporate attorney to disclose material information

Although the *NSMC* court did not clearly outline the extent of the attorney's duty to disclose material information, it is clear from the court's tone that an attorney's justification for nondisclosure will be subject to a thorough after the fact analysis. Perhaps the most far reaching aspect of the case is the court's conclusion that the duty of disclosure between the attorney and the corporation runs not only to the directors, but also to the shareholders.[143] Although it is well-settled that a corporate director owes a fiduciary duty to shareholders,[144] there is little precedent supporting the court's conclusion that a duty to disclose runs from a corporation's outside counsel to his client's shareholders. The court's articulation of the attorney's duty to disclose, however, is easier to comprehend when viewed in the context of the inadequacy of shareholder remedies against a judgment proof corporation. The *NSMC* opinion expressly declined to define the scope of the attorney's duty to disclose, but later cases will no doubt attempt to define the exact nature of this duty at the expense of a securities bar caught unawares. Although it is rueful that the securities bar has been left with no easily discernible aiding and abetting standard after *NSMC*, this concern must be weighed against the fact that corporate shareholders, unequipped with effective tools to ward off securities law fraud, should be allowed to look to corporate attorneys to guard shareholder interests against the excesses of corporate directors. The *NSMC* case will at least bring about a long needed reexamination of the relationship between the lawyer's Code of Professional Responsibility and the need for full and fair disclosure under the federal securities laws.[145]

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to his client's shareholders requires the attorney to weigh any information which might later prove damaging to shareholder interests. Determining whether a certain piece of information is material is a difficult task. In the context of the duty of disclosure owed by a corporate director to a shareholder, the Supreme Court has stated that a fact is material if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." TSC Indus., Inc., v. Northway, Inc., 426 U.S. 438, 449 (1976). The Court stated that the question of materiality is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor. *Id.* at 445. The imposition of such a standard regarding a misleading proxy statement, given the existence of a fiduciary duty between a director and a shareholder, does not seem unreasonable. Whether such a duty should be imposed on outside counsel, however, has been questioned. *See* Parker, *supra* note 114, at 546-51.

One of the difficulties in establishing a duty of disclosure between a securities practitioner and the investing public is that the attorney's precise responsibilities in a securities transaction are difficult to identify. *Id.* at 551-52. In contrast, an accountant may use good faith adherence to Generally Accepted Accounting Principles as a shield against § 10(b) aiding and abetting liability. *See* SEC v. Arthur Young & Co., [Current] FED. SEC. L. REP. (CCH) ¶ 96,766 (9th Cir. Feb. 1, 1979). No such carefully delineated set of instructions exists for a securities practitioner. *See* Parker, *supra* note 112, at 551-52.

[143] *See* 457 F. Supp. at 713-14. The *NSMC* court characterized the duty between the outside corporate counsel and its clients' shareholders as a fiduciary duty. *Id.*

[144] *See, e.g.*, Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 364 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); Swanson v. American Consumer Indus., Inc., 415 F.2d 1326, 1334 (7th Cir. 1969).

[145] By redefining the scope and breadth of the attorney's duty, *NSMC* will force the

Substantial Assistance and the Duty to Investigate

Accountants, by the nature of their profession, have long owed a duty to disclose material information to a client's shareholders. An accountant's certified audit, prepared for the corporate client, is usually the sole criterion upon which a corporate shareholder can make an informed investment decision. Although this duty to disclose is clear, what is less clear is the extent of the accountant's duty to investigate his client's financial position while preparing his report. A recent Ninth Circuit decision has examined the question of how thorough an accountant's investigation need be in order to avoid section 10(b) aiding and abetting liability.

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attorney to consider the impact of information on shareholders, not just directors. In this respect, *NSMC* is similar to *Bar Chris*. *See* Escott v. Bar Chris Constr. Corp., 283 F. Supp. 643, 686-90 (S.D.N.Y. 1968). In *Bar Chris*, the court found an attorney-director liable for signing a misleading registration statement. *Id.* at 690. In commenting on the attorney's attempt to establish his "due diligence" defenses under § 11(b)(3)(C) of the '33 Act, the court stated that the attorney-director would have to satisfy a higher standard of due diligence than would the other director-defendants because of his expertise in the federal securities laws. *Id.* at 690; *see* 15 U.S.C. § 77k(b)(3) (1976). The *NSMC* court seemed to take *Bar Chris* to heart when it stated that the aiders-abettors, because they failed to speak at the closing regarding the problems with the merger, lent an air of legitimacy to the transaction. 457 F. Supp. at 713.

The *NSMC* court refered to the attorney's responsibilities to his corporate client. *Id.* at 713-14. The court seemed to define the corporate client as including the shareholders, since it is this group to which the attorney's duty to disclose runs. *Id.* The ramifications of *NSMC*, assuming the above to be true, are unsettling to corporate counsel. The attorney aiders-abettors in *NSMC* relied on "business judgment" as a defense, implying that their decision not to disclose was based upon their belief that the factors opposing consummation of the merger did not outweigh those factors supporting the closing. *See id.* at 693-94, 713; text accompanying notes 127-29 *supra*. The *NSMC* court, by stating that such a business judgment would not suffice to justify non-disclosure of such material information, placed corporate counsel in the difficult position of both looking out for shareholder interests and giving corporate officers and directors advice regarding the probable legality of their conduct. Given the differing interests between corporate boards and shareholders, attorney decisions in light of *NSMC* will be difficult indeed. Also, in a situation in which there exist two warring factions of shareholders, it is difficult to perceive to which group of shareholders an attorney's duty will run. The risks an attorney takes in deciding whether to disclose information to shareholders is great, because the SEC has the power to suspend, either temporarily or permanently, an attorney whose actions constitute either "unethical or improper conduct." *See* 17 C.F.R. § 201.2(e)(1) (1978).

A recent SEC administrative action under rule 2(e) has further confused a securities bar already confounded by *NSMC*. The SEC alleged that two attorneys, by failing to ensure that a director reveal his company's credit problems to the other directors and shareholders, aided and abetted a section 10(b) violation. *In re* Carter, SEC. REG. & L. REP. (BNA) No. 494, March 14, 1979, at A-13; *see SEC Slap: Heavy Blow to Lawyers*, April 9, 1979, at 1, col. 1-2. An administrative law judge (ALJ), proceeding under the theory that an attorney need not violate the securities laws in order to be held liable as an aider-abettor, suspended the two attorneys from practice for one year. *In re* Carter, SEC. REG. & L. REP. (BNA) No. 494, March 14, 1979, at A-13. The *Carter* case has been viewed with considerable trepidation by the securities bar. *See* Bialkin, *Commission's Latest 2(e) Proceeding Profoundly Disquiets Securities Bar*, The Nat'l L.J., April 30, 1979, at 25, col. 1.

In *SEC v. Arthur Young & Co.*,[146] the SEC charged Arthur Young, an accounting firm, with aiding and abetting an independent section 10(b) violation.[147] The Commission asserted that Arthur Young prepared its audit "with blinders on," and that the firm should have done more to reveal to investors the illegal conduct of the corporation's management.[148] The defendant argued that good faith compliance with Generally Accepted Accounting Principles (GAAP), a standard requiring the exercise of "due professional care," should satisfy an accountant's duty to investigate and therefore immunize the defendant from any section 10(b) aiding and abetting liability.[149] The standard advanced by the SEC, according to the court, for determining whether an accountant adequately performed his functions is whether he conducted his audit in a manner that would reveal to an ordinarily prudent investor a reasonably accurate reflection of the financial risk such an investor would bear if he invested in the corporation.[150] The court rejected the SEC's standard, stating that an auditor is neither an insurer of his client's compliance with the securities laws, nor an enforcement arm of the SEC.[151] Concluding that Arthur Young proved good faith compliance with GAAP, the court of appeals affirmed the trial court

[146] [Current] FED. SEC. L. REP. (CCH) ¶ 96,766 (9th Cir. Feb. 1, 1979).

[147] *Id.* at 95,005. The *Arthur Young* case grew out of the Jack Burke-Geotek oil fraud cases. SEC v. Geotek, 426 F. Supp. 715 (N.D. Cal. 1976). In *Geotek*, the SEC brought suit against Burke, Geotek, and Arthur Young, alleging that Burke, through Goetek, violated § 10(b) by making material misrepresentations and/or omissions in Geotek's offering circulars, oil exploration program agreements, prospectuses, limited partnership agreements and management agreements. The SEC also alleged that Arthur Young, Burke and Geotek's accountants, aided and abetted Burke's violations by making material misstatements and/or omissions in its audit report certifications of the Burke and Geotek financial documents. *Id.* at 725-26.

[148] [Current] FED. SEC. L. REP. (CCH) ¶ 96,766 at 95,006. The SEC charged that Arthur Yound, in the performance of its duties, either knew or should have known of the primary defendants' fraud. SEC v. Geotek, 426 F. Supp. 715, 730 (N.D. Cal. 1976). In essence, the SEC charged that Arthur Young should have done a more thorough audit of Burke and Geotek. *Id.* at 759. The trial court, disagreeing with the SEC, directed an entry of final judgment for Arthur Young. *Id.* at 731.

[149] [Current] FED. SEC. L. REP. (CCH) ¶ 96,766 at 96,006. The general standards to be used by accountants in preparing their audits are that the audit should be prepared by someone with adequate training, that independence be maintained by the accountant, and that the accountant exercise due professional care while preparing the audit. AICPA, PROFESSIONAL STANDARDS, STATEMENTS ON AUDITING STANDARDS, No. 1, § 150.01. Exercise of due professional care requires the accountant to review his product critically, but does not guarantee infallability or perfect judgment. *Id.* at §§ 230.02; 230.03. In particular, an audit made in accordance with Generally Accepted Accounting Principles (GAAP) cannot be expected to guarantee that a client's illegal acts will be detected. *Id.* at § 328.03.

[150] [Current] FED. SEC. L. REP. (CCH) ¶ 96,766 at 95,006. The standard proposed by the SEC imposes a stricter investigative duty upon accountants than do GAAP. *See* AICPA, PROFESSIONAL STANDARDS, STATEMENTS ON AUDITING STANDARDS, No. 1, § 150.01.

[151] [Current] FED. SEC. L. REP. (CCH) ¶ 96,766 at 95,006-07. The *Arthur Young* court stated that the SEC's demanding standard amounts to a conscription bill directed towards accountants. *Id.* Unfortunately for the SEC, stated the court, Congress has yet to pass such a bill. *Id.*

verdict in favor of the firm.[152]

Although *NSMC* and *Arthur Young* dealt with different duties and professions, it is noteworthy that the court in *Arthur Young*, unlike *NSMC*, precisely delineated the scope of the duty owed.[153] The *NSMC* court, in establishing a duty to disclose material information running from the attorney to the shareholder, rejected the attorney's contention that no such duty should exist due to the fact that the ABA Code of Professional Responsibility (Code) forbids disclosure of attorney-client communications.[154] The *Arthur Young* court carefully limited the parameters of the accountant's duty to investigate, accepting the accountant's assertion that their duty is fully set forth in GAAP.[155] The crucial distinction between *Arthur Young* and *NSMC*, however, may well lie in the profession involved rather than the duty owed or the respective merits of the Code and GAAP.

Section 10(b) aiding and abetting was designed to impute liability to peripheral actors in a securities law violation.[156] There must be some periphery of action, therefore, beyond which aiding and abetting liability will not lie. In order to define this boundary, *Monsen*, *NSMC* and *Arthur Young* looked to what the defrauded party could expect of the professionals involved, and to what was expected of these professionals generally. The *NSMC* court, in holding that an attorney owed a duty to disclose material information to his client's shareholders, was heavily influenced by the active role played by the attorneys in the merger.[157] Lawyers, according to *NSMC*, lend an appearance of legitimacy to a transaction.[158] For this reason, courts will closely scrutinize their conduct and hold them to high standards. Adherence to the Code will not absolve an attorney from section 10(b) liability when he knows, or should know, that shareholder interests are endangered by management actions.[159] In *Monsen*, the defendant bank

[152] [Current] FED. SEC. L. REP. (CCH) ¶ 96,766 at 95,007. The court stated that good faith compliance was necessary to absolve Arthur Young from section 10(b) liability since deliberate concealment of a material fact, even though the accountant literally complies with GAAP, is no shield. *Id.*; *see* United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

[153] *See* text accompanying notes 139 & 151 *supra*.

[154] 457 F. Supp. at 713; *see* note 145 *supra*.

[155] [Current] FED. SEC. L. REP. (CCH) ¶ 96,766 at 95,006.

[156] *See* text accompanying note 82 *supra*. Various cases in the past year have dealt with the question of whether respondeat superior is an appropriate method for the imposition of peripheral liability in the federal securities law field. *See, e.g.*, Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978) (employer of aider-abettor admitted liability); SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978) (employer of aider-abettor admitted liability); Sharp v. Coopers & Lybrand, 457 F. Supp. 879 (E.D. Pa. 1978) (court holds employer liable on respondeat superior theory). Whether respondeat superior can be squared with the *Ernst & Ernst* scienter requirement has been the subject of some controversy. *See* EIGHTH ANNUAL INST. ON SEC. REGULATIONS (A. Fleishner, R. Mundheim, B. Vandegrift, eds. 1977) 369-75.

[157] 457 F. Supp. at 713; *see* notes 139 & 145 *supra*.

[158] 457 F. Supp. at 713.

[159] *See id.*; note 145 *supra*.

probably would not have been held liable as an aider-abettor but for evidence showing its self-aggrandizement in the transaction.[160] Absent evidence tending to show self-aggrandizement, a lending institution should not be held liable as an aider-abettor, because the bank's role in the transaction, although significant, probably does not induce shareholder reliance or trust to the extent that an attorney's actions would.[161] The *Arthur Young* decision imposes the lowest burden. Accountants, unlike lawyers, do not lend an air of legitimacy to a transaction. Accountants do not insure the truthfulness of their audits, only the integrity of their preparation.[162] So long as the accountant satisfies the GAAP investigation standard, section 10(b) aiding and abetting liability should not lie. The battle between the SEC's expanded recovery-watchdog theories and the professional's desire to avoid peripheral liability should guarantee that the aiding and abetting area will remain among the most lively in the domain of section 10(b).

C. SCIENTER

The Supreme Court's 1976 decision in *Ernst & Ernst v. Hochfelder*[163] firmly established that negligent conduct is insufficient to support a private damages action brought under section 10(b) of the '34 Act[164] and Rule 10b-5.[165] Although the *Hochfelder* decision resolved a conflict among the circuits by eliminating negligence as a basis for liability in a private damages action,[166] the Court refused to specify the degree of culpability necessary to establish liability in a private action.[167] Moreover, the *Hochfelder* decision did not specify the degree of culpability the SEC must prove in an injunctive action. In attempting to resolve these two questions, lower federal courts have reached conflicting results.

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[160] *See* note 112 *supra.*

[161] Banks, like accountants, do not lend an air of legitimacy to a transaction. They only finance transactions.

[162] *See* AICPA, PROFESSIONAL STANDARDS, STATEMENTS ON AUDITING STANDARDS, No. 1, § 230.03; note 149 *supra.*

[163] 425 U.S. 185 (1976). The *Hochfelder* Court held that a private action for damages could not be maintained without an allegation of scienter. *Id.* at 193. The Court did not hold that the specific intent to deceive was necessary, just that mere negligence by the defendant would not suffice. *Id.* at 293 n.12; *see* Note, *Rule 10b-5 Liability After Hochfelder: Abandoning the Concept of Aiding and Abetting,* 45 U. CHI. L. REV. 218, 231 (1978); 1976-1977 *Securities Law Developments: Rule 10b-5,* 34 WASH. & LEE L. REV. 882, 910 n.176 (1977) [hereinafter cited as 1976-1977 *Developments*].

[164] 15 U.S.C. § 78j(b) (1976); note 2 *supra.*

[165] 17 C.F.R. § 240.10b-5 (1978); note 3 *supra.*

[166] Before the Supreme Court decided *Hochfelder,* eight circuit courts had ruled on the question of the requisite degree of culpability in private damages actions. *See generally* Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5:* Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213, 213-14 n.6 (1977) [hereinafter cited as Bucklo]; Note, *The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) After* Ernst & Ernst v. Hochfelder, 77 COLUM. L. REV. 419, 420 n.6 (1977) [hereinafter cited as *Scienter Requirement*].

[167] 425 U.S. at 193-94 n.12.

1. *Private Damage Actions*

One of the questions left unanswered by *Hochfelder* was whether reckless conduct satisfies the Court's scienter requirement for a Rule 10b-5 violation.[168] The common law actions of misrepresentation and deceit required proof of scienter.[169] Reckless behavior, as well as intentional or knowing conduct, were regarded as forms of scienter sufficient to support these common law actions.[170] Courts since *Hochfelder*, consistent with

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[168] *Id.*

[169] *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 684-86 (4th ed. 1971) [hereinafter cited as PROSSER]. The leading common law case on fraud, Derry v. Peek, [1889] 14 A.C. 337, 374, held that to prove fraud the plaintiff must prove that a false misrepresentation had been made "(1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false." *See* PROSSER, *supra*, § 107, at 669. In actions for fraud, the majority of American courts have accepted *Derry's* holding, and have required proof of one of the culpable states of mind, which became known as scienter. *Id.* at 669-700.

[170] *Id.* at 700-01; A. BROMBERG, SECURITIES LAW: FRAUD § 84 (503), at 204.103 (1975); 3 LOSS, *supra* note 39, at 1432. *See generally* Bucklo, *Scienter and Rule 10b-5*, 67 NW. U. L. REV. 562 (1972) [hereinafter cited as Bucklo, *Scienter*]; Haimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 BUS. LAW. 147 (1976) [hereinafter cited as Haimoff].

When a misrepresentation or omission is made five states of mind are possible. (1) The defendant may have honestly believed the statement to be true, with his belief based on solid reasoning and factual analysis, yet external factors cause the statement to be false; or the defendant omitted to reveal a material fact when a reasonable man either would not have known the fact or, if he knew it, not known the fact was material. (2) The defendant may have honestly believed the statement to be true, but a reasonable man would not have made the statement without further factual basis; or through negligence the defendant did not know the omitted fact, or if he knew it, negligently did not know the omitted fact was material. (3) The defendant believed his statement to be true, but there was no basis for the belief; or the defendant was reckless in either not knowing of the fact or not knowing of its materiality. (4) The defendant knew his statement was false; or the defendant knew the omitted fact was material. (5) The defendant knew the statement was false and intended the statement to cause injury; or the defendant intended the omitted fact to cause harm. *See* Bucklo, *Scienter*, *supra*, at 568; *Scienter Requirement*, *supra*, note 166, at 419. The states of mind described above in (3), (4) or (5) satisfied the common law scienter requirement. *See, e.g.*, PROSSER, *supra* note 169, at 701; Bucklo, *Scienter*, *supra*, at 569. *See also* Derry v. Peek, [1889] 14 A.C. 337, 374. The antifraud provisions of the federal securities laws are based on common law principles. Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 45-46 (2d Cir. 1978); Holdsworth v. Strong, 545 F.2d 687, 693-94 (10th Cir. 1976), *cert. denied*, 439 U.S. 955 (1977).

The *Hochfelder* court defined scienter as the "intent to deceive, manipulate, or defraud." 425 U.S. at 194 n.12. This language could be read to mean that the defendant must intend to bring about a specific result, the defrauding of the plaintiff, before Rule 10b-5 is violated. *See* Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 45-46; *Scienter Requirement*, *supra* note 166, at 419 n.2. The *Hochfelder* Court did not, however, exclude recklessness as a state of mind capable of supporting a Rule 10b-5 violation. 425 U.S. at 193-94 n.12. Therefore, since the Court did not express any intent to break from settled common law standards, the court clearly did not intend to preclude liability in a private damage action where the defendant acted recklessly, but only to preclude liability for "mere negligence." Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 470 (1977). *See generally* Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of* Hochfelder, 51 N.Y.U.L. REV. 769 (1976) [hereinafter cited as Berner & Franklin]; Lowenfels, *Scienter or Negligence Required for SEC Injunctions Under Section 10(b) and Rule 10b-5: A Fascinating Paradox*, 33 BUS. LAW. 789 (1978) [hereinafter cited as Lowenfels]; Note, *SEC* common law precedent, have uniformly held that reckless conduct is sufficient to support private damage actions under Rule 10b-5.[171]

Two federal circuit courts recently considered the culpability requirement in private damage actions and held that reckless as well as knowing conduct meets the *Hochfelder* standard. In *Rolf v. Blyth, Eastman Dillon & Co.*,[172] the Second Circuit concluded that the reckless conduct of an alleged aider and abettor of a Rule 10b-5 violation[173] satisfied the scienter requirement. The court limited its holding, however, by addressing only those situations where a fiduciary relationship exists.[174] In *Rolf*, a registered representative of Blyth, Eastman Dillon & Co. (BEDCO) was found liable for aiding and abetting the Rule 10b-5 violation of an independent investment advisor.[175] The broker's misrepresentations arose from his continued assurances to the plaintiff that the investment advisor was doing a good job managing the plaintiff's account, was a competent investment advisor, and was one in whom the plaintiff could repose his trust. The investment advisor's purchases, most of which were made through the broker and BEDCO, steadily declined in value during the period in which the statements were made to the plaintiff.[176] Even though the plaintiff's broker thought that some of the securities bought for the account were "junk", the district court found that the broker was ignorant of the investment advisor's fraudulent stock manipulations.[177] The court concluded, however, that the broker's statements were made with reckless disregard as to their truth or falsity.[178]

Enforcement Actions to Enjoin Violations of Section 10(b) and Rule 10b-5: The Scienter Question, 5 HOFSTRA L. REV. 831 (1977).

[171] *See, e.g.*, Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44-47 (2d Cir. 1978); Wright v. Heizer Corp., 560 F.2d 236, 252 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978); Dupuy v. Dupuy, 551 F.2d 1005, 1020 (5th Cir. 1977), *cert. denied*, 434 U.S. 911 (1978); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27, 37 (2d Cir. 1976). *See generally* 1977-1978 *Securitiess Law Developments: Rule 10b-5*, 35 WASH. & LEE L. REV. 799, 827 (1978) [hereinafter cited as 1977-1978 *Developments*].

[172] 570 F.2d 38 (2d Cir.), *cert. denied*, 99 S.Ct. 642 (1978).

[173] *See* text accompanying notes 81-162 *supra*.

[174] 570 F.2d at 44 n.9. The *Rolf* court expressly refused to decide whether recklessness satisfies the scienter requirement where the alleged aider and abettor owes no duty of disclosure or loyalty to the defrauded party. *Id.*

[175] *Id.* at 41-44. When Yamada, the investment advisor, took over Dr. Rolf's portfolio on May 9, 1969, the plaintiff's equity was $1,423,000. By March 29, 1970, the value of the portfolio had dropped to $446,000. The district court concluded that the investment advisor had engaged in fraudulent manipulation of the plaintiff's stocks. Rolf v. Blyth, Eastman Dillon & Co., 424 F. Supp. 1021, 1043 (S.D.N.Y. 1977). BEDCO's registered representative was to work closely with the investment advisor in the selection and purchase of stocks, and generally supervise the management of the plaintiff's account. In fact, the plaintiff trusted the pair to the extent that he gave broad authorization to the investment advisor with full trading discretion and left his account with BEDCO's representative. The investment advisor settled with the plaintiff out of court and was not a party to the instant action. 570 F.2d at 41 n.2.

[176] *Id.* at 42-43.

[177] 424 F. Supp. at 1042-43.

[178] *Id.* at 1042.

The Second Circuit affirmed the lower court's finding that the broker's conduct was reckless.[179] The circuit court based its decision that recklessness constituted scienter on four grounds. First, the fiduciary relationship compels a recklessness standard for the scienter requirement.[180] A fiduciary must adhere to special rules of conduct and is expected to fairly and fully disclose to the person he owes the fiduciary duty.[181] Since the broker in *Rolf* was a fiduciary, he owed a special duty to the plaintiff and was obligated to act in the plaintiff's best interest. The *Rolf* court stated that liability based on the recklessness of a fiduciary was not the same as liability based on negligence, a standard of culpability expressly disapproved by the *Hochfelder* court.[182] The second basis offered by the court for holding that reckless behavior met the Supreme Court's scienter requirement was the common law concept of knowing conduct.[183] *Hochfelder* defined scienter as "knowing or intentional misconduct."[184] The *Rolf* court reasoned that scienter included the common law concept of knowing conduct and that recklessness was a form of knowing conduct at common law. The court concluded that since the federal securities laws are based on common law concepts, scienter must include recklessness for purposes of section 10(b) and Rule 10b-5.[185] Third, the *Rolf* court found that the precedent of the Second Circuit, developed both before and after *Hochfelder*, held that recklessness satisfies the scienter requirement.[186] Finally, the court did not want to impose a seemingly impossible burden of proof on a plaintiff by requiring proof of the specific intent to deceive or defraud.[187] The court stated that to require proof of the specific intent to defraud would

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[179] 570 F.2d at 44, 48. Because of the fiduciary relationship between the plaintiff and the broker, the court obviously felt that the broker had a duty to inquire about Yamada's dealings before assuring the plaintiff of the quality of the investments. *Id.* at 47-48.

[180] *Id.* at 45.

[181] *See* D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES, at 679-80 (1973) [hereinafter cited as DOBBS].

[182] 570 F.2d at 45. At common law a fiduciary must do more than simply avoid misleading by half-truths or active concealment. DOBBS, *supra* note 181, at 680. A fiduciary has the duty to fully disclose material information. If a fiduciary does not fully disclose, either because of a conscious decision or a reckless ignorance of the truth, he is liable to the party to whom he owes the duty. This breach of fiduciary duty was known at common law as equitable or constructive fraud. *Id.* at 679.

[183] 570 F.2d at 45; *see* notes 169-70 *supra*.

[184] 425 U.S. at 197.

[185] 570 F.2d at 45-46; *see* note 170 *supra*.

[186] 570 F.2d at 46 (citing Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc) and Shentob v. Shearson Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971)). The court cited several cases from other circuits holding that the recklessness standard is consistent with *Hochfelder*. *See, e.g.,* Sanders v. John Nuveen & Co., 554 F.2d 790, 792 (7th Cir. 1977); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1040, 1043-45 (7th Cir. 1977), *cert. denied,* 434 U.S. 875 (1978); McLean v. Alexander, 420 F. Supp. 1057, 1080-82 (D. Del. 1976).

[187] Specific intent is an intent to bring about a particular result, such as the deception of a plaintiff. *Cf.* Note, *Proving Discriminatory Intent From a Facially Neutral Decision With a Disproportionate Impact,* 36 WASH. & LEE L. REV. 109, 118 (1978).

"disembowel the private cause of action under § 10(b)"[188] and require a standard of proof never thought necessary at common law. The *Rolf* majority was careful not to impose liability for wholly faultless conduct[189] by defining reckless conduct as conduct that was "highly unreasonable" and which portrayed "an extreme departure from the standards of ordinary care. . .to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."[190] Using this standard, no purely negligent conduct could be held to violate Rule 10b-5.

In *Nelson v. Serwold,*[191] a case involving a failure to disclose material facts, the Ninth Circuit held that a defendant could violate Rule 10b-5 with either knowing or reckless conduct.[192] In *Nelson,* the defendant was president of a group of investors[193] who owned a majority of Poulsbo Rural Telephone Association (Poulsbo Telephone) stock.[194] During the settlement of the estate of a relative of the plaintiff,[195] the defendant was asked

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[188] 570 F.2d at 47. In dissent, Judge Mansfield disagreed with the legal standard employed by the majority. Judge Mansfield would impose liability for aiding and abetting a violation of Rule 10b-5 only if the aider-abetter "deliberately shut his eyes to the obvious, such as material facts that would be patent upon a mere cursory examination or review." *Id.* at 52. The dissent concluded that the majority was imposing liability for mere negligence, a standard contrary to the specific holding in *Hochfelder. Id.*

The dissent seems to overlook the fact that an affirmative misrepresentation can be "made by one who is conscious that he has no sufficient basis of information to justify [it]." PROSSER, *supra* note 169, at 701. The dissent's standard would allow a statement to be made without any regard to the actual facts underlying the situation. If a person knows he does not have sufficient basis for his statements, he acts intentionally. *See* example 5, note 170. Moreover, requiring deliberate action means that there must be a conscious decision not to investigate. Implicit in the standard proposed by the dissent is the requirement that the plaintiff prove that the defendant had the intent to defraud before an action under Rule 10b-5 will lie. Requiring proof of intentional or knowing conduct would make the standard under Rule 10b-5 more exacting than the standard required for proof of common law fraud. *See* Haimoff, *supra* note 170, at 151; 1976-1977 *Developments, suppa* note 163, at 921. Under a recklessness standard, a defendant must at least make himself aware of obvious facts. *See* 1975-1976 *Securities Law Developments: Rule 10b-5,* 33 WASH. & LEE L. REV. 937, 937 (1976) [hereinafter cited as 1975-1976 *Developments*]. A departure from such a standard would encourage defendants to neglect their fiduciary duties and would eliminate any incentive to make a reasonable investigation, thereby lowering the protection afforded by the common law. Such a result was not intended by the *Hochfelder* Court and was correctly rejected by the *Rolf* majority.

[189] 570 F.2d at 46 n.15.

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

[191] 576 F.2d 1332 (9th Cir.), *cert. denied,* 99 S.Ct. 464 (1978).

[192] *Id.* The actual communications providing the basis of the suit were between the defendant and an attorney for a relative of the plaintiff during an attempt to settle the relative's estate. *Id.* at 1334.

[193] *Id.* at 1334-35. Fifty-six per cent of the Poulsbo Rural Telephone Association stock was owned by a control group. The group bought the stock with plans to modernize the company and make it into a marketable entity which would eventually be sold for a substantial profit. *Id.* at 1334.

[194] *Id.* Poulsbo Telephone was a small, antiquated telephone company operating in the state of Washington. *Id.*

[195] *Id.* at 1334-35; *see* note 191 *supra.*

to reveal the status of thirty-six shares of Poulsbo Telephone stock which had been issued to the deceased.[196] In the negotiations between the parties for the sale of the stock, neither the existence nor the plans of the control group[197] were revealed by the defendant. In an attempt to buy the stock, the defendant originally offered $5.00 per share[198] which the plaintiff, because he had no other information, assumed was the fair market value.[199] The parties eventually agreed upon a price of $6.94 per share, although the stock had a book value of approximately $60.00 per share.[200] When the control group sold the stock in 1971 to United Utilities, Inc.,[201] (United) each share of Poulsbo Telephone was exchanged for a block of twenty-five shares of United stock worth approximately $500.00.

In reaching a decision in *Nelson,*[202] the Ninth Circuit analyzed the scope of the *Hochfelder* scienter requirement. The court concluded that the Supreme Court had held only that negligent conduct would not violate Rule 10b-5, not that the specific intent to defraud was required.[203] Relying on decisions subsequent to *Hochfelder,*[204] and the statements of distinguished jurists[205] prior to *Hochfelder,* the *Nelson* court held that scienter included knowing or reckless conduct.[206] The court found that the failure of the defendant to inform the plaintiff of the control group's existence and of their plan to upgrade Poulsbo Telephone and eventually sell it was done with "knowledge".[207] By finding that the defendant knew of his omissions,[208] the court determined that the defendant knew that the information about the control group and its long-range plans would be material[209]

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[196] 576 F.2d at 1334-35.

[197] *Id.* at 1336; *see* note 193 *supra.*

[198] 576 F.2d at 1335.

[199] *Id.*; *see* note 210 *infra.*

[200] 576 F.2d at 1335.

[201] *Id.*

[202] *Id.* The district court's opinion was handed down before *Hochfelder* and relied on White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974) (no scienter necessary in Rule 10b-5 private damages action), and Myzel v. Fields, 386 F.2d 718, 734, 747 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968) (rejection of scienter standard). The district court also found that the defendants did not act "deliberately" or "cold-bloodedly" to defraud the plaintiffs. 576 F.2d at 1337. With the change in the law announced by *Hochfelder,* the Ninth Circuit had to determine if the district court had premised its holding on negligence or if some form of scienter was present. *Id.* The circuit court concluded that the evidence supported a finding of recklessness. *Id.* at 1338.

[203] *Id.*; *see* note 163 *supra.*

[204] Bailey v. Meister Brau, Inc., 535 F.2d 982, 993 (7th Cir. 1976); McLean v. Alexander, 420 F. Supp. 1057, 1078 (D. Del. 1976).

[205] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968) (en banc) (Friendly, J., concurring), *cert. denied,* 394 U.S. 976 (1969); Kohn V. American Metal Climax, Inc., 458 F.2d 255, 280-81 (3rd Cir.) (Adams, J., concurring and dissenting), *cert. denied,* 409 U.S. 874 (1972).

[206] 576 F.2d at 1337.

[207] *Id.*

[208] *Id.*

[209] The court stated that "a statement or an omission is material if it reasonably could have been expected to influence the decision to sell." *Id.* at 1335.

to the Nelson estate's determination whether to sell and the price to ask for the stock. The court held that actual knowledge of materiality, coupled with a conscious decision not to reveal, is knowing conduct within the meaning of scienter established by *Hochfelder* and at common law.[210]

The Second Circuit in *Rolf* and the Ninth Circuit in *Nelson* joined an overwhelming majority of courts holding that recklessness satisfies the *Hochfelder* Court's requirement of scienter in Rule 10b-5 private damage actions.[211] Neither case imposes liability for purely negligent conduct.[212]

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[210] 576 F.2d at 1337-38. At common law scienter included knowing conduct. *See* PROSSER, *supra* note 169, at 700-01; Haimoff, *supra* note 170, at 157; *Scienter Requirement, supra* note 166, at 419; 1975-1976 *Developments, supra* note 188, at 937. The type of conduct described in *Nelson* corresponds with example four, note 170.

In addition to finding knowing conduct, the *Nelson* court determined that the evaluation of the "status" of the stock, referring to the fair market value of the stock, was reckless. Although this evaluation was actually done by the defendant's attorney, the court imputed this recklessness to the defendant. 576 F.2d at 1338. Even though the reasoning of the court is not particularly clear, the alternative finding that the evaluation of the status of the stock was reckless could be interpreted to mean that the defendants were reckless in not knowing the materiality of their omission, thus fulfilling one part of the recklessness test developed by the Seventh Circuit in Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir. 1977). In *Sundstrand,* the Seventh Circuit developed a two part test for determining recklessness that requires proof of both an objective and subjective component. The objective component of the test is fulfilled by actual knowledge of material facts or by a total disregard of that knowledge. These facts must be so obvious to any reasonable man that the defendant is legally bound as knowing them. *Id.* at 1045. The subjective element of the *Sundstrand* test is fulfilled by an intentional decision, as opposed to an unintentional one, not to reveal the information. *Id. See* 1977-1978 *Developments, supra* note 171, at 829-30. Therefore, since the defendant in *Nelson* knowingly did not reveal the control group's existence, and was reckless in not knowing the materiality of the omission, the defendant satisfied both the objective and subjective elements of the *Sundstrand* test.

Another decision holding that recklessness satisfies the *Hochfelder* scienter requirement is Sharp v. Coopers & Lybrand, 457 F. Supp. 879 (E.D. Pa. 1978). In *Sharp,* an employee of the defendant accounting firm allegedly made material misrepresentations and omissions recklessly or with an intent to defraud. The misrepresentations and omissions were contained in an opinion letter explaining the federal tax consequences of investments in a limited partnership interest in an oil drilling venture. After a jury verdict finding the defendant guilty of violating Rule 10b-5, the defendant made motions for judgment n.o.v. and a new trial claiming that recklessness did not satisfy the *Hochfelder* requirement. The court rejected this assertion, relying on Coleco Indus., Inc. v. Berman, 567 F.2d 569, 574 (3d Cir. 1977), *cert. denied,* 99 S.Ct. 106 (1978). The defendant also claimed that the court had incorrectly charged the jury about the meaning of scienter. The jury was charged with the definition of recklessness developed in Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719 (W.D. Okla. 1976). The *Franke* court stated:

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

Id. at 725. Serious consideration by the jury of the *Franke* language could not possibly lead to a finding of liability for purely negligent conduct. Therefore, the *Hochfelder* requirement was satisfied.

[211] *See* note 171 *supra.*

Both decisions support the policies of full disclosure and reasonable investigation by persons buying and selling securities and effectuate the common law doctrines that underlie the antifraud provisions of the federal securities laws.[213]

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[212] *But see* Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 52 (2d Cir. 1978) (Mansfield, J., dissenting); note 189 *supra*.

The Fifth Circuit also has stated that the SEC must prove scienter in an injunctive action. *See* text accompanying notes 225-31 *infra*. In SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978), however, a negligence standard may have been employed mistakenly. In *Blatt* the defendant was the personal attorney for a co-defendant and corporate counsel for Corporation of the Americas Limited [COAL]. *Id.* at 1328. When the defendants learned that Exquisite Form Industries, Inc. [Exquisite] wanted to purchase a block of COAL stock, they made material omissions to several COAL shareholders to entice them into selling their stock. After holding the stock for less than six months, the defendants sold the stock and made $315,000 on their $59,662 investment. Approximately one year later when Exquisite planned a merger with COAL, the defendant transferred his COAL stock into trust so that the trustee could go on record as opposed to the merger. By opposing the merger, the defendant hoped to work out a more favorable deal for his stock. The district court found that the defendant's failure to inform sellers of COAL stock of the likelihood of the sale to Exquisite, his failure to inform Exquisite management of his beneficial ownership of COAL stock, and his failure to inform Exquisite of his objection to the COAL-Exquisite merger, were all material omissions. *Id.* at 1332. Because the Fifth Circuit requires proof of scienter in SEC injunction actions, as well as private damages suits, *see* text accompanying notes 225-32 *infra*, the court had to determine if the defendants possessed the mental state required to violate Rule 10b-5. The court stated

> The record in this action reveals knowing omissions by each appellant. The court below found that Blatt and Pullman had inside knowledge. Unquestionably they knew that the information was not disclosed to sellers of COAL stock. Their conduct, in our judgment, encompassed just the type of "knowing or intentional misconduct" that § 10(b) was intended to proscribe.

Id. at 1334. This reasoning is flawed, however, because the court focused on the wrong type of "knowing". Unless the defendants simply forgot to reveal the information, *see* 1977-1978 *Developments, supra* note 171, at 829, their omissions were knowing in that they realized they were not disseminating all the information they possessed. The *Blatt* defendants did not simply forget to reveal the material information. The "knowing or intentional" conduct that § 10(b) proscribes, however, is the knowledge that the information withheld is material or that the statements made are false. *See* note 170 *supra*. Unless the defendant knows the information is material or acts in reckless disregard of that knowledge, *see* note 170 *supra*, Rule 10b-5 is not applicable. The *Blatt* court failed to recognize the *Hochfelder* focus on scienter as a state of mind, in that one may be aware of the facts, yet not have an intent to deceive because he believes that the facts omitted are not material or that the omission does not make other representations misleading. *See* BLOOMENTHAL, FED. SEC. CORP. L. REP. 16 (1979). The standard applied in *Blatt* would punish not only negligent conduct, but purely innocent conduct as well.

Moreover, the court declined to define reckless conduct. 583 F.2d 1334 n.27. The standard purportedly used by the *Blatt* court is knowing conduct, *see* note 170 *supra* (example four), rather than recklessness. Common law "knowing conduct", sufficient for proof of scienter, requires actual proof that the defendant knew his statement was false or that his omission would have a false impression. *See* PROSSER, *supra* note 169, at 686; notes 169-70 *supra*. Simple proof that the speaker knew more information than he revealed is not "knowing" conduct as that term is used at common law. *See* notes 169-70 *supra*.

[213] *See* notes 169-70 *supra*.

2. *SEC Injunctive Actions*

Another question left unresolved by the Supreme Court in *Hochfelder* was whether scienter must be proven in SEC injunctive actions.[214] The SEC brings injunctive actions to protect the investing public from future violations of the securities law.[215] Since an investor is harmed as much by negligent conduct that causes injury as by an action undertaken with scienter,[216] some courts have required the SEC to prove only simple negligence to establish a violation of Rule 10b-5.[217] Other courts have held that the scienter standard for private damage suits must apply in SEC actions because of the harsh remedies available to the SEC, including the power to force restitution or a disgorgement of profits,[218] the appointment of a receiver,[219] an accounting,[220] and freeze orders on a company's stock.[221] In addition, the possibility of collateral use of an SEC injunctive order in a subsequent private damage[222] or criminal suit[223] underscores the severity of

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[214] The Court in *Hochfelder* expressly refused to decide whether scienter was necessary in a suit for injunctive relief under § 10(b) and Rule 10b-5. 425 U.S. at 194 n.12.

[215] *E.g.*, SEC v. Management Dynamics, Inc., 515 F.2d 801, 808 (2d Cir. 1975); SEC v. Western Geothermal & Power Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,590, at 94,524 (D. Ariz. Sept. 16, 1978); 1976-1977 *Developments, supra* note 163, at 911-12. The SEC is authorized to bring injunctive actions by § 20(b) of the '33 Act, and § 21(d) of the '34 Act. 15 U.S.C. § 77t(b) and 78u(d) (1976). The standard for granting an injunction is whether there is "positive proof of a reasonable likelihood of future illegal conduct." SEC v. Wills, [Current] FED. SEC. L. REP. (CCH) ¶ 96,712 at 94,771 (D.D.C. Dec. 18, 1978); *see* SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 18 (2d Cir. 1977). The district court in *Wills* identified several important factors a court considers before granting an injunction: whether there is proof of fraud or scienter, whether the violations were technical or flagrant and outrageous, whether the defendants realized they violated the securities laws and whether they were in position to continue these violations, and whether the violation was an isolated incident or involved many violations. SEC v. Wills, [Current] FED. SEC. L. REP. (CCH) ¶ 96,712, at 94,772 (D.D.C. Dec. 18, 1978); *see* SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 100 (2d Cir. 1978); SEC v. Manor Nursing Centers Inc., 458 F.2d 1082, 1100 (2d Cir. 1972).

[216] *See SEC General Counsel's Memorandum Regarding* Ernst & Ernst v. Hochfelder, SEC. REG. & L. REP. (BNA), No. 354 at F-1 - F-2 (May 26, 1976); Floor, *The Scienter Requirement Under Rule 10b-5 and Reliance on Advice of Counsel After* Hochfelder, 12 NEW ENGL. L. REV. 191, 208-13 (1976).

[217] *See, e.g.*, SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976); SEC v. Western Geothermal & Power Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,590 at 94,923 (D. Ariz. Sept. 16, 1978).

[218] *See, e.g.*, SEC v. Blatt, 583 F.2d 1325, 1327 (5th Cir. 1978); SEC v. Shapiro, 494 F.2d 1301, 1305 (2d Cir. 1974); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1098 (2d Cir. 1972).

[219] *See e.g.*, SEC v. Charles Plohn & Co., 448 F. 2d 546 (2d Cir. 1971); SEC v. Arkansas Loan & Thrift Corp., 427 F. 2d 1171 (8th Cir. 1970); SEC v. Barlett, 422 F.2d 475 (8th Cir. 1970).

[220] SEC v. National Sec., Inc., 393 U.S. 453 (1969).

[221] *See* SEC v. Radio Hill Mines Co., [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,855, at 90,192 (S.D.N.Y. 1970).

[222] SEC v. Radio Hill Mines Co., [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,785, at 93,412 (S.D.N.Y. 1973). An attorney might be permanently disqualified from practicing before the SEC as a result of an injunction. *See* SEC 1933 Act Rev. Nos. 5088

the injunctive action. Because of these competing policies, legal commentators are also divided on this issue.[224] During the past year courts continued to disagree over whether negligence or scienter need be proven in an SEC injunctive action.

In *SEC v. Blatt,*[225] the Fifth Circuit weighed the competing considerations before deciding that the SEC must prove scienter in an injunctive suit.[226] The court noted that past decisions often considered public policy arguments, such as the SEC's public guardian function and the mild remedies obtained by the SEC, as a way to differentiate between private action and SEC enforcement suits.[227] The court concluded, however, that even though policy arguments were appealing, "the language of the statute must control when sufficiently clear in its context."[228] Moreover, the court found that the scienter requirement applied with more force to an SEC action than to a private damages suit because Congress did not contemplate private actions when section 10(b) was enacted.[229] Thus the *Blatt* court concluded that since Rule 10b-5 injunctive actions and private damage suits are "creatures of the same statute",[230] the necessity of proving culpability must be the same.[231]

The federal district court for the District of Columbia recently took a similar approach in *SEC v. Wills.*[232] Wills and his co-defendant were execu-

(1970) and 5147 (1977); SEC Rule of Practice, 2(e); 1978-1979 *Securities Law Developments: Supreme Court Definition of the Parameter of Class Actions in Shareholder Litigation,* 36 WASH. & LEE L. REV. 884 (1979) [hereinafter cited as *Shareholder Litigation*].

[223] Frank v. United States, 395 U.S. 147, 148 (1969).

[224] *Compare Scienter Requirement, supra* note 166, at 445 (scienter not required in SEC injunctive actions) *and* Note, *SEC Injunctive Actions: A Negligence Standard under Rule 10b-5,* 28 SYRACUSE L. REV. 763, 785 (1977) (scienter not required); *with* Berner & Franklin, *supra* note 170, at 797-98 (SEC must prove scienter); *and* Lowenfels, *supra* note 170, at 807-09 (scienter necessary).

In an injunctive action, a plaintiff normally must show an irreparable harm and an inadequate remedy at law. DOBBS, *supra* note 181, at 57. The SEC need show neither. *See* Rondeau v. Masinee Paper Corp., 422 U.S. 49, 57 (1975); K. BIALKIN, THE 10B SERIES OF RULES, at 205-06 (1975). Since the SEC is specifically empowered to seek injunctions, it need only meet the requirements of the statute. *See* note 215 *supra.*

[225] 583 F.2d 1325 (5th Cir. 1978); *see* note 212 *supra.*

[226] 583 F.2d at 1332-33. After noting that the scienter issue was left unresolved by the Court in *Hochfelder,* the *Blatt* court briefly reviewed the *Hochfelder* reasoning for requiring scienter in a private damages action. *Id.* The court was persuaded by the *Hochfelder* Court's focus on the statutory language, and the legislative and administrative history of § 10b. The *Blatt* court somewhat discounted the *Hochfelder* discussion of the interrelationship of the civil liability provisions in the '33 and '34 Acts. *Id.* at 1333. *See* 425 U.S. at 206-09.

[227] 583 F.2d at 1333.

[228] *Id.* The court labeled policy considerations as "extraneous". *Id.*

[229] *Id.* at 1333 n.21. The Fifth Circuit stated "[t]he Supreme Court has determined that Congress did not contemplate private actions under § 10(b). *Hochfelder,* 425 U.S. at 196 . . .Therefore, it follows logically that the scienter requirement implicit in the statute must have been intended for SEC proceedings." *Id. See* text accompanying notes 254-57 *infra.*

[230] 583 F.2d at 1333.

[231] *Id.*

[232] [Current] FED. SEC. L. REP. (CCH) ¶ 96,712 (D.D.C. Dec. 4, 1978).

tive officers[233] in a three company land development corporate structure.[234] While the defendants were in office, these companies issued $100 million of senior debentures.[235] During the time these debentures were outstanding, the defendants' companies filed several forms with the SEC, including form 10-K covering the calender year 1974, several quarterly 10-Q's, and an Exchange Offer Prospectus and Solicitation Statement.[236] The SEC maintained that each of these documents contained material misrepresentations and omissions[237] as to the changing nature of the companies' business and financial position[238] in violation of the securities laws.[239] The SEC sought both an injunction and disgorgement of compensation paid the defendants during the time of the misrepresentation.[240]

After considering the facts, the *Wills* court reviewed the relevant arguments regarding scienter in a Rule 10b-5 injunctive action. The court noted that an injunctive action, unlike the private damage action in *Hochfelder,* could not expand the defendants' potential liability to private plaintiffs through use of a negligence standard.[241] The court also observed that there were different policy considerations underlying SEC actions and private damage actions,[242] and that an approach that concentrated on the impact of the defendant's action on the investing public, rather than consideration

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[233] *Id.* at 94,758.

[234] *Id.* at 94,757-58.

[235] *Id.* at 94,758.

[236] *Id.; see* 17 C.F.R. §§ 249.308a; 243.310 (1978).

[237] [Current] FED. SEC. L. REP. (CCH) ¶ 96,712, at 94,758.

[238] *Id.* at 94,761.

[239] The SEC alleged violations of §§ 5(b)(1) and 17(a) of the '33 Act and §§ 10(b), 13(a) and 14(a) & (e) of the '34 Act and Rules 13a-1, 13a-11, 13a-13, 14a-9 and 10b-5 promulgated thereunder. [Current] FED. SEC. L. REP. (CCH) ¶ 96,712, at 94,757.

The *Wills* court found that negligent conduct could violate §§ 13(a) and 14(a) & (e) of the '34 Act and §§ 5(b) (i) and 17(a) (3) of the '33 Act, and that the defendants had negligently made material omissions which violated these sections. *Id.* at 94,768-74. For a further discussion of § 17(a), see text accompanying notes 301-33 *infra.*

[240] *Id.* at 94,771.

[241] *Id.* at 94,769. Since negligent action is easier to prove than action performed with scienter, the *Hochfelder* Court felt that the number of plaintiffs bringing suits would be greatly increased if a negligence standard was adopted. 425 U.S. at 214 n.33. The use of a negligence standard in an SEC action would not affect a private damages action because a private plaintiff still must prove scienter to recover. SEC v. Commonwealth Chem. Sec. Inc., 574 F.2d 90, 96-97 n.4. A finding of scienter in an SEC action probably would have collateral estoppel effect in a private damages action. *See generally Shareholder Litigation, supra* note 222.

[242] [Current] FED. SEC. L. REP. (CCH) ¶ 96,712, at 94,769. A private damage action seeks to redress individual wrongs and reasonably allocate losses incurred by particular investors. The SEC seeks to protect the public at large while providing a remedial function. *Id.* at 94,769. A broad standard of culpability would further the policies of the securities laws while not inflicting unreasonable harm. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 200-01 (1963); SEC v. Texas Gulf Sulfur, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied,* 394 U.S. 976 (1969). The SEC injunction is and should be a flexible and effective enforcement tool. *See* 3 Loss, *supra* note 201, at 1981; *Scienter Requirement, supra* note 166, at 440.

of the defendant's state of mind, might be proper.[243] However, the court determined that three of the four factors found determinative in *Hochfelder* — the language of section 10(b), the section's legislative history and the administrative history[244] — were equally persuasive in a suit for an injunction.[254] The court found further that since the language of section 10(b) applies equally to the SEC and a private plaintiff, and since the legislative history of section 10(b) did not focus on private damage actions, the section should be interpreted the same for each type of action.[246] On the basis of this reasoning, the *Wills* court held that scienter is an essential element of an SEC injunctive action under section 10(b).

The only substantial difference in analysis between *Wills* and *Blatt*[248] is the *Wills* court's consideration of public policy.[249] The Supreme Court in *Hochfelder* found no reason to examine the policy considerations that underlie section 10(b), finding the language of that section dispositive.[250] The *Hochfelder* Court found that the language of section 10(b) "specifically"[251] included action undertaken with scienter and that appealing policy considerations could not change the wording of the statute.[252] Even though *Hochfelder* interpreted section 10(b) only in the context of a private damages action,[253] when section 10(b) was written there was no contemplation of a private right of action.[254] Since Congress did not con-

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[243] [Current] FED. SEC. L. REP. (CCH) ¶ 96,712, at 94,769 (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 200-01 (1963)). By focusing on the result rather than the degree of scienter, negligence is easily prescribed.

[244] 425 U.S. at 201-12.

[245] [Current] FED. SEC. L. REP. (CCH) ¶ 96,712, at 94,769.

[246] *Id.*

[247] *Id.* After adopting the recklessness test set forth in Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir. 1978), the court decided that neither of the defendants had acted recklessly in connection with the non disclosures and mistatements made in the Exchange Offer Prospectus and Solicitation Statement, and denied injunctive relief. [Current] FED. SEC. L. REP. (CCH) ¶ 96,712, at 94,774.

The District of Columbia had foreshadowed the reasoning eventually employed in *Wills* four months earlier in SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978). In *NSMC* the court stated that the "analysis of the language of the statutory provision strongly suggests that proof of scienter is required in all actions under § 10(b), regardless of the identity of the parties involved". *Id.* at 710. The court expressly refused to rule on the issue, however, finding that all defendants in *NSMC* acted with scienter. *Id.*

[248] *See* text accompanying notes 225-31 *supra.*

[249] *See* note 241 *supra.*

[250] The *Hochfelder* Court rested its decision on four basic grounds. The Court concluded that the language of § 10(b) clearly connoted intentional conduct, 425 U.S. at 201, that the legislative history of the '34 Act demonstrated that scienter was required by § 10(b), *id.* at 201, 206, that comparison with other sections of the securities statutes demonstrated procedural restrictions not present in § 10(b), *id.* at 208-09, and that the administrative history of Rule 10b-5 showed that it was restricted to activities involving scienter. *Id.* at 212.

[251] *Id.* at 214.

[252] *Id.* at 214 n.33.

[253] *Id.* at 193-94 n.12.

[254] *See* S. REP. No. 792, 73d Cong., 2d Sess. 5-6 (1934); SEC Rel. No. 3230 (May 21, 1942). *See also* SEC v. Blatt, 583 F.2d 1325, 1333 n.21 (5th Cir. 1978).

template a private right of action under section 10(b),[255] Congress must have intended that scienter be required in SEC injunctions, as the injunction was the only action available at the time.[256] Therefore, if consideration of public policy is inappropriate when interpreting section 10(b) in the context of a private damages action,[257] such consideration is equally inappropriate for SEC actions.

In contrast to the courts in *Blatt* and *Wills,* the Second Circuit in *SEC v. Aaron*[258] held that the SEC need not prove scienter in injunctive actions based on Rule 10b-5 or section 17(a) of the '33 Act.[259] In *Aaron,* the defendant supervised the sales and training activities of registered representatives of an SEC registered broker-dealer.[260] Two employees of the broker-dealer who were supervised by the defendant[261] made false and misleading statements to prospective purchasers of stock.[262] The defendant was notified twice that his sales representatives were making misleading statements,[263] yet did nothing to stop their actions.[264] The district court found that the defendant knew the statements made by the other employees were false and misleading because of the information he possessed and that he had a duty to stop the misrepresentations.[265] The Second Circuit concluded that the lower court's finding that the defendant acted with scienter was unnecessary[266] and affirmed the grant of final injunctive relief.[267]

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[255] 425 U.S. at 196.

[256] *But see* Douglas & Bates, *The Federal Securities Act of 1933,* 43 YALE L.J. 171, 181 (1933) (arguing that section 17(a) of the 1933 Act applies to innocent conduct); text accompanying notes 258-92 *infra.*

[257] 425 U.S. at 214 n.33.

[258] [Current] FED. SEC. L. REP. (CCH) ¶ 96,800 (2d Cir. March 12, 1979).

[259] *Id.* at 95,128. The SEC's complaint also alleged a violation of § 5 of the '33 Act. 15 U.S.C. § 77e (1976).

[260] [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,043, at 91,684 (S.D.N.Y. May 5, 1977). The defendant, an employee for 15 years, was coordinator of several departments of his father's firm, E. L. Aaron & Co., and managed the firm's sales force. The defendant also maintained important information files about all of the securities his company actively traded. [Current] FED. SEC. L. REP. (CCH) ¶ 96,800 at 95,124.

[261] *Id.* The two registered representatives who made the misleading statements operated from Aaron & Co.'s Roslyn Heights, New York office. The defendant regularly worked in the downtown New York office. *Id.*

[262] *Id.* The two sales representatives were attempting to sell Lawn-A-Mat Chemical & Equipment Corp. (LAM) stock by representing that LAM was building a new small car and a tractor and was in solid financial position. *Id.*

[263] *Id.* Several of the people solicited by the salesmen were already stockholders of LAM and knew of the recent financial losses, and the lack of new product development. Several of these people informed LAM officers of the statements of the sales representatives. LAM officers warned both salesmen of their misleading statements before contacting the defendant. *Id.*

[264] *Id.*

[265] [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,043, at 91,686 (S.D.N.Y. May 5, 1977); *see* note 260 *supra.*

[266] [Current] FED. SEC. L. REP. (CCH) ¶ 96,800, at 95,128 n.8.

[267] *Id.* at 95,124.

In *Aaron,* the Second Circuit noted that the "compelling"[268] distinctions between injunctive and private damage actions dictated the necessity of employing a negligence standard in injunctive actions. The court identified four of these distinctions in reaching its decision. First, the court felt that the pre—*Hochfelder* precedent of the Second Circuit, which held that the SEC need not show scienter in an injunctive action,[269] had not been altered by *Hochfelder.* These pre-*Hochfelder* decisions focused on the SEC's public protection function rather than the private action's redress of past wrongs by awarding monetary relief.[270] Second, the *Aaron* court examined the statutory language of section 10(b) and concluded that the language of section 10(b) was unclear and subject to an interpretation which differed from the Supreme Court in *Hochfelder*[271] and the Fifth Circuit in *SEC v. Blatt.*[272] By finding that the wording of the statute was unclear, the court felt that a review of legislative history was appropriate.[273] Third, the *Aaron* court seized on language from *Hochfelder* that the legislative history of section 10(b) offered no guidance in determining congressional intent.[274] Thus, in an attempt to determine congressional intent, the *Aaron* court examined the legislative history of section 17(a) of the '33 Act and the statutory provision authorizing SEC injunctive actions, section 21(d) of the '34 Act.[275]

The court concluded that the legislative history of section 17(a) demonstrated that Congress rejected a scienter requirement for the enforcement of section 17(a).[276] The court decided that this same pattern of culpability

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[268] *Id.* at 95,129.

[269] *Id.; see, e.g.,* SEC v. Management Dynamics, Inc., 515 F.2d 801, 809 2d Cir. 1975); SEC v. Manor Nursing Center, Inc., 458 F.2d 1082, 1096 (2d Cir. 1972). The *Aaron* court attributed significance to the fact that the Second Circuit had correctly interpreted § 10(b) when employed in private damage actions, before the *Hochfelder* decision, uniformly holding that scienter was required. *E.g.,* Lanza v. Drexel & Co., 479 F.2d 1277, 1301, 1305-06 (2d Cir. 1973) (en banc); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971).

[270] [Current] FED. SEC. L. REP. (CCH) ¶ 96,800, at 95,130. The *Aaron* court cited a Second Circuit opinion of a few months earlier, SEC v. Coven, 581 F.2d 1020, 1027-28 (2d Cir. 1978), *see* text accompanying notes 307-18 *infra,* which compared the goals of an enforcement action with a private damage action. *See* note 242 *supra.*

[271] 425 U.S. at 214.

[272] 583 F.2d at 1333; *see* text accompanying note 228 *supra.*

[273] [Current] FED. SEC. L. REP. (CCH) ¶ 96,800, at 95,130.

[274] *Id.* The *Aaron* court seems to have interpreted the phrase, "bereft of any explicit explanation of Congress' intent," 425 U.S. at 201, to mean that the legislative history of § 10(b) offered *no* explanation of congressional intent, so that the history was not in conflict with a scienter standard. This interpretation is strained. The *Hochfelder* Court was referring to the legislative history of the entire '34 Act, not only § 10(b). 425 U.S. 201-07. Therefore, the use of the word "explicit" should be interpreted to mean clear-cut or unambiguous. Further, the *Aaron* court seems to ignore the *Hochfelder* statement that the relevant portions of the legislative history of the '34 Act supported the scienter standard. *Id.*

[275] [Current] FED. SEC. L. REP (CCH) ¶ 96,800, at 94,130-31.

[276] *Id.* at 94,131-32. The court used the same reasoning and quoted the same legislative history of § 17(a) as did the *Coven* court. *See* text accompanying notes 317-19 *infra.*

had been incorporated into the '34 Act.[277] The *Aaron* court also reviewed the legislative history of section 21(d),[278] and concluded that the SEC was not required to prove scienter. The court quoted language from the report of the Senate Committee on Banking, Housing and Urban Affairs,[279] which was reviewing the Securities Acts Amendments of 1975. The report stated that, "in particular, issues related to matters of damages, such as scienter, causation and the extent of damages, are elements *not* required to be demonstrated in a Commission injunctive action."[280] The *Aaron* court felt that there could be no clearer indication of congressional intent to exempt SEC injunctive actions from the private action scienter requirement.[281]

Finally, the fourth distinction offered by the court for rejecting a scienter standard in SEC injunctive actions was that while *Hochfelder* was concerned that a negligence standard would broaden the class of Rule 10b-5 plaintiffs and nullify express civil remedies, a negligence standard would more easily fit into the overall enforcement scheme of the securities laws.[282] A negligence standard would not abrogate any other provisions of the federal securities laws, and would end the disunity among the similar provisions of the '33 Act.[283]

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[277] *See* Section 210 of Title II of the 1934 Act, ch. 404, § 210, 48 Stat. 881 (1934). The court's conclusion that the '34 Act incorporated the culpability requirements of the '33 Act is doubtful. Section 210 merely transferred to the SEC the Federal Trade Commission's "powers, duties, and functions". *Id.* Section 210 further states that "[a]ll rights and interests accruing or to accrue under the Securities Act of 1933 . . .may be exercised and enforced". *Id.* Section 210 makes no mention of the pattern of culpability of the '33 Act or the incorporation of that pattern into the '34 Act.

[278] [Current] FED. SEC. L. REP. (CCH) ¶ 96,800, at 95,130.

The *Aaron* court's reliance on section 21 of the '34 Act appears to be misplaced. Section 21(d) provides:

> Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder. . .it may in its discretion bring an action. . .to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.

15 U.S.C. § 78u(d) (1976). As is obvious from the wording of the statute, the Commission must still prove a violation of the '34 Act. If the SEC is utilizing § 10(b) and § 10(b) may only be violated by conduct undertaken with scienter, *see* note 293 *infra*, the SEC may only obtain an injunction upon proof of scienter.

[279] S. REP. No. 75, 94 Cong., 1st Sess. 76 (1975).

[280] *Id.* (emphasis in original).

[281] [Current] FED. SEC. L. REP. (CCH) ¶ 96,800, at 95,131. The Senate Committee on Banking, Housing, and Urban Affairs report, S. REP. No. 75, 94 Cong., 1st Sess. 76 (1975), dealt with an amendment to § 21 which added a new subsection that "exempt[ed] actions brought by the Commission under the federal securities laws from consolidation or coordination with other actions not brought by the Commission unless such consolidation is consented to by the Commission". *Id.* at 73. The amendment was not concerned with the question of scienter in SEC actions, cannot be read to deal with the question of scienter, and has no bearing on the actual legislative history of § 10(b).

[282] [Current] FED. SEC. L. REP. (CCH) ¶ 96,800, at 95,131. A negligence standard would allow the SEC to more effectively enforce the antifraud provisions of the federal securities laws.

[283] *Id.*; *see* text accompanying notes 336-37 *infra*.

In the past year a federal district court of Arizona in *SEC v. Western Geothermal & Power Corp.*,[284] also held that proof of scienter is unnecessary in SEC actions based on Rule 10b-5 or section 17(a) of the '33 Act.[285] The scienter issue was before the court on a motion to dismiss,[286] and even though only the court's findings of fact and conclusions of law were presented, the court's basis of decision is apparent. The court in *Western Geothermal* noted that the SEC enforces the federal securities laws in order to protect the public, not to punish a state of mind.[287] The court also found that the investing public is injured by negligent violations as much as willful ones and that the *Hochfelder* standard of scienter does not apply.[288] Therefore, the court reasoned that scienter need not be alleged or proven in SEC injunctive actions.[289] The court's reasons for determining that negligent conduct supports a Rule 10b-5 injunctive action are based on the SEC's role as protector of the investing public.[290] However, decisions interpreting Rule 10b-5 in light of public policy rather than relying on the language of section 10(b),[291] are questionable in light of *Hochfelder.*[292]

Whether the SEC need prove scienter in an injunctive action brought under Rule 10b-5 and section 10(b) remains an open question.[293] The *Aaron* court apparently misinterpreted both the language of *Hochfelder*[294] and section 210 of Title II of the '34 Act.[295] The court also incorrectly focused

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[284] [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,590 (D. Ariz. Sept. 16, 1978).

[285] *Id.* at 94,524. The SEC, in addition to its section 10(b) claim, sought injunctions under § 12 of the '33 Act, 15 U.S.C. § 771 (1976), for the sale of unregistered securities and under § 9(a) of the '34 Act, 15 U.S.C. § 78(a) (1976), for stock manipulation. [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,590, at 94,523.

[286] *Id.*

[287] *Id.* at 94,524.

[288] *Id.*

[289] *Id.*

[290] *Id.*; *see* text accompanying notes 287-88 *supra.*

[291] *See* text accompanying notes 250-57 *supra.*

[292] *See* text accompanying notes 248-57 *supra.*

[293] The most compelling reason to require scienter in SEC actions brought under § 10b is that the Supreme Court has interpreted the actual language of the section. The language is the same for the Commission as it is for a private plaintiff. Rather than focus on who the plaintiff happens to be, the proper focus should be on the defendant. If the defendant violates the statute only when he acts with scienter, 425 U.S. at 193, 214, then the prescribed conduct has been defined. The identity of the plaintiff should make no difference. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 217 (Blackmun, J., dissenting).

In other areas of the law, the *remedy* granted often depends on the defendant's state of mind. To obtain damages based on fraud, for example, the plaintiff must prove that the defendant acted with scienter. *See* DOBBS, *supra* note 181, at 608. To get recission of a contract, however, the plaintiff need only prove that the defendant made a negligent misrepresentation, DOBBS, *supra* note 181, at 609; PROSSER, *supra* note 169, at 709, and in some instances, an innocent misrepresentation would suffice. *See* PROSSER, *supra* note 169, at 709. This focus on relief has not been applied in the federal securities laws. Although a private plaintiff seeking injunctive relief must demonstrate an inadequate remedy at law and irreparable harm, the SEC has not been required to make a similar showing. *See* note 224 *supra.*

[294] *See* note 274 *supra.*

[295] *See* note 277 *supra.*

on section 21(d) rather than section 10(b),[296] and relied on a questionable interpretation of legislative history.[297] The correct decisions were in *Blatt* and *Wills*, stressing the language, administrative and legislative history of section 10(b) rather than exploring policy differences between private damage and injunctive actions. Both decisions conform with the *Hochfelder* holding and the spirit of the Supreme Court's recent trend of contracting the scope of protection provided private plaintiffs under the federal securities laws.[298] Yet the Supreme Court seemingly has failed to recognize that, unlike private plaintiffs, the SEC needs flexibility to enforce more effectively the antifraud provisions of the securities laws. A negligence standard for Rule 10b-5 injunctive actions would be neither unfair for defendants nor restrict the flow of securities transactions. Absent a Supreme Court decision to the contrary, however, Congress must amend section 10(b) so that the SEC may enjoin purely negligent conduct[299] if the securities laws are to be interpreted by the lower courts in a remedial manner.

Congressional enactment of the American Law Institute's Proposed Federal Securities Code[300] (Code) would be an alternative to amending section 10(b). The antifraud provisions of the Code eliminate the scienter requirement in an injunctive action by prohibiting any fraudulent act or misrepresentation.[301] A misrepresentation is defined as "an untrue statement of a material fact, or. . .an omission to state a material fact necessary to prevent the statements made from being misleading in the light of the circumstances under which they are made."[302] Since a misrepresentation may be made without scienter,[303] the Commission would not need

[296] *See* note 278 *supra.*

[297] *See* note 281 *supra.*

[298] *See* 1977-78 *Developments, supra* note 262, at 799 n.1. In the last four years, seven major decisions have seriously curtailed private rights of action under the federal securities laws. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738-39 (1975) (private plaintiff in Rule 10b-5 case must be a purchaser or seller of a security); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (private plaintiff must prove scienter to recover damages under rule 10b-5); United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 858 n.24 (1975) (definition of a security restricted); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 35 (1977) (tender offeror suing as a take-over bidder had no right to sue for damages under § 14(e) of the '34 Act); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (restricting the meaning of materiality under § 14(a) of the '34 Act); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977) (Rule 10b-5 does not reach breaches of fiduciary duty in connection with a short-form corporate merger); International Bhd. of Teamsters v. Daniel, 99 S. Ct. 790, 796 (1979) (further restriction of a definition of a security).

[299] The SEC is powerless to effect any change since the scope of liability under Rule 10b-5 is limited by the language of § 10(b). Rule 10b-5 cannot be directed toward negligent conduct until § 10(b) is amended. *See* note 310 *infra.*

[300] ALI FEDERAL SECURITIES CODE (Proposed Official Draft)(1978).

[301] *Id.* § 1602(a).

[302] *Id.* § 297(a). Section 1819(a) allows the commission to bring an injunctive action to enjoin any violation of the Code.

[303] A person acts with scienter under the Code "if he knows he is making a misrepresentation. . .or acts in reckless disregard of whether that is so". § 299.50.

to prove scienter to get an injunction under the Code.[304]

The relationship between section 17(a) of the '33 Act[305] and Rule 10b-5 has become an increasingly important issue within the past year. Although the language of Rule 10b-5 is virtually identical to section 17(a),[306] section 17(a) applies only to the "offer or sale"[307] of securities, while Rule 10b-5 applies to the "purchase or sale"[308] of a security. Since the word "purchase" is absent from section 17(a), the section cannot be used to remedy misrepresentations or omissions by a purchaser of a security. However, the vast majority of transactions challenged under Rule 10b-5 are covered by section 17(a) as well. Since *Hochfelder*, the critical question has been whether scienter must be shown in an SEC injunctive action brought under section 17(a).[309] The courts addressing this issue in the past year have held that scienter is not a necessary element of an SEC injunction action under section 17(a).[310]

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[304] *See* § 1819(a); § 287, note (8)(e). The Code's counterpart of civil liability under Rule 10b-5 is found in § 1703(a). When a defendant violates § 1602(a), *see* text accompanying note 301 *supra*, he also violates § 1703(a). Since a violation of § 1602(a) is not premised on a showing of scienter, no showing of scienter is necessary to establish civil liability. Subsection (f) of 1703 provides the defendant with a good faith defense if he can show "he reasonably did not believe that there was a misrepresentation. . . ." § 1703(f). *See generally* D. Ruder & A. Sommers, Meeting of the Committee on Federal Regulation of Securities, 26-29 (Chicago, Ill., Oct. 13-14, 1978); D. Ruder, Transcript of Procedings of Panel Discussion Presented by The Federal Regulation of Securities Committee, 79-97 (Williamsburg, Va., April 8, 1978).

[305] 15 U.S.C. § 77(a) (1976); *see* note 34 *supra*.

[306] Although the language of § 17(a) and Rule 10b-5 are virtually identical, the language of §§ 10(b) and 17(a) differ significantly.

[307] 15 U.S.C. § 77(a) (1976).

[308] 17 C.F.R. § 240.10b-5 (1978).

[309] Five circuit courts have expressly or impliedly recognized that a private right of action exists under § 17(a). *See* Daniel v. International Bhd. of Teamsters, 561 F.2d 1223, 1244-45 (7th Cir. 1977); Newman v. Prior, 518 F.2d 97, 99 (4th Cir. 1975); Lanza v. Drexel & Co., 479 F.2d 1277, 1280 n.2. (2d Cir. 1973); Kellman v. ICS, Inc., 447 F.2d 1305, 1308 (6th Cir. 1971); Smith v. Jackson Tool & Die, Inc., 419 F.2d 152, 154 (5th Cir. 1969). The Supreme Court twice has refused to decide the issue. *See* International Bhd. of Teamsters v. Daniel, 99 S. Ct. 790, 795 n.9 (1979); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733-34 n.6 (1975). The Eighth Circuit has held that § 17(a) does not confer a private cause of action for damages on a purchaser of a security. Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 155, 159 (8th Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978). The question whether scienter is required in a private action is undecided, even though the only three cases that have dealt with culpability in private actions under section 17(a) have held scienter necessary. Sanders v. John Nuveen & Co., 554 F.2d 790, 795 (7th Cir. 1977); Valles Salgado v. Piedmont Capital Corp., 452 F. Supp. 853, 858 n.8 (D.P.R. 1978); Malik v. Universal Resources Corp., 425 F. Supp. 350, 363 (S.D. Cal. 1976). *See generally* Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641 (1978) [hereinafter cited as Hazen].

[310] SEC v. American Realty Trust, 586 F.2d 1001, 1007 (4th Cir. 1978); SEC v. Coven, 581 F.2d 1020, 1027-28 (2d Cir. 1978).

The Supreme Court's basis for decision in *Hochfelder* engendered the dispute over the interpretation of the language of Rule 10b-5 and § 17(a). *Hochfelder* did not hold that the language of Rule 10b-5 required proof of scienter. 425 U.S. at 213-14. The Court held specifically that the words "device", "manipulative", and "contrivance" used in § 10(b) were not

The Second Circuit recently held in *SEC v. Coven*[311] that negligent conduct could form the basis of injunctive relief under section 17(a).[312] The defendant was an attorney acting as special counsel for a corporation for the purpose of implementing a public offering of the company's securities.[313] The Second Circuit affirmed the lower court's decision that the defendant had aided and abetted a section 17(a) violation regarding the fraudulent closing of an escrow account in connection with the public offering.[314] The *Coven* court based its decision that negligence violates section 17(a) on three broad reasons. First, the court examined the language of section 17(a) and found that since the words "manipulation or deceptive device or contrivance"[315] were not present, the scienter element drawn by the *Hochfelder* court from the language of section 10(b) did not apply to section 17(a).[316] Second, the court looked at the legislative history of section 17(a).[317] The Senate's version of section 17 contained the words "with the intent to defraud" whereas the House version did not.[318] The Conference Committee adopted the House version, implicitly rejecting the requirement of an intent to defraud.[319] Finally, the court found that the

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aimed at negligent conduct. The Court decided that these words "connote intentional or willful conduct designed to defraud investors by controlling or artifically affecting the price of securities". 425 U.S. at 199. Therefore, if § 10(b) was aimed only at conduct embracing scienter, the SEC could not promulgate a rule requiring a standard of proof less than scienter. *See* 1976-1977 *Developments, supra* note 163, at 915 n.201. This reasoning, however, impliedly recognizes that the language of Rule 10b-5 was designed to apply to negligence. Thus § 17(a), encompassing virtually the same language of Rule 10b-5, must also apply to negligence. *See* Hazen, *supra* note 309, at 673.

311 581 F.2d 1020 (2d Cir. 1978).

312 *Id.* at 1027-30.

313 *Id.* at 1021. The defendant was in complete control of the public offering. His services included offering legal opinions regarding the proposed issue, finding underwriters, and drafting documents concerning the 6,000,000 shares to be offered at $.10 per share. *Id.*

314 *Id.* The escrow account was set up so that if 3,000,000 of the shares were not sold within 60 days, and if the escrow account did not contain $300,000, all monies would be returned to the purchasers of the stock. *Id.* at 1022. The district court found, and the Second Circuit agreed, that the account never contained $300,000. *Id.* The defendant incurred § 17(a) liability when he either negligently or recklessly wrote a letter to the bank holding the escrow account, certifying that 3,075,000 of the shares were sold. *Id.* at 1023, 1029.

315 *Id.* at 1026-27.

316 The Supreme Court specifically relied on the term "manipulative or deceptive device or contrivance" in *Hochfelder* when intepreting § 10b of the '34 Act. 425 U.S. at 197. The Second Circuit concluded that all three subsections of § 17(a) were aimed at negligent conduct. 581 F.2d at 1026. Although some courts have interpreted the language of subsections (1) and (3) to be aimed at intentional conduct because they use the words "defraud" and "fraud", *see* Sanders v. John Nuveen & Co., Inc., 554 F.2d 790, 795 (7th Cir. 1977); 3 Loss, *supra* note 39, at 1441-42, the *Coven* court read the section as a whole and concluded that the section "was intended to expand common law notions of the elements of fraud". 581 F.2d at 1026 n.11.

317 *Id.* at 1027.

318 *Id.*

319 *Id.* The description of the scope of injunctive enforcement under the '33 Act resembles the language of § 17(a). H. R. REP. No. 85, 73d Cong., 1st Sess. 6 (1933).

The court also thought that statements by legal commentators expressing the opinion public policy of protecting the investing public through equitable remedies[320] could be served only by allowing the SEC to obtain injunctive relief upon a showing of negligent conduct.[321] After finding that the negligent conduct was likely to continue, the court affirmed the lower court's grant of injunctive relief.[322]

In a case that reversed the only decision squarely holding that section 17(a) requires intent,[323] the Fourth Circuit held in *SEC v. American Realty Trust*[324] that the SEC is not required to prove scienter in an injunctive action based on section 17(a).[325] In *American Realty,* Thomas Broyhill, president of American Realty Trust caused three material omissions to be made in a March 1974 prospectus issued in connection with the offering of debentures.[326] In reaching its decision, the circuit court rejected the contention that since the language of Rule 10b-5 and section 17(a) were virtually identical, then, as a result of the reasoning in *Hochfelder,* section 17(a) must require intent.[327] The court correctly noted that unlike Rule 10b-5, section 17(a) was a congressional enactment, thus not subject to the SEC's rule making limitations.[328] Therefore, the court stated that the importation of the "manipulative device" language of section 10(b) into Rule 10b-5, has no bearing upon a proper interpretation of section 17a(2).[329] Since section

that § 17(a) was aimed at negligent conduct were important. The court relied on a statement by the soon-to-be Justice Douglas that "even innocent acts to obtain money or property by means of untrue statements of material facts or omissions to state material facts were unlawful." Douglas & Bates, *The Federal Securities Act of 1933,* 43 YALE L.J. 171, 181 (1933). *See also* James, *The Securities Act of 1933,* 32 MICH. L. REV. 624, 656 (1934).

[320] Since the *Hochfelder* decision dealt only with § 10(b) and Rule 10b-5, consideration of the public policy underlying § 17(a) is not foreclosed.

[321] 581 F.2d at 1027-28. The court emphasized that an SEC enforcement action protects the investing public and does not seek to punish a particular defendant. *Id.*

[322] *Id.* at 1031. Adopting the recklessness standard outlined in Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d at 44-47, *see* text accompanying notes 172-90 *supra,* the court also found that Coven had been reckless and had probably violated § 10(b) and Rule 10b-5. 581 F.2d at 1029.

[323] SEC v. American Realty Trust, 429 F. supp. 1148, 1171 (E.D. Va. 1971).

[324] 586 F.2d 1001 (4th Cir. 1978).

[325] *Id.* at 1007.

[326] *Id.* at 1003. The SEC also alleged material omissions in two forms 10K and a proxy statement, but the court did not pass on these allegations. *Id.* at 1002. The material omissions in the prospectus concerned the defendant's decision to guarantee a loan from a New York bank to a partnership associated with the defendant, to loan this partnership $368,000 which the partnership could then loan to a Virginia corporation so that the corporation could pay overdue rent of $368,000 back to the defendant, and also to loan a couple $1.2 million to develop a tract of land into a subdivision. *Id.* at 1003-04. A close examination of these transactions revealed that the partnership was composed of a relative and friend of the defendant's president, the sons and daughters of three trustees of the defendant owned 49.44% of the Virginia corporation, and the couple were joint venturers in the subdivision project with the daughter and son-in-law of the defendant's president. *Id.* at 1004.

[327] *Id.* at 1005-06; *see* note 310 *supra.*

[328] 586 F.2d at 1006. *Hochfelder* held that the SEC did not have rulemaking power to promulgate a rule not requiring scienter since § 10(b) required scienter. 425 U.S. at 213-14; *see* 1976-1977 *Developments, supra* note 163, at 909-10 n.174.

[329] 586 F.2d at 1006.

17(a) does not contain language equivalent to "fraud" or "willfulness", Congress apparently intended to proscribe negligent conduct as well as intentional conduct.[330] The *American Realty* court also agreed with the Second Circuit's analysis of the legislative history in *Coven*, which interpreted the congressional rejection of the Senate's version of section 17(a) requiring the intent to defraud,[331] as the repudiation of a scienter requirement. The *American Realty* court concluded that the proof of serious negligent conduct warranted the granting of an injunction against future violations.[332]

The Second Circuit in *SEC v. Coven*[333] and the Fourth Circuit in *SEC v. American Realty Trust*[334] used virtually the same reasoning employed by the Supreme Court in *Hochfelder*[335] to find that the SEC is not required to prove scienter in an injunctive action brought under section 17(a). Both courts found the wording of the statute, the legislative history, and policy arguments dispositive.

Because of the wording of the statute,[336] the SEC cannot use section 17(a) to enjoin fraudulent misrepresentations or omissions by a purchaser, as opposed to a seller, of a security.[337] An anomalous situation now exists in which the SEC is able to use section 17(a) to enjoin negligent conduct on the part of sellers that operates to defraud buyers, yet is powerless to stop negligent conduct on the part of buyers that operates to defraud sellers. This logical inconsistency is more a matter of semantics than of substance. Rule 10b-5 applies to both buyers and sellers of securities, yet requires proof of scienter to support a violation, while section 17(a) applies

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[330] *Id.* at 1006. The American Realty court focused its analysis on § 17(a)(2). *Id.* Even though the court stated that the language of the entire section does not suggest that Congress meant to reach only intentional conduct rather than negligence, § 17(a)(2) is bracketed between (1) and (3) that specifically refer to fraud. *Id.* The court refused to hold that subsections (1) and (3) did not require scienter, and suggested in a footnote that they might be aimed at intentional conduct only. *Id.* at 1006 n.5. *But see* note 316 *supra.*

[331] *See* text accompanying notes 317-19 *supra.*

[332] 586 F.2d at 1007. In SEC v. Wills, [Current] FED. SEC. L. REP. (CCH) ¶ 96,712, at 94,770 (D.D.C. Dec. 18, 1978), *see* text accompanying notes 232-47 *supra,* the district court for the District of Columbia followed the *Coven* and *American Realty* reasoning, holding that scienter is not required in an SEC injunctive action under § 17(a). *See also* SEC v. Western Goethermal & Power Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,590 (Sept. 16, 1978) (scienter not required under § 17(a)). *But see* Greenfield v. Cheek, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,560 (Ariz. App., Sept. 19, 1978) (scienter required in damage action brought under § 17(a)). *Accord* Sanders v. John Nuveen & Co., 554 F.2d 790, 794-95 (7th Cir. 1977).

[333] 571 F.2d 1020 (2d Cir. 1978); *see* text accompanying notes 311-12 *supra.*

[334] 586 F.2d 1001 (4th Cir. 1978); see text accompanying notes 323-32 *supra.*

[335] The *Hochfelder* decision was based on analysis of the actual words of § 10(b), the legislative and administrative history, and the section's relation to the other securities laws. 425 U.S. at 200, 201, 201-07, 212; *see* note 250 *supra. Coven* and *American Realty* rely on the language of the statute, legislative and administrative history and policy reasons to rule on § 17(a). *See* text accompanying notes 311-33 *supra.*

[336] *See* note 305 *supra.*

[337] *See* text accompanying notes 307-09 *supra.*