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iii. Rule 10B-5

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bility of the exemption if the Rules are not complied with may be anticipated.

Although Rule 144 has been in effect for three years,⁷⁵ the volume of requests for replies by the SEC still appears to be immense.⁷⁶ These requests primarily concern the computation of holding periods, and the definition of "restricted" securities. In analyzing questions concerning the holding periods, the SEC has emphasized that the purchaser should be subjected to the risks of his investment, thereby preventing any indirect public distribution. The numerous amendments adopted in 1974 ease some of the burden on the issuer without compromising the purposes of the Rule, and therefore, facilitate compliance with its provisions.

III. RULE 10b-5

A. Birnbaum Triumphant—The Supreme Court Upholds the Purchaser-Seller Requirement

Rule 10b-5's purchaser-seller requirement,¹ judicially labelled the *Birnbaum* Rule,² is now the most formidable obstacle confronting securities fraud claimants. The Supreme Court's recent decision in *Blue Chip Stamps v. Manor Drug Stores*³ resolved any judicial doubts

⁷⁵ For a general discussion of the development of Rule 144 over the 1972-1974 period, see Lipton, Fogelson & Warnken, *Rule 144—A Summary Review After Two Years*, 29 BUS. LAW. 1183 (1974). For checklists to determine the applicability of Rule 144, see Green, *Selling Restricted Securities Under Rule 144—A Practical Guide*, 18 PRAC. LAW. No. 5 at 13 (1972); Starr, *Suggested Rule 144 Checklist*, 27 BUS. LAW. 1073 (1972); Note, *A Checklist For Compliance With Rule 144*, 67 NW. U.L. REV. 169 (Supp. 1972).

⁷⁶ Nineteen requests are reported in the CCH reporter, however, there were over 500 replies by the SEC to inquiries regarding Rule 144. See 1974 No-Action and Interpretive Letters lists, 5 CCH FED. SEC. L. REP. at 63,111-275 (1974).

¹Both § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b) (1970), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974), prohibit fraudulent activities "in connection with the purchase or sale of any security."

²The purchaser-seller requirement was first formulated in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

³43 U.S.L.W. 4707 (June 9, 1975). The complaint in *Blue Chip* alleged misrepresentation in the offering of securities made pursuant to an antitrust consent decree which required the defendant, Blue Chip Stamps, to offer stock to all stamp users. The defendant misrepresented the true value of the securities, which allegedly exceeded the offering price by \$214, thereby inducing the plaintiff *not* to make the purchase. The district court denied the plaintiff standing because there had been no actual purchase or sale of securities between the parties. Under such circumstances, the lower court determined that there was no causal connection between the misrepresentation and

on this question of standing: plaintiffs who do not meet the statutory definition of purchaser or seller under the Securities Exchange Act will be barred from seeking remedies under Rule 10b-5. The decision, aside from unequivocally upholding the purchaser-seller requirement,⁴ additionally suggests that future Rule 10b-5 plaintiffs will find the courts less receptive to expansive application of the Rule. Although the Court adopted what had been the majority rule among circuit courts as to plaintiff standing,⁵ *Blue Chip* is the first case in the Supreme Court to restrict the explosive growth of Rule 10b-5 in recent years. One implication is that *Blue Chip's* limiting principles may be carried over into other areas where elements of a claim under Rule 10b-5 also have been expansively construed by the lower federal courts.⁶

A more immediate consequence of the decision, however, is whether the purchaser-seller requirement will be inflexibly applied to potential plaintiffs in the future, or whether any of the modifications of the *Birnbaum* Rule survived *Blue Chip*. The rule had not been inflexibly applied by the lower federal courts to exclude claimants who were not strictly purchasers or sellers of securities.⁷ *Birnbaum* had been viewed by some courts as a policy both limiting the number of potential plaintiffs and restricting antifraud litigation, rather than as a rigid rule of standing.⁸ Thus, four exceptions from a strict appli-

the injury, and that any damage award would be speculative. 339 F. Supp. at 40.

The Ninth Circuit Court of Appeals reversed the district court, however, reasoning that neither ground cited for denial of standing was present in the case. Other courts previously had granted standing in similar contexts under the aborted purchase or sale exception to the *Birnbaum* Rule, based upon the premise that the existence of a contractual relationship between the parties constituted sufficient evidence of causation and damages. The circuit court concluded that the consent decree ordering the offer of securities by Blue Chip Stamps served the same function as a contractual relationship between the plaintiff and the defendant. Thus the plaintiff had proper standing to sue under the modified purchaser-seller requirement. *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136 (9th Cir. 1973), *reversed*, ____ U.S. ____, 43 U.S.L.W. 4707 (June 9, 1975).

⁴43 U.S.L.W. at 4717.

⁵*Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339, 342 n.5 (9th Cir. 1972). The Seventh Circuit had abrogated the *Birnbaum* Rule in *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974), *noted in* 31 WASH. & LEE L. REV. 757 (1974). The Supreme Court denied certiorari in *Eason*, but has apparently overruled its holding by the *Blue Chip* decision.

⁶See text accompanying note 47 *infra*.

⁷See *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970), which includes an extensive discussion of the exceptions to the *Birnbaum* Rule.

⁸*James v. Gerber Products Co.*, 483 F.2d 944, 948 (6th Cir. 1973); *Heyman v.*

cation of *Birnbaum* were recognized under circumstances involving forced sales,⁹ aborted purchases or sales,¹⁰ corporate antifraud derivative suits,¹¹ and private injunctive actions.¹² A fifth exception to *Birnbaum*, which permitted beneficial owners of securities held by trustees to sue parties purchasing from the trustee, emerged during the past year.¹³ In affirming *Birnbaum*, however, the Supreme Court failed to indicate specifically if any of the recognized exceptions to the strict purchaser-seller requirement could continue to be applied by the federal courts.¹⁴ Analysis of the Court's rationale in *Blue Chip* indicates that at least some of these modifications of the purchaser-seller requirement can no longer be judicially applied.

The Court based its affirmation of the *Birnbaum* Rule on three grounds: judicial precedent, statutory history and construction, and policy.¹⁵ The Court's principal and most persuasive argument for upholding the *Birnbaum* Rule rested upon the text and history of the statute. Both Justice Rehnquist, writing for the Court, and Justice Powell, concurring, pointed out that § 10(b) of the Securities Exchange Act and Rule 10b-5 prohibit only activities "in connection with the purchase or sale of any security."¹⁶ Further, they noted that § 3a(14) of the Act defined the term sale as including "any contract to sell or otherwise dispose of" securities.¹⁷ Thus, while holders of puts, calls, options and other contractual rights or duties are protected as purchasers or sellers under the statute, the plaintiff in *Blue Chip*, who was only a non-purchasing offeree of shares,¹⁸ did not meet the statutory criteria for standing to sue. A judicial conclusion that

Heyman, 356 F. Supp. 958, 965 (S.D.N.Y. 1973).

⁹*Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967).

¹⁰*A. T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967).

¹¹*Herpich v. Wallace*, 430 F.2d 792, 803-04 (5th Cir. 1970).

¹²*Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967).

¹³See cases cited in note 8 *supra*.

¹⁴In affirming the purchaser-seller requirement, the Court stated that "[t]aken together with the precedential support for the *Birnbaum* rule over a period of more than 20 years . . . [we] conclude that it is a sound rule and should be followed." 43 U.S.L.W. at 4715. The Court made no direct mention of any of the modifications to *Birnbaum*.

¹⁵*Id.*

¹⁶*Id.* at 4710, 4717.

¹⁷*Id.* at 4715, 4717. The Securities Exchange Act provides that "[t]he terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire," and "[t]he terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." 15 U.S.C. § 78c(13-14) (1970).

¹⁸See note 3 *supra*.

the plaintiff was similarly situated to persons clearly protected by the statute was insufficient standing to maintain an action under § 10(b) or Rule 10b-5.¹⁹

The Court's rejection of the practice of analogizing potential plaintiffs to those claimants who meet the statutory requirements forecloses absolutely any claims of standing by beneficial owners of securities which are fraudulently sold. The Sixth Circuit in *James v. Gerber Products Co.*²⁰ had allowed suit by a beneficial owner of securities who alleged fraud between the trustee-seller and defendant-purchaser of the plaintiff's securities. Although the plaintiff was not strictly a seller, the court reasoned that she had the "interests of a defacto seller" and that denial of standing would not promote the inherent purpose of the *Birnbaum* Rule to limit litigation.²¹ *Blue Chip* rejected this form of reasoning by analogy or reliance upon the purpose of the *Birnbaum* Rule as used by the *James* court for a strict statutory test, emphasizing instead that a plaintiff must himself be a purchaser or seller to sue under Rule 10b-5.²² Similarly, the forced seller exception first proposed in *Vine v. Beneficial Finance Co.*²³ appears to have been impliedly overruled by the Court.

The *Vine* court had granted standing to a plaintiff who alleged fraud in the execution of a short form merger which left him a minority shareholder with a claim for cash against the newly formed corporation or the right to seek judicial appraisal of the value of his shares. In either event, the court stated, the plaintiff would have to exchange his shares for cash from the defendant, thus making him an eventual forced seller. While it would be a clearer case of standing if the plaintiff had actually exchanged his shares for cash, the *Vine* court opined that requiring him to do so was a needless formality.²⁴ It is not so clear after *Blue Chip*, on the other hand, whether tendering the shares under similar circumstances remains merely a needless formality. The *Vine* court found that the terms "otherwise acquire [dispose of]" used in the statutory definitions of purchase and sale²⁵ were sufficiently broad to encompass a forced sale by short form merger.²⁶

¹⁹43 U.S.L.W. at 4716.

²⁰483 F.2d 944 (6th Cir. 1973). The plaintiff in *James* claimed fraud between the trustee and the defendant in the sale of trust shares at a low market price to provide stock for Gerber's executive stock option plan.

²¹*Id.* at 948.

²²43 U.S.L.W. at 4714.

²³374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

²⁴*Id.* at 634.

²⁵See note 17 *supra*.

²⁶374 F.2d at 634.

But the Supreme Court's firm insistence upon an actual purchase or sale in *Blue Chip* suggests that an actual tender or exchange of shares will be required for forced sellers to sue under Rule 10b-5. Justice Rehnquist emphasized:

The virtue of the *Birnbaum* rule, simply stated . . . is that it limits the class of plaintiffs to those who have at least dealt in the security to which the prospectus, representation, or omission relates.²⁷

The Court's insistence upon the fact of actual dealing in corporate securities further limits the *Birnbaum* exceptions for corporate derivative suits²⁸ and private injunctions under Rule 10b-5.²⁹ The majority opinion identified three classes of plaintiffs barred by the *Birnbaum* Rule: potential purchasers of shares who failed to purchase due to unduly gloomy representations; actual shareholders who failed to sell because of excessively optimistic representations or nondisclosure of adverse information; and shareholders, creditors or other parties suffering loss due to corporate activities in connection with purchases or sales which violate Rule 10b-5. The latter two classes of plaintiffs could circumvent *Birnbaum* by bringing a corporate derivative action if the corporation had been a purchaser or seller, stated the Court, but the first class was precluded from relief under Rule 10b-5 by the purchaser-seller requirement.³⁰ Hence, the Court did not abrogate the exception for derivative suits under Rule 10b-5 where the corporation is a purchaser or seller.

Similarly, the corollary of this principle requires that private plaintiffs be purchasers or sellers to enjoin continuing violations of Rule 10b-5. While the Court noted that the *Birnbaum* Rule is inapplicable to the SEC when it sues to enjoin violations of the Rule,³¹ it

²⁷43 U.S.L.W. at 4714.

²⁸See note 11 *supra*.

²⁹See note 12 *supra*.

³⁰43 U.S.L.W. at 4711-12.

³¹The Court cited its decision in *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969), as establishing that the purchaser-seller requirement imposed no standing limitation on the SEC when it sues for injunctive relief. 43 U.S.L.W. at 4716 n.14. The Securities Exchange Act authorizes the SEC to seek an injunction against violations of the Act or rules and regulations promulgated thereunder. 15 U.S.C. § 78u(e)(1970). Although the SEC need not be a purchaser or seller to seek injunctive relief, it must show fraud in connection with a purchase or sale to obtain an injunction under § 10(b) and Rule 10b-5. In *National Securities*, the Court held that an exchange of shares under a merger plan constituted a sale which could be enjoined under the antifraud provisions. 393 U.S. at 467.

made no reference with regard to private plaintiff standing. The Court's insistence on a transaction of purchase or sale by parties seeking damages³² leads to the conclusion that a similar requirement is requisite for private injunctive relief. Further, the Court's explicit rejection of analogizing parties meeting statutory criteria to similar parties not meeting the same requisites³³ also implies that plaintiffs who are not purchasers or sellers under the statute will be unable to seek injunctive relief under Rule 10b-5 in the future.³⁴ Thus, in cases of derivative suits or private injunctive relief, the Court impliedly required that private plaintiffs must assert some direct damage to themselves through a purchase or sale transaction.

The final judicial exception to *Birnbaum*, however, involved transactions in which an actual purchase or sale never occurred. This exception, known as the aborted purchase or sale doctrine, was first applied in *A. T. Brod & Co. v. Perlow*³⁵ when the plaintiff broker alleged a fraudulent scheme by the defendant whereby he ordered shares through the broker intending to pay for them only if the price subsequently rose. When the price of the shares declined, the defendant refused to pay for the securities, forcing the broker-plaintiff to sell the shares at a loss. The *Brod* court granted standing to the plaintiff because he was clearly a purchaser of securities,³⁶ albeit at the fraudulent behest of the defendant. A later court, following the aborted purchaser-seller doctrine, pointed out that in such instances there was a contractual obligation between the plaintiff and the defendant to purchase or sell securities which was aborted by the alleged fraud of one of the parties.³⁷ Although there may be strictly no purchase or sale of securities, the contractual relation between the

³²See text accompanying note 27 *supra*.

³³*Compare* *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 546 (2d Cir. 1967). The *Mutual Shares* court allowed a plaintiff to seek an injunction restraining alleged manipulative practices intended to induce sale of shares to the defendant by stockholders. Reasoning that the SEC could seek an injunction, the court determined that the plaintiff logically played a similar role in private enforcement of the Securities Exchange Act.

³⁴See *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970). The Fifth Circuit permitted the plaintiff in *Herpich* to maintain a corporate derivative suit seeking to restrain a fraudulently induced merger. But because the corporation was the only party who had purchased or sold securities, the action could be maintained derivatively on behalf of the corporation. The court did not reach the issue whether the plaintiff, who was neither a purchaser nor a seller, could maintain the action in his own right. *Id.* at 812.

³⁵375 F.2d 393 (2d Cir. 1967).

³⁶*Id.* at 397 n.3.

³⁷*Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339, 345 (9th Cir. 1972).

parties fulfills the statutory definition of purchase or sale,³⁸ and brings the plaintiff within the strict terms of the *Birnbaum* Rule as upheld by the Supreme Court.

The common thread throughout the Court's *Blue Chip* opinion is its insistence that plaintiffs meet the statutory requirements of purchaser or seller for standing to obtain under the Securities Exchange Act. The Court did not address the issue of retaining the modifications to *Birnbaum*, and its strict statutory approach to the purchaser-seller requirement militates against a flexible approach to this standing requisite.³⁹ Hence, those modifications which meet the statutory criteria—derivative suits and injunctive actions when the corporation is a purchaser or seller, and aborted transactions—may continue to be applied by the courts. Situations where the plaintiff is not a purchaser or seller within the statutory definitions, in particular the forced seller exception, will no longer support a cause of action under Rule 10b-5.

Although the majority also relied upon policy reasons to bolster its conclusion, the better course for lower courts in the future will be to apply the statutory limitations to potential plaintiffs and not to promulgate new exceptions which may still meet *Birnbaum's* policy of limiting litigation by not significantly expanding the class of potential litigants.

But beyond the immediate impact of *Blue Chip* upon the purchaser-seller requirement, the decision further portends a less benign judicial attitude towards Rule 10b-5. The policy arguments for strict application of the *Birnbaum* Rule pronounced by Justice Rehnquist centered around the possible use of Rule 10b-5 as a fountainhead for strike suits against issuer or corporate defendants. Such suits, the Court noted, have a settlement value to the plaintiff far out of proportion to the probability of success after trial on the merits when claims could successfully resist a motion to dismiss or summary judgment. Once the claim reached the trial stage, there would be no objective fact of purchase or sale by which the plaintiff's injury could be measured. Thus, in the Court's opinion, recovery might be had based solely upon the plaintiff's own oral testimony that he would have purchased securities if the alleged misrepresentation or omission had not occurred.⁴⁰ Under such circumstances,

³⁸See note 17 *supra*.

³⁹While the Court characterized the purchaser-seller requirement as an issue of standing, 43 U.S.L.W. at 4717, it apparently did not use the term in the constitutional sense. Compare *Herpich v. Wallace*, 430 F.2d 792, 805-06 (5th Cir. 1970).

⁴⁰43 U.S.L.W. at 4712-15.

. . . bystanders to the securities marketing process could await developments on the sidelines without risk, claiming that inaccuracies in disclosure caused nonselling in a falling market and that unduly pessimistic predictions by the issuer followed by a rising market caused them to allow retrospectively golden opportunities to pass.⁴¹

Justice Blackmun filed a dissenting opinion which accused the majority of a "preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public."⁴² The essential test for Rule 10b-5 claims, the dissent asserted, should be "the showing of a logical nexus between the alleged fraud and the sale or purchase of a security."⁴³ Thus, Justice Blackmun, joined by Justices Douglas and Brennan, would have continued expansive application of Rule 10b-5, looking more to the nature or impact of the alleged fraud, rather than follow the statute-bound analysis of the majority.

Regardless of the merits of either the majority or dissenting viewpoint, the most significant ramification of *Blue Chip* is that the Court has chosen to establish some limits upon Rule 10b-5 rights of action. One recent commentator had noted that the *Birnbaum* Rule remained one of the few fixed boundaries limiting the field of Rule 10b-5 claims.⁴⁴ The Court has apparently chosen to circumscribe the Rule by the purchaser-seller requirement with draconian decisiveness. Rule 10b-5 does not encompass all potential securities fraud claimants, and the Court acknowledged that some otherwise meritorious claims must be relegated to non-federal forums for redress.⁴⁵ Hence, further changes in the plaintiff class protected by Rule 10b-5 or § 10(b) must come from Congressional amendment of the law, not from the courts.⁴⁶

The Court's unwillingness to expand further the limits of Rule 10b-5 may soon be carried into other securities fraud elements. The Court has granted certiorari to consider whether the Rule proscribes negligent as well as deceptive conduct.⁴⁷ Fortunately, the *Blue Chip*

⁴¹*Id.* at 4714.

⁴²*Id.* at 4719.

⁴³*Id.* at 4721.

⁴⁴Bromberg, *Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 167 (Special Issue 1974).

⁴⁵43 U.S.L.W. at 4712 n.9.

⁴⁶The SEC cannot amend Rule 10b-5 to modify the purchaser-seller requirement, as any extension beyond the statutory authority for such a rule would be an *ultra vires* exercise of Commission powers.

⁴⁷See *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), *petition for cert.*

decision scrupulously avoided unnecessary dictum with regards to other areas of the antifraud provisions. How the Court may resolve the scienter issue under Rule 10b-5 on much less firm statutory ground than available with the purchaser-seller requirement is a matter of conjecture.⁴⁸ For the present, however, *Birnbaum* stands as the most rigorous barrier to the plaintiff's right of action under Rule 10b-5.

B. Scienter

Rule 10b-5 does not impose strict liability upon violators; plaintiffs must prove sufficient culpability, commonly referred to as scienter,¹ to recover under the Rule. The federal circuits differ on the minimum degree of scienter necessary for liability, but two distinct standards, negligence and recklessness,² have emerged.³ During the

granted, 43 U.S.L.W. 3550 (U.S. April 14, 1975) (No. 74-1042). See also text accompanying notes 25-63 at 757-63.

⁴⁸"Section 10 (b) was one of the least controversial parts of the 1934 Act." 1 A. BROMBERG, *SECURITIES LAW: FRAUD, SEC RULE 10b-5* § 2.2(300), at 331 (1973). One of the drafters of the Securities Exchange Act, Thomas G. Corcoran, characterized the provision as a catch-all clause designed to prevent manipulative devices. *Id.* The history of the promulgation of Rule 10b-5 is similarly obscure as to whether or not the Rule was intended to encompass negligence as well as fraudulent and deceptive conduct. See *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).

¹ See generally 2 A. BROMBERG, *SECURITIES LAW: FRAUD, SEC RULE 10b-5* § 8.4 (1973) [hereinafter cited as BROMBERG]. The term scienter, as used in securities fraud litigation, does not have the common law meaning of conscious intent to defraud. See, e.g., *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). Scienter, when used in this context can mean negligence, recklessness, knowledge or intent. See notes 2-3 *infra*.

² Negligence is the least degree of fault which will allow recovery in some of the federal circuits. See note 3 *infra*. Negligence is generally characterized as a lack of due diligence or unreasonable conduct. *Batchelor v. Legg & Co.*, 52 F.R.D. 545, 549 (D. Md. 1971). Recklessness, the next higher degree of culpability, is defined as failure or refusal to ascertain material facts when readily available. *Cohen v. Franchard Corp.*, 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973). Recklessness is the lowest scienter standard which will permit recovery in all circuits which have considered the issue. See note 3 *infra*. The two increasingly more culpable states of mind are knowledge and intent to defraud. See also 2 BROMBERG § 8.4 (500).

³ Until recently the Seventh, Eighth, Ninth and Tenth Circuits were believed to allow recovery upon proof of negligence. The Second and Fifth Circuits, on the other hand, required proof of at least recklessness. Many of the older circuit court cases that explained the different standards were tabulated for comparison in *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 312-16 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972), and *Bucklo, Scienter and Rule 10b-5*, 67 Nw. U.L. Rev. 562, 598 (1972). See also *Sargent v. Genesco, Inc.*, 492 F.2d 750, 761 (5th Cir. 1974). The Third Circuit, while

past year, two circuits which formerly were believed to apply a negligence standard abandoned it for stricter tests of culpability.

In *White v. Abrams*,⁴ the Ninth Circuit disavowed any single minimum scienter requirement and proposed instead the application of a flexible duty standard. Rejecting a single scienter test as unworkable, the *White* court measured culpability in terms of the degree of duty imposed upon the defendant by Rule 10b-5 coupled with the defendant's state of mind.⁵ The court suggested that in certain circumstances negligence may constitute the appropriate scienter standard,⁶ while in other cases intentional conduct may be necessary for recovery. For example, the court stated that when the securities laws impose high duties of care and diligence upon the defendant, negligence should constitute sufficient culpability. On the other hand, when the law does not impose a high standard of conduct on the defendant, more than negligent conduct must be proved for recovery.⁷ Hence, the appropriate scienter standard for securities fraud cases in the Ninth Circuit may be either stricter or more lenient than that utilized by other circuits, depending on the duty formulation applied

declining to determine a minimum standard, recently indicated that actual knowledge would constitute sufficient scienter. *Rochez Bros. v. Rhoades*, 491 F.2d 402, 407 (3d Cir. 1974).

One commentator has noted that although some circuits claim to impose liability for negligence, either directly or by implication, no appellate court has yet done so in a private damage action. Bucklo, *supra* at 590. *But see* Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974), *petition for cert. granted*, 43 U.S.L.W. 3550 (U.S. Apr. 14, 1975) (No. 74-1042).

⁴ 495 F.2d 724 (9th Cir. 1974), *noted in* 32 WASH. & LEE L. REV. 99 (1975).

⁵ The court suggested five factors to be considered in formulating the degree of duty to be imposed on the defendant: (1) the relationship of the defendant to the plaintiff; (2) the defendant's access to information as compared to the plaintiff's access; (3) the benefit the defendant derives from the relationship; (4) the defendant's awareness that the plaintiff would rely on his advice; (5) the defendant's role in initiating the transaction. 495 F.2d at 735-36.

⁶ *White* did not use the term negligence to characterize the culpability standard imposed under conditions of high duty and good faith owed to the plaintiff. Two courts interpreting *White* have stated that negligence will suffice for liability. *In re U.S. Financial Securities Litigation*, CCH FED. SEC. L. REP. ¶ 94,844 (S.D. Cal. Sept. 11, 1974) (negligence under certain circumstances); *Little v. First California Co.*, CCH FED. SEC. L. REP. ¶ 94,745 (D. Ariz. July 11, 1974) (implying negligence sufficient in all circumstances). The former opinion properly interpreted the flexible duty standard. The *Little* court probably misinterpreted *White* by implying that negligence would suffice under all circumstances. *See* 495 F.2d at 734. *See also* Marx v. Computer Sciences Corp., 507 F.2d 485, 490 (9th Cir. 1974); *Jackson v. Bache & Co.*, 381 F. Supp. 71 (N.D. Cal. 1974).

⁷ 495 F.2d at 736.

by the trial court.⁸ In essence, however, *White* represents a movement toward stricter requirements of culpability, since it rejects the universal application of a minimum negligence standard.

A more decisive rejection of the negligence standard was made by the Tenth Circuit in *Clegg v. Conk*,⁹ which, in the opinion, of the court, corrected the "prevalent misunderstanding" among authorities and commentators over that circuit's minimum scienter criteria. The *Clegg* court stated that "there is required something additional by way of scienter or conscious fault than mere negligence," in order to impose liability under Rule 10b-5.¹⁰ While prior Tenth Circuit courts had implied a negligence standard or strict liability under the Rule, the circuit had never actually imposed liability for innocent or negligent violations.¹¹ The culpability standard announced by the *Clegg* court thus merely realigned the stated scienter test with the actual prior practice of that circuit. Nevertheless, the Tenth Circuit's explicit rejection of strict liability or a negligence standard under any circumstances was an even stronger indicium of a trend towards stricter culpability requirements under Rule 10b-5 than the *White* court's qualified rejection of a negligence criterion.¹²

Repudiation of a negligence standard by the Ninth and Tenth Circuits suggests that courts which have previously relied upon the

⁸ Whether the flexible duty standard will prove workable remains to be seen. Only one case has applied the standard. *Jackson v. Bache & Co.*, 381 F. Supp. 71 (N.D. Cal. 1974). See Note, *The Development of a Flexible Duty Standard of Liability Under SEC Rule 10b-5*, 32 WASH. & LEE L. REV. 99 (1975); cf. *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), *petition for cert. granted*, 43 U.S.L.W. 3550 (U.S. Apr. 14, 1975) (No. 74-1042).

⁹ 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, 43 U.S.L.W. 3659 (June 16, 1975).

¹⁰ *Id.* at 1361 (footnote omitted).

¹¹ The *Clegg* court reviewed extensively all earlier Tenth Circuit cases involving scienter and Rule 10b-5 and concluded that liability had never been imposed for simple negligence not involving some fraudulent purpose or species of scienter stricter than negligence. 507 F.2d at 1362. The court is correct in this conclusion. While in *Stevens v. Vowell*, 343 F.2d 374, 379 (10th Cir. 1965), the circuit court had stated "[i]t is only necessary to prove one of the prohibited actions such as the material misstatement of a fact or the omission to state a material fact" to recover under Rule 10b-5, the facts of the case demonstrated knowledge by the defendant. See also *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973).

¹² Only two circuits would presently impose liability for negligent violations of Rule 10b-5 under all circumstances. See *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), *petition for cert. granted*, 43 U.S.L.W. 3550 (U.S. Apr. 14, 1975) (No. 74-1042); *Vanderboom v. Sexton*, 422 F.2d 1233, 1239 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970). See also note 13 *infra*.

now discredited authority from those circuits should either reexamine the Rule 10b-5 culpability standard in light of recent developments or clearly articulate the basis and scope of liability for negligence under the Rule.¹³ Whether negligence is the appropriate minimum standard of scienter has not been definitively resolved by the courts, but *White* and *Clegg* evidence a clear trend away from that standard.

C. Duties of Inquiry and Disclosure—Attorney and Accountant Liability for Negligence

Liability under Rule 10b-5 is not limited to persons who directly participate in a fraudulent scheme. Secondary defendants, known as aider-abettors, may be held liable for their assistance to the primary wrongdoer.¹ Although the distinction between primary and secondary defendants is not always clear, aiding-abetting requires intent to further a scheme to defraud, or knowledge of such a scheme, coupled with substantial assistance to the primary wrongdoer.² Substantial assistance may be given by active participation in the scheme,³ or by inaction if the secondary defendant is a person upon whom special responsibilities are imposed by the securities laws.⁴ The knowledge

¹³ Both *White* and *Clegg* have either overruled or seriously limited application of earlier circuit decisions which had supposedly established a negligence standard. See *Stevens v. Vowell*, *supra* note 11; *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961). All three cases have been heavily relied upon by other courts to establish a negligence standard. *E.g.*, *Vanderboom v. Sexton*, 422 F.2d 1233, 1239 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); *Myzel v. Fields*, 386 F.2d 718, 747 (8th Cir. 1967); *cert. denied*, 390 U.S. 951 (1968).

¹ See generally Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972) [hereinafter cited as Ruder]; see also Lowenfels, *Expanding Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 COLUM. L. REV. 412 (1974).

² See *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 681-82 (N.D. Ind. 1966), 286 F. Supp. 702, 728 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147, 154-55 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); *Rosen v. Dick*, CCH FED. SEC. L. REP. ¶ 94,786 (S.D.N.Y. Sept. 3, 1974), Ruder at 620. Professor Bromberg has also distinguished aiding-abetting from primary liability on the basis of a lesser degree of participation or importance of the acts performed. 2 A. BROMBERG, *SECURITIES LAW: FRAUD, SEC RULE 10b-5*, § 8.5(515) (1973) [hereinafter cited as BROMBERG]. See, *e.g.*, *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1097 (2d Cir. 1972).

³ *E.g.*, *Brennan v. Midwestern United Life Ins. Co.*, 286 F. Supp. 702, 728 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147, 154-55 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); *Rosen v. Dick*, CCH FED. SEC. L. REP. ¶ 94,786 (S.D.N.Y. Sept. 3, 1974).

⁴ The *Brennan* series of cases, see cases cited in note 2 *supra*, imply that liability for inaction may result where there is a special duty imposed on the aider-abettor to

criterion has been expressed as a requirement of culpability or scienter and has been defined in terms of negligence, recklessness, and knowledge or intent to further the fraudulent conduct.⁵ In private actions, secondary liability has generally been imposed upon proof of actual knowledge of the fraudulent scheme.⁶ On the other hand, negligence has satisfied the culpability requirement in SEC enforcement actions. However, the culpability standards applied in either type of action have not distinguished between active or passive assistance.

The failure of federal courts to recognize a dichotomy between active and inactive assistance by aider-abettors was remedied during the past year. Courts began to distinguish active from passive participation with regard to the different culpability standards used to determine liability in both private and enforcement actions.⁸

Standards for Injunctive Relief

The most abrupt departure from prior case law was in the area of SEC enforcement suits. In *SEC v. Coffey*⁹ the Sixth Circuit withdrew a district court injunction against two alleged aider-abettors charged with negligently violating Rule 10b-5. The circuit court rejected the SEC's contention that mere negligence was sufficient for injunctive

report violations of Rule 10b-5. 259 F. Supp. at 681-82. The question of liability where only inaction is involved was reserved on appeal by the circuit court. 417 F.2d at 155. The Second Circuit, however, has apparently adopted the inaction-duty theory as a basis for liability, provided other requisites of culpability are proved. *See Lanza v. Drexel & Co.*, 479 F.2d 1277, 1302-03 (2d Cir. 1973). *See also Pettit v. American Stock Exchange*, 217 F. Supp. 21 (S.D.N.Y. 1963).

⁵ See note 2 at 750.

⁶ *See, e.g., Lanza v. Drexel & Co.*, 479 F.2d 1277, 1302-03 (2d Cir. 1973) (no liability for inaction where defendant had no knowledge of the scheme); *Rosen v. Dick*, CCH FED. SEC. L. REP. ¶ 94,786 (S.D.N.Y. Sept. 3, 1974) (allegations of knowledge and active assistance state a claim).

⁷ *See, e.g., SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973), noted in 87 HARV. L. REV. 1860 (1974); 34 MD. L. REV. 327 (1974).

⁸ See text accompanying notes 10-12, 24-26 *infra*.

⁹ 493 F.2d 1304 (6th Cir. 1974), cert. denied, 43 U.S.L.W. 3416 (Jan. 27, 1975). The case involved alleged misrepresentations to secure a loan from the Ohio Workmen's Compensation Fund. The corporation, King Resources, employed Crofters, Inc. as a "money finder" to arrange loans from the state of Ohio. Crofters obtained a prime commercial paper credit rating for King Resources from the National Credit Office. Appellant King was board chairman of King Resources, and appellant Coffey was its financial vice-president. The SEC claimed that King Resources had failed to disclose adverse material facts about its financial condition to the state of Ohio and the National Credit Office. Almost all negotiations for the credit rating were conducted by the money finder, Crofters. The only major action of either appellant was communication between Coffey and the National Credit Office.

relief and instead required a showing of willful or reckless disregard for the truth. A dual-level standard was implied by the court: where the aider-abettor actively assisted the securities fraud scheme, knowing participation was requisite to enjoining the defendant; conversely, when assistance was by inaction only, then conscious intent to aid the violation of Rule 10b-5 was necessary.¹⁰

In refusing to apply a negligence standard to aider-abettors, the *Coffey* court explicitly rejected a recent holding by the Second Circuit.¹¹ In *SEC v. Spectrum, Ltd.*¹² the Second Circuit applied a negligence standard in an enforcement action against an attorney who had prepared an opinion letter used to sell unregistered stock. This decision was a case of first impression whereby an attorney, acting in his professional capacity, was found enjoined as an aider-abettor to securities fraud. The court justified its use of a negligence standard on the basis of the attorney's special responsibilities under the securities laws and the unquestionable reliance which the investing public must place on legal opinion letters.¹³

Spectrum was the first case in which a court unequivocally applied a negligence standard in an enforcement proceeding against an

¹⁰ Appellant King's conduct consisted primarily of inaction. See 493 F.2d at 1316. Appellant Coffey, on the other hand, was either a primary participant or an active aider-abettor based on his providing information to the National Credit Office. *Id.* The *Coffey* court did not precisely explain the reason for applying different standards to each defendant, but the distinction made in the text is substantiated by a careful reading of the decision.

¹¹ The *Coffey* court rejected the negligence standard applied in *SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973), as not applicable in the case before it. 493 F.2d at 1316 n.30. The Sixth Circuit found *Spectrum* correct on its facts, but nevertheless established a knowledge test to enjoin aiding-abetting. *Id.* at 1316.

The Seventh Circuit in *SEC v. Dolnick*, 501 F.2d 1279 (7th Cir. 1974), explicitly rejected the injunctive relief standards applied by the *Coffey* court. The *Dolnick* court granted injunctive relief against a securities salesman who had knowingly sold unregistered securities in violation of Rule 10b-5. The court stated that defendant Dolnick was at least an aider-abettor to securities fraud, although from the facts he could have been a primary participant as well. Noting the enforcement standard of liability used in *Coffey* was willful or reckless disregard for the truth, the *Dolnick* court rejected the standard as "inconsistent with the law of this circuit." *Id.* at 1284, citing *SEC v. Van Horn*, 371 F.2d 181 (7th Cir. 1966). The *Dolnick* court apparently misinterpreted *Coffey*, citing *Coffey's* injunction standard for primary defendants, rather than the aider-abettor standard of knowledge or intent.

¹² 489 F.2d 535 (2d Cir. 1973).

¹³ The Second Circuit had noted previously that attorneys have a duty to investigate the accuracy of a prospectus and may not rely blindly on information obtained from a client which is apparently misleading. *SEC v. Frank*, 388 F.2d 486 (2d Cir. 1968).

aider-abettor. Application of a negligence standard to aider-abettors was a logical extension of prior case law holding negligence sufficient to enjoin primary violators.¹⁴ The *Coffey* court, on the other hand, specifically refused to apply a negligence standard to either active or passive aiding-abetting. The court reasoned that proof of knowledge or intent to assist the fraud, rather than lesser proof requirements involved in negligence, was necessary to guard against imposition of liability for innocent omissions or non-culpable inaction.¹⁵

The rationale and conclusion of the *Coffey* court can be criticized on three grounds. First, a negligence standard does not impose liability upon innocent or non-culpable parties, since negligence requires a finding of fault on the defendant's part.¹⁶ Second, an increased standard of care is usually applied to persons with special responsibilities under the securities laws. This reasoning was persuasive to the *Spectrum* court, since it applied the negligence standard to an attorney experienced in securities law.¹⁷ Similarly, the defendants in *Coffey*, as corporate officers, arguably had a duty to be aware of corporate activities which might involve securities fraud. Application of a negligence standard would promote conscientious and diligent performance of officers' duties.¹⁸ Third, the *Coffey* court's refusal to apply a negligence standard in an enforcement action may result in confusion similar to that which currently prevails due to the variety of scienter standards applied by circuit courts in private damage actions.¹⁹ The Supreme Court's decision not to hear the *Coffey* case²⁰ leaves the circuit courts free to apply varying culpability requirements as prerequisites to grants of injunctive relief against aider-abettors.

Despite the discrepancy in the conclusions reached by the

¹⁴ See, e.g., *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1092 (2d Cir. 1972), and cases cited therein. The rationale for a negligence standard is that since no monetary damages are involved, the penalties are minimal. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 865 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969).

¹⁵ 493 F.2d 1304, 1317 (6th Cir. 1974), *cert. denied*, 43 U.S.L.W. 3416 (Jan. 27, 1975).

¹⁶ Cf. *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974) (liability without fault rejected; negligence may suffice for liability in some cases). Other courts have, however, rejected on policy grounds a negligence standard for private actions. See, e.g., *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973).

¹⁷ See text accompanying note 13 *supra*.

¹⁸ Absence of monetary liability in injunctive actions ameliorates the impact of the injunction. See note 14 *supra*.

¹⁹ See text accompanying notes 2-3 at 750.

²⁰ 43 U.S.L.W. 3416 (Jan. 27, 1975).

Spectrum and *Coffey* courts, the cases focused upon two factors receiving increasing judicial scrutiny in connection with the formulation of culpability standards. These are the nature of the assistance rendered by the aider-abettor and his status as a professional or person with special duties under the securities laws. Both courts considered these two factors highly important, although the standards which were finally applied lack uniformity or consistent correlation with the suggested factors.²¹

Private Liability for Aiding-Abetting

Recent private actions further indicate that federal courts are increasingly sensitive to the distinctions between active and inactive aiding-abetting, and are willing to impose stricter standards of liability upon certain classes of secondary defendants. For example, in *Hochfelder v. Midwest Stock Exchange*²² the Seventh Circuit applied a dual-level test analogous to the one used in *Coffey*. The *Midwest Stock Exchange* case involved claims of aiding-abetting arising from negligent supervision of a securities broker and the subsequent failure to detect his fraudulent practices. The court concluded that where inaction was involved, the plaintiff must prove that the defendant had, or but for a breach of his duty of inquiry would have had, knowledge of the fraud.²³ On the other hand, for active aiding-abetting, the court stated that negligence is the appropriate standard.²⁴ In a companion case, *Hochfelder v. Ernst & Ernst*,²⁵ the Seventh Circuit subsequently amplified the standard applied to inactive

²¹ Compare *SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973) (attorney gave active assistance; negligence standard), with *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), cert. denied, 43 U.S.L.W. 3416 (Jan. 27, 1975) (corporate officers, active and inactive assistance; knowledge or intent standard).

²² 503 F.2d 364 (7th Cir.), cert. denied, 419 U.S. 875 (1974).

²³ 503 F.2d at 374.

²⁴ "Absent proof of negligence, we will not stand in willingness to impose a standard of strict liability on Midwest due to its issuance of the [membership] plaque." *Id.* at 375. The plaintiff maintained that issuance of a membership plaque by the exchange was aiding-abetting by affirmative action.

The decision to apply a negligence standard to active aiding-abetting is consistent with earlier Seventh Circuit decisions which applied the same standard to primary participants. See, e.g., *Parrent v. Midwest Rug Mills, Inc.*, 455 F.2d 123, 126 (7th Cir. 1972). Compare *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (alleged aiding-abetting by inaction; no liability for negligence); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974) (aiding-abetting by affirmative acts; liability based on willful, deliberate or reckless disregard for the truth).

²⁵ 503 F.2d 1100 (7th Cir. 1974), petition for cert. granted, 43 U.S.L.W. 3550 (U.S. Apr. 14, 1975) (No. 74-1042).

aiding and abetting announced in *Midwest Stock Exchange*.

Ernst & Ernst involved a suit against an independent auditing firm for aiding and abetting securities fraud by inaction. Defendant Ernst & Ernst had failed to investigate an office rule regarding the opening of the primary wrongdoer's mail.²⁶ The plaintiff maintained that this "mail rule" was a material inadequacy in internal accounting controls which the defendant was under a duty of inquiry to investigate.²⁷ Ernst & Ernst's failure to investigate and report the mail rule allegedly violated generally accepted standards of accounting procedure²⁸ and thus aided and abetted a violation of Rule 10b-5. The court suggested that a five-step test be used to establish a prima facie case of aiding-abetting. A claim could be made by demonstrating that: (1) the defendant had a duty of inquiry; (2) the plaintiff was a beneficiary of the duty of inquiry; (3) the defendant breached his duty of inquiry; (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure; (5) there existed a causal connection between the breached duties of inquiry and disclosure and the underlying fraud.²⁹ The *Ernst & Ernst* court relied on the *Midwest Stock Exchange* case to support this standard, but with one subtle distinction. While *Midwest Stock Exchange* used a knowledge criterion for inactive aiding-abetting,³⁰ *Ernst & Ernst* suggested that negligence was the proper standard. The court noted that if an auditor breached his duty of inquiry through lack of due care he concomitantly breached his duty of disclosure.³¹ Thus, the Seventh Circuit held that the auditors could be liable for negligent failure to detect material inadequacies and, since such inadequacies were unknown to them, full disclosure was impossible.³²

²⁶ The "mail rule" provided that all mail personally addressed to the primary wrongdoer would only be opened by him. The mail was allowed to accumulate unopened when he was absent from the office. The primary wrongdoer corresponded with his defrauded clients through the mails, and the scheme would have been discovered by reading his mail. 503 F.2d at 1109.

²⁷ *Id.*

²⁸ 503 F.2d at 1108.

²⁹ 503 F.2d at 1110. The court suggested that the test was a flexible standard of liability, *id.* at 1104, but failed to indicate whether the factors themselves or the standard applied would vary depending on the factors present in any particular case. *Cf. White v. Abrams*, 495 F.2d 724 (9th Cir. 1974).

³⁰ See text accompanying note 23 *supra*.

³¹ 503 F.2d at 1114. See also note 32 *infra*.

³² This is the logic of *Ernst & Ernst*. 503 F.2d at 1104. A duty to investigate necessarily implies any material inadequacy will be disclosed. Failure to discover material omissions or misrepresentations where the defendant is under a duty of inquiry concomitantly breaches the duty of disclosure. *Id.* at 1114. This reasoning appar-

Ernst & Ernst establishes that public accountants will be held to higher standards of conduct under Rule 10b-5 than some corporate officers.³³ The scope of the duty of inquiry will be limited to factors which must be disclosed under generally accepted accounting standards, but the required degree of culpability will be simple negligence, even for passive aiding-abetting.³⁴

Although the Seventh Circuit's decision was the first to unequivocally impose liability for negligence on aider-abettors, a recent district court case from the Second Circuit reached a similar result. An auditor's report which failed to qualify and report adequately a transaction in a statement used to place securities privately was found materially misleading by the court in *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*.³⁵ The qualified auditor's report did not convey a true picture of the nature of the transaction which had been executed to create paper assets for the corporation, and thus was misleading to investors.³⁶ Noting that public accountants traditionally have a duty to the public, the court stated that the auditor had an affirmative duty to disclose facts material to a securities transaction.³⁷ The judicial inquiry was not whether the report satisfied "esoteric accounting norms," but whether the report presented a fair and true financial picture.³⁸ The court also phrased the prerequisite elements of liability in terms of materiality, disclosure duty, scienter,

ently imposes a negligence standard on parties with a duty of inquiry under Rule 10b-5. The court also imposed a burden of proof on the plaintiff to show a causal connection between the breach of duty of inquiry or disclosure and facilitation of the fraud. *Id.* at 1115. Apparently the plaintiff must show that an investigation would have uncovered the fraud and so required its disclosure.

³³ Compare *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 43 U.S.L.W. 3416 (Jan. 27, 1975) (corporate officers enjoined for aiding-abetting only on showing of knowledge or intent), and *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (corporate director not liable for negligent inaction).

³⁴ The *Ernst & Ernst* case may thus impliedly overrule a part of the *Midwest Stock Exchange* case. See text accompanying note 23 *supra*.

³⁵ 378 F. Supp. 112 (S.D.N.Y. 1974).

³⁶ *Id.* at 125.

³⁷ *Accord*, *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94, 104-05 (N.D. Ill. 1967). *But see* *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971). In *Wessel*, an independent auditor was sued as an aider-abettor to securities fraud. The court denied liability, stating, "We find nothing in Rule 10b-5 that purports to impose liability on anyone whose conduct consists solely of inaction." *Id.* at 283. This holding apparently contradicts the inaction-duty standard of liability. However, it is limited by the facts that the false financial statements were not prepared in connection with the purchase or sale of securities, and were further altered without the auditor's knowledge before inclusion in the false prospectus.

³⁸ 378 F. Supp. 112 (S.D.N.Y. 1974).

reliance and damages.³⁹ The culpability standard for failure to discover the omissions or misrepresentations was willful, deliberate or reckless disregard for the truth which would be the equivalent of knowledge.⁴⁰ The *Herzfeld* court's definition of culpability, the standard of duty of inquiry, and the elements of a claim thus apparently differed from the criteria used by the *Ernst & Ernst* court.

While the *Ernst & Ernst* court used a negligence standard of culpability, *Herzfeld* required a showing of knowledge. The distinction can be attributed to the different scienter standards applied by the Seventh and Second Circuits.⁴¹ The standard applied by each court did not distinguish between active and passive assistance by the secondary defendant, thereby contradicting the dichotomy suggested in the *Midwest Stock Exchange* case. Nevertheless, while the *Herzfeld* court's knowledge standard included liability for a reckless failure to discover fraudulent conduct, and is thus distinguishable from negligence, the application of such a standard to circumstances involving independent auditors may reach negligence.⁴²

In terms of the standard applied to the adequacy of disclosure, *Ernst & Ernst* followed the generally accepted standards of the accounting profession. The *Herzfeld* court, on the other hand, used a standard which required that the report present a fair and true picture to investors.⁴³ The fair and true standard appears more ambiguous than the test of *Ernst & Ernst*, although in application the standards used by each court may coincide in effect and result despite the distinction made by the courts.⁴⁴ Both decisions do, nevertheless, establish some guidelines for defining the persons subject to special duties under the securities acts and the standards which will be applied to them.

Public accountants most clearly have a duty to inquire into matters affecting the reliability and integrity of financial records,⁴⁵ and

³⁹ Compare the elements suggested by the *Ernst & Ernst* court at text accompanying note 29 *supra*.

⁴⁰ 378 F. Supp. at 126.

⁴¹ See cases cited in note 24 *supra*.

⁴² See text accompanying notes 59-62 *infra*.

⁴³ See text accompanying note 38 *supra*.

⁴⁴ Accepted standards of accounting are not always unambiguous, however. Whether the "mail rule" in *Ernst & Ernst* was a material inadequacy in internal accounting controls which required disclosure was an issue of fact to be resolved at trial, thereby requiring remand. 503 F.2d at 1111. The *Herzfeld* standard of whether the report presents a fair and true financial picture, see text accompanying note 40 *supra*, is an inherently more ambiguous standard as less reliance will be placed upon the accounting profession's own standards.

⁴⁵ The basis for the auditor's duty, both at common law and as imposed by the

this duty runs to the public as well as to the client.⁴⁶ Corporate insiders also have been held to have duties of disclosure if they trade in securities on inside information.⁴⁷ Similarly, members of the SEC have stated publicly that securities lawyers have duties running not only to their clients, but to the investing public at large.⁴⁸ How far the class of persons subject to special duties under the securities laws might extend beyond insiders and professionals has not yet been the subject of extensive judicial comment.⁴⁹

Once the class of persons with special duties under the securities laws has been defined, a court must also determine exactly what duties will be imposed upon the defendant. Two distinct duties were imposed by both the *Herzfeld* and *Ernst & Ernst* courts: a duty of inquiry and a duty of disclosure. Each duty presents a different compliance problem for potential defendants. The extent of the duty of inquiry at present is ambiguous.⁵⁰ Whether an office mail rule in the *Ernst & Ernst* case was a material inadequacy in internal accounting controls constituted a major question before the court.⁵¹ Similar du-

securities statutes and professional standards, was extensively discussed by the *Ernst & Ernst* court. 503 F.2d at 1105-11.

⁴⁶ See, e.g., *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94, 104-05 (N.D. Ill. 1967). For an explanation of recent developments in accountants' common law liabilities for negligence, see Gormley, *Accountants' Professional Liability—A Ten Year Review*, 29 BUS. LAW. 1205 (1974).

⁴⁷ *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731 (10th Cir. 1974) (corporate president was aider-abettor; required to disclose what he knew); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) (anyone in possession of material inside information must disclose it or abstain from trading in such securities).

⁴⁸ Members of the SEC have urged that the securities lawyer has duties to the investing public to insure that all material facts in a securities transaction are fully and fairly disclosed. See Statement of SEC Chairman Ray Garrett, 29 BUS. LAW. 7, 12 (Special Issue 1974); Sommer, *The Emerging Responsibilities of The Securities Lawyer*, CCH FED. SEC. L. REP. ¶ 79,631 (1974).

⁴⁹ See cases cited at note 47 *supra*. See also *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236-37 (2d Cir. 1974) (stockbroker liable for breach of duty of disclosure to all persons in the open market without knowledge of material inside information possessed by defendant).

⁵⁰ See note 44 *supra*. See also *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (outside director not participating in fraudulent transaction not liable for negligent failure to detect fraud); *SEC v. Frank*, 388 F.2d 486, 489 (2d Cir. 1968) (lawyer cannot knowingly assist in circulating false statements because his client furnished them; but he does not commit fraud by failure to detect technical mistakes beyond his competence).

⁵¹ 503 F.2d at 1111. The court defined a material inadequacy as a condition allowing someone to perpetrate errors or irregularities in accounting records, and concluded that the issue of whether the "mail rule" was a per se inadequacy in internal account-

ties of inquiry have been applied to attorneys with regard to information given to them in connection with a securities transaction.⁵² However, the question of whether or not a specific fact is material and thus requires further investigation frequently will be answered by guesswork or speculation in view of the myriad facts which become known to the auditor or lawyer in the course of his employment.⁵³

The concomitant duty of disclosure suggests even more troublesome problems for accountants and lawyers. Once the potential aider-abettor learns of either actual or suspected violations, he must disclose them or face liability.⁵⁴ However, no judicial authority has suggested how and to whom disclosure should be made, whether in a public forum or to the SEC.⁵⁵ Some commentators have suggested that lawyers and auditors do possess significant power in advising on securities transactions: a qualified or withheld opinion letter will probably abort the entire transaction.⁵⁶ However, when the qualifying material facts are brought to light in the later stages of a transaction,⁵⁷ or the disputed fact is one over which minds could reasonably differ, the attorney may of necessity choose his client's position.⁵⁸

ing controls was best resolved at trial. *Id.* But the court then declined to find that the auditor had a duty to inquire into compliance with NASD rules. *Id.* at 1111-14.

⁵² See *SEC v. Frank*, 388 F.2d 486, 489 (2d Cir. 1968).

⁵³ The *Ernst & Ernst* court did not find the "mail rule" automatically material. See notes 44, 51 *supra*. The extent of the lawyer's duty to investigate information provided to him by his client has been vaguely defined. See note 13 *supra*.

⁵⁴ See note 32 *supra*.

⁵⁵ Primary defendants violate Rule 10b-5 by trading on material inside information without disclosing it to the investing public. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236-37 (2d Cir. 1974). Such disclosure would probably be in breach of a confidential or fiduciary duty under common law. Aider-abettors do not have the option to abstain from trading and avoid liability for nondisclosure. When the independent violation occurs, aider-abettors may become automatically liable for failure to disclose. See also *Meyerhofer v. Empire Fire & Marine Ins. Co.*, 497 F.2d 1190 (2d Cir. 1974); Johnson, *The Expanding Responsibilities of Attorneys in Practice before the SEC*, 25 MERCER L. REV. 637, 667 (1974).

⁵⁶ See Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities of Attorneys Under the Federal Securities Statutes*, 34 OHIO ST. L.J. 231 (1973).

⁵⁷ This was the situation in the *National Student Marketing* case, where adverse material facts were not revealed until just prior to closing the transaction. The lawyers issued opinion letters stating that all necessary steps to consummate the merger were valid and that no federal or state law had been violated, rather than disclose the new information and resolicit approval from shareholders of the corporations involved. See *SEC v. National Student Marketing Corp.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,360 (D.D.C. 1972) (complaint filed).

⁵⁸ The lawyer may also terminate his employment by his client. The ABA Code of Professional Responsibility has some suggestions. A lawyer may refuse to participate in conduct he believes to be unlawful, even though there is legal support for the course of action. Disciplinary Rule 7-101(B)(2) [hereinafter D.R.]. A lawyer shall not counsel

Courts speak of liability in terms of duties to investigate and disclose material information in securities transactions. This language appears to imply a uniform negligence standard at least for lawyers and accountants who aid and abet securities fraud. The *Ernst & Ernst* court was clear on one point: if an auditor breached his duty of inquiry through lack of due care, he simultaneously breached his duty of disclosure.⁵⁹ This is an indication that at least the Seventh Circuit would impose liability for a negligent failure to detect and disclose fraud.⁶⁰ Similarly, although denying that liability will be imposed for negligent conduct under Rule 10b-5, the *Herzfeld* court approaches that result.⁶¹ However, to conclude that a negligence standard will generally be applied to this class of aider-abettors would be misleading.⁶² Use of a negligence standard in private litigation involving aiding-abetting represents a departure from the judicial trend towards requiring more than negligent conduct to impose liability upon primary defendants.⁶³ The result in extreme cases will be anom-

or assist his client in conduct which is illegal or fraudulent, D.R. 7-102(A)(7), and the attorney must disclose fraudulent conduct by his client when the information is unprivileged. Rule 7-102(B)(1). The attorney may withdraw from employment where his client seeks to pursue an illegal course of conduct, D.R. 2-110(C)(1)(b), or his client insists he pursue an illegal course of conduct, D.R. 2-110(C)(1)(c). The lawyer may reveal the intention of his client to commit a crime and the information necessary to prevent the crime. D.R. 4-101(C)(3). The disciplinary rules are not completely clear on the extent of the attorney's duties; neither will they be helpful when the situation facing the attorney is less than unequivocally illegal.

⁵⁹ 503 F.2d at 1114. See also note 34 *supra*.

⁶⁰ See note 32 *supra*.

⁶¹ Although the auditor had knowledge of the fraudulent transaction in *Herzfeld*, the court would hold an auditor liable for failure to discover misrepresentations or omissions amounting to willful, deliberate, or reckless disregard for the truth. The recklessness standard as applied by the Second Circuit includes failure or refusal to ascertain and disclose material facts when readily available and there are reasonable grounds to believe they exist. *Cohen v. Franchard Corp.*, 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973). This recklessness, or inquiry-notice standard is important for an accountant who will be aware of many such facts. If he should ignore one material fact, such as the "mail rule" in *Ernst & Ernst*, then arguably there is a reckless violation. Under such circumstances the distinction between recklessness and negligence almost disappears.

⁶² In contrast, the Second Circuit has rejected a negligence standard with regard to both primary and secondary defendants. *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973). *Ernst & Ernst* is the first private damage suit to impose a negligence standard in a case where the facts demonstrate only a negligent violation of Rule 10b-5, and not knowing or reckless conduct. *Compare Parrent v. Midwest Rug Mills, Inc.*, 455 F.2d 123, 126 (7th Cir. 1972) (negligence standard used to determine statute of limitations).

⁶³ See text accompanying notes 12-13 at 752-53.

alous as primary wrongdoers could conceivably be subjected to lesser standards of due care than their accountant or attorney aider-abettors.

Conclusion

The developments of the past year are not completely clear in establishing standards to be applied to aider-abettors in securities fraud cases. It is evident, however, that courts are in fact applying different standards of culpability based upon the active or passive nature of the aiding-abetting. In particular, greater culpability will be required where assistance is by inaction rather than action.⁶⁴ Persons with special responsibilities under the securities acts, professionals who trade securities and advise or audit securities traders, will be held to higher standards of conduct than their non-professional counterparts.⁶⁵ The standards imposed upon professionals are now approaching a negligence theory of liability, perhaps without regard for a distinction between active and passive aiding-abetting.⁶⁶ This development in the law of aiding-abetting violations of Rule 10b-5 places these professionals in the difficult, if not impossible, position of evaluating all information that comes to their attention for its potential fraudulent aspects. Perhaps the only evaluation criteria under these circumstances was given by Judge Friendly in his comment that these decisions will be "judged in the bright gleam of hindsight."⁶⁷

D. Damages

In the computation of damages in securities fraud cases, federal courts generally have followed either the out-of-pocket measure¹ or a rescission theory.² The former measure permits recovery of the difference between the fair value of the securities at the time of the fraud-

⁶⁴ See text accompanying notes 9-10, 22-24 *supra*.

⁶⁵ See text accompanying notes 45-49 *supra*.

⁶⁶ See text accompanying notes 59-62 and note 32 *supra*. But see text accompanying notes 22-25 *supra*.

⁶⁷ SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969). See also 2 BROMBERG § 8.5(533) at 208.25.

¹ See, e.g., Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

² See, e.g., Myzel v. Fields, 386 F.2d 718, 743 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); Janigan v. Taylor 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

lent transfer and the actual consideration paid.³ Rescission of the transfer produces essentially the same result,⁴ but the fact that the parties are returned to the status quo suggests that any increases in the value of the securities during the interim between the sale and the remedy will inure to the defrauded seller.⁵ Thus, the distinction between the two theories of recovery is minimal.

The only Supreme Court case in the area of securities fraud damages is *Affiliated Ute Citizens v. United States*,⁶ in which the Court favored use of the rescission measure. Finding that in some cases out-of-pocket damages would be appropriate, the Court nevertheless held that when the defendant subsequently resold the fraudulently acquired securities at a profit greater than the defrauded seller's actual loss, the measure of the plaintiff's damages should be the defendant's profit on resale.⁷ Thus, the Court apparently indorsed the rescission theory allowing recovery of value accretions occurring after the fraudulent transaction.

Affiliated Ute Citizens did not establish a definitive measure of damages, however. The transaction in that case involved face-to-face contact between a small number of purchasers and sellers rather than the large-scale fraud which may be perpetrated through the national securities exchanges.⁸ The potential damage recovery in a successful

³ *Ross v. Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1967). The fair value of the security is usually computed on the date of the transaction. However, when the security is infrequently traded, as may be the case with a close corporation, subsequent sales which more nearly reflect the true value will be used to measure the plaintiff's loss. *Id.*

⁴ See cases cited in note 2 *supra*. See also *Baumel v. Rosen*, 412 F.2d 571, 575 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970).

⁵ *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *Baumel v. Rosen*, 283 F. Supp. 128, 145 (D. Md. 1968), *modified*, 412 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970). The Second Circuit has also suggested that accretions in value may inure to defrauded purchasers, although measuring the increase in value may be difficult. See note 18 *infra*.

There are other problems inherent in both measures which could affect the amount of the damage award. For example, the date of valuation for subsequent increases in value can greatly affect the damage award. See *Baumel v. Rosen*, 412 F.2d 571, 574-75 (4th Cir. 1969), *modifying* 283 F. Supp. 128, 147 (D. Md. 1968). The valuation of securities which are not readily marketable is also a problem for the courts. See, e.g., *Thomas v. Duralite Co.*, 386 F. Supp. 698, 724-26 (D.N.J. 1974); *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967).

⁶ 406 U.S. 128, 154-55 (1972).

⁷ *Id.*, citing *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). See also text accompanying notes 15-16 *infra*.

⁸ While privity is not required in private damage actions under Rule 10b-5, see, e.g., *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 101 (10th Cir.), *cert. denied*,

private action lodged by numerous plaintiffs under Rule 10b-5 for open-market fraud would raise the spectre of corporate bankruptcy to pay the award, and has thus been a concern of both courts and commentators.⁹ The remedial measure ultimately used in open market fraud suits must turn on grounds of policy rather than restitution or out-of-pocket measures.¹⁰

However, since no open market suits involving a large potential damage award have come to final judgment, courts have been able to develop sophisticated Rule 10b-5 damage theories largely free from these considerations. Hence, courts have prohibited recovery of punitive damages,¹¹ required disgorgement of fraudulently gained prof-

404 U.S. 1004 (1971), no large class actions involving potentially extensive damages have reached final judgment. The absence of a privity requirement allows persons purchasing or selling in the open market to sue a corporation, for example, when its officers or agents violate Rule 10b-5 through insider trading. See *Texas Gulf Sulphur, supra*. Thus damages paid by the corporation may far exceed the unlawful gains of its agents. The Second Circuit recently refused to limit the *Affiliated Ute Citizens* case to privity transactions, *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 240 (2d Cir. 1974), which indicates a willingness to impose liability without regard for damage limitations.

One response to the issue of damages involving fraud in a stock traded on national securities exchanges has been the "cover" award. *Mitchell v. Texas Gulf Sulphur Co.*, *supra* at 104-06. In *Mitchell*, damages were awarded based on the amount it would cost a defrauded seller to reinvest in the same security within a reasonable time after discovery of the fraud. Damages were computed by using the highest value of the stock within nine days following disclosure of the fraudulent conduct which had misled the investing public. *Accord*, *Fridrich v. Bradford, CCH FED. SEC. L. REP.* ¶ 94,723 (M.D. Tenn. 1974).

⁹ See, e.g., *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 105 n.13 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 866-67 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969); Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. OF ILL. L.F. 651, 669 (1972); Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U. L. REV. 423, 428-29 (1968) (suggesting that restitution damages in the *Texas Gulf Sulphur* litigation could vary between \$84 million and \$390 million depending on the period selected in which recovery would be allowed). Cf. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, Civ. No. 74-2542, 75-7003 (2d Cir. Apr. 11, 1975) (awarding \$25.8 million damages for violations of Securities Exchange Act, § 14e). See also note 37 *infra*.

¹⁰ Suggestions for measurement of damages in open market fraud cases have been made by several commentators. See, e.g., Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STANFORD L. REV. 371, 385 (1974); Comment, *Liability Under Rule 10b-5 for Negligently Misleading Corporate Releases: A Proposal for the Apportionment of Losses*, 122 U. PA. L. REV. 162 (1973).

¹¹ *deHaas v. Empire Petroleum Co.*, 435 F.2d 1223, 1232 (10th Cir. 1970); *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969). Punitive damages arguably are disallowed by statute. See Securities Exchange Act § 28(a), 15

its,¹² and denied indemnity among securities fraud defendants.¹³ Each of these damage rules was amplified by courts during the past year,¹⁴ but two innovations were particularly significant. One such development involved the fashioning of an exception to the policy prohibiting indemnification. The other judicial innovation revived a previously dormant restitution-based theory which had suggested that consequential damages would be recoverable under Rule 10b-5.

The first of the two remedial developments, in the area of consequential damages, was based upon the 1965 decision of *Janigan v. Taylor*.¹⁵ In *Janigan*, the First Circuit stated that increases in the value of securities subsequent to a fraudulently induced sale would accrue to the plaintiff-seller.¹⁶ The First Circuit considered the differ-

U.S.C. § 78bb(a) (1970). The explicit recovery provisions of the Securities Act also limit recovery to the consideration paid by the claimant. Securities Act § 11(e), 15 U.S.C. § 77k(e) (1970) (registration statement liability); Securities Act § 12(2), 15 U.S.C. § 77l(2) (1970) (prospectus liability). Nor is there any evidence that Congress intended to impose punitive damages by the securities acts. *deHaas v. Empire Petroleum Co.*, *supra* at 1230; *Green v. Wolf Corp.*, *supra* at 303; *cf. Helvering v. Hallock*, 309 U.S. 106, 119-20 (1940).

While courts frequently deny punitive damages under federal laws, such damages are permissible under state laws. When state law will allow exemplary damages for fraud, such damages are recoverable in federal courts on state law claims present under the doctrine of pendent jurisdiction. *Flaks v. Koegel*, 504 F.2d 702 (2d Cir. 1974); *Coffee v. Permian Corp.*, 474 F.2d 1040, 1044 (5th Cir.), *cert. denied*, 412 U.S. 920 (1973); *Young v. Taylor*, 466 F.2d 1329, 1338 (10th Cir. 1972).

¹² *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1307 (2d Cir.), *cert. denied*, 404 U.S. 1004 (1971); *accord*, *SEC v. Golconda Mining Co.*, 327 F. Supp. 257 (S.D.N.Y. 1971). The measure of profit in such cases has been based on the difference between the purchase price and the price at the time when the defendant could legally purchase on the open market. This disgorgement theory was recently applied to an inside trader, yielding an unexpected result. In *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974), the defendant was required to disgorge paper profits in excess of actual profits made when the shares were finally sold. The defendant had illegally purchased shares of a corporation on undisclosed information concerning a merger possibility. The stock price rose when the plans were announced and subsequently declined when the merger was abandoned. The court required that paper profits as of the date of public disclosure be disgorged to insure the deterrent effect of the securities laws. The measure was not a penalty, the court reasoned, since the later losses merely resulted from the defendant's unwise decision to keep the stock after public disclosure. *Id.* at 1309. The court cited no authority for its disgorgement of paper profits theory, but the decision is supported by earlier case law. *See SEC v. Texas Gulf Sulphur Co.*, *supra*. The court stated that restitution of paper profits was necessary to avoid a "heads-I-win-tails-you-lose" opportunity for the violator who could otherwise keep subsequent profits but would not suffer losses. 494 F.2d at 1309.

¹³ See text accompanying notes 27-28 *infra*.

¹⁴ See notes 8, 11 and 12 *supra*.

¹⁵ 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

¹⁶ *Id.* at 786. The *Janigan* court noted that there were some limitations on this

ence between the value of the securities at the date of sale and the price paid, with interest from that date, and "such outlays as were legitimately attributable to the defendant's conduct" as the proper measure of damages.¹⁷ This measure was recently applied by two courts to permit an action for consequential damages under the securities laws.

The Second Circuit first suggested that a plaintiff-purchaser might recover consequential damages upon establishing a causal nexus with the underlying fraud.¹⁸ The Second Circuit's decision in *Zeller v. Bogue Electric Manufacturing Corp.*,¹⁹ subsequently was cited by the Seventh Circuit in *Madigan, Inc. v. Goodman*²⁰ as authority for the award of consequential damages. *Madigan* is the more enlightening of the two cases; the court explained in detail both the nature of allowable consequential damages and the requisite burden of proof necessary to recover the claimed damages.

The corporate plaintiff in *Madigan* sought consequential damages resulting from its purchase of an insolvent insurance company. The defendant had allegedly withheld information concerning the com-

principle, such as situations in which extraordinary increases in value were effected by subsequent special efforts of the defendant unrelated to the fraud. Increased value attributable to such efforts could not be recovered by the plaintiffs. *Id.*

The Third Circuit recently adopted this limiting rule, but failed to suggest what efforts would qualify. *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974). The circuit court overruled a district court finding that aggressive management of a corporate officer-defendant and control of the corporation were responsible for increases in value subsequent to the fraudulent conduct. Noting that aggressive management was within the corporate officer's duties and that control was obtained directly by fraud, the appellate court found that *Janigan* was inapplicable to insulate the defendant from liability for increased value. *Id.* at 412.

¹⁷ 344 F.2d at 786, quoting *Sigafus v. Porter*, 179 U.S. 116, 125 (1900). The statement constitutes dicta since *Janigan* involved a suit by a defrauded seller.

¹⁸ *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 803 (2d Cir.), cert. denied, 414 U.S. 908 (1973). The court further suggested that there would be nothing wrong with varying the degree of the certainty of proof necessary to show the causal nexus "somewhat inversely with the depth of the fraud." *Id.* at 803 n.11.

The *Zeller* court also indicated that it would apply the damages rule of *Affiliated Ute Citizens*, see text accompanying note 7 *supra*, to purchasers as well as sellers. The *Affiliated Ute Citizens* case involved only sellers of securities, but the *Zeller* decision would apply the same rule to purchasers, granting them profits from their purchase proceeds if such proceeds could be traced with any certainty. *Id.* at 802 n.10. The difficulty in applying an increased-value recovery to purchasers is that money used to purchase the security may be commingled with other funds or reinvested, making calculation of the increased value complex, if not impossible. In the case of defrauded sellers, however, the measure is based on the subsequent value of the shares sold.

¹⁹ 476 F.2d 795 (2d Cir.), cert. denied, 414 U.S. 908 (1973).

²⁰ 498 F.2d 233, 238 (7th Cir. 1974).

pany's insolvency in violation of Rule 10b-5. Although the plaintiff later sold its stock at the original acquisition price, it claimed that losses had been incurred in maintaining the insurance company's solvency, paying for litigation expenses arising from the transaction, and paying policy claims. The district court ruled that the corporate plaintiff had suffered no damages because it had sold the shares at the same price it had paid.²¹ On appeal, the circuit court ruled that recovery of consequential damages should be allowed for expenses reasonably incurred to minimize losses, to fulfill fiduciary obligations to insurance policy holders, and to comply with state regulations. Thus, upon proper proof, the plaintiff could recover capital contributions to maintain the solvency of the insurance company, brokerage commissions paid to acquire the company, and damages for lost alternative investments.²²

The results in both *Madigan* and *Zeller* have expanded the measure of recovery beyond the mere fraud and non-fraud value differential present at the time of the purchase or sale.²³ Such recovery will probably be limited to those instances which involve corporate acquisitions, as in *Madigan*, or corporate derivative suits, as in *Zeller*. The effect on ordinary investors will thus be minimal, as they will rarely incur any expenditures beyond the purchase price of the securities.²⁴

The second recently modified damage principle, the no-indemnity rule, while even less significant to the interests of ordinary investors,

²¹ 357 F. Supp. 1331 (N.D. Ill. 1973).

²² The court required the plaintiff to show that the danger of insolvency, which the expenditures were made to avoid, existed prior to the sale and was fraudulently concealed by the defendant. 498 F.2d at 239. Not all alleged damages were recoverable, however. Losses on the purchase price, expense of other related litigation, lost profits, and other expected benefits from the purchase were not allowed.

In *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), cert. denied, 414 U.S. 908 (1973), the plaintiff claimed consequential damages in the form of the difference in interest rates between what the parent corporation would have normally paid and the lower rate it fraudulently obtained from the subsidiary. The court did not view the plaintiff's prospects for recovery as bright, but concluded that he should have been allowed to present his claim. *Id.* at 803.

²³ The *Madigan* court stated that there was "no reason in the policy of the securities laws why [the] right to recovery should depend on exactly when the loss was realized or on whether the loss was fully reflected in a change in the securities' price." 498 F.2d at 238-39.

²⁴ Courts might possibly apply the lost alternative investment theory of *Madigan* to ordinary investors. The *Madigan* court noted that should the plaintiff seek to recover more than the market rate of interest, he must prove with a "good deal of certainty" that he would have made a particular alternative investment at a higher rate of return. 498 F.2d at 240.

may become an important deterrent of fraudulent conduct by corporate officers. Generally, indemnity between joint wrongdoers has been denied in securities fraud cases.²⁵ The rationale for this denial has been that indemnity would shift the burden of damages from one wrongdoer to another, allowing a guilty party to escape liability, and thus would discourage compliance with the requirements of the securities laws.²⁶ In *Thomas v. Duralite Co.*²⁷ the court allowed a corporation indemnification against its officers whose self-serving fraudulent acts saddled the corporation with vicarious liability.²⁸ On first impression the *Thomas* court's allowance of indemnity under these limited conditions appears reasonable. Since the burden of damages was shifted to the corporate officers who were primary wrongdoers, the threat of massive damages paid to injured investors by the corporation based on the fraudulent misdeeds of its officers was seemingly obviated.²⁹ Such a rule may have limited application, however. In open-market transactions which may culminate in extensive liability,³⁰ the damages may exceed the defendant-officers' ability to pay, thereby imposing practical limits on the corporation's right to indemnity. Further, the shifting of liability to such defendants may result in a financial burden far in excess of actual culpability, wrong-

²⁵ See, e.g., *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1287-88 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970); *Alexander & Baldwin, Inc. v. Peat, Marwick, Mitchell & Co.*, CCH FED. SEC. L. REP. ¶ 94,773 (S.D.N.Y. 1974).

²⁶ On the other hand, the same policy reasons also support enforcing contribution among joint defendants, so that no one is free from liability. *Globus v. Law Research Serv., Inc.*, 318 F. Supp. 955 (S.D.N.Y. 1970); *aff'd per curiam*, 442 F.2d 1346 (2d Cir.), cert. denied, 404 U.S. 941 (1971). The no-indemnity rule has, however, been criticized for failing to allow indemnity of less culpable defendants by more culpable ones. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 658 (1972).

²⁷ 386 F. Supp. 698 (D.N.J. 1974).

²⁸ 386 F. Supp. at 728, *citing deHaas v. Empire Petroleum Co.*, 286 F. Supp. 809, 816 (D. Colo. 1968), *rev'd on other grounds*, 435 F.2d 1223 (10th Cir. 1970). The limited provision for indemnity suggested by the district court in *deHaas* was not appealed to the circuit court and had been ignored by subsequent courts. See also *Gould v. American Hawaiian S.S. Co.*, CCH FED. SEC. L. REP. ¶ 94,919 (D. Del. Dec. 19, 1974). The *Gould* court relied upon *Thomas*, among other cases, to reach the same conclusion concerning indemnity under Rule 10b-5. However, the *Gould* court concluded that such indemnity would not be allowed in an action under § 14(a) of the Securities Exchange Act, 15 U.S.C. § 78n(a) (1970), which was the issue before the court.

²⁹ See text accompanying note 9 *supra*. Obviously indemnity would not be available to the corporation when fraud could be imputed to the corporate entity.

³⁰ E.g., *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971).

ful conduct, or ill-gotten gain. Such grossly disproportionate recovery has been rejected as punitive in nature and not allowable under the federal securities laws.³¹

The limited allowance of indemnity illustrated by the *Thomas* decision will serve to deter fraudulent conduct, since officers will be unable to limit their damages to the extent of their wrongful profits. But the indemnity principle should not be extended to allow indemnification of less culpable defendants by others more seriously implicated in the fraudulent scheme. The policy of the securities laws imposes high standards upon officers who are associated with the preparation of registration statements³² and stock prospectuses.³³ Allowance of indemnity between these parties would only permit some to escape liability for their failure to comply with statutory or publicly imposed duties. Disallowance of indemnity serves to insure that all parties will adequately perform their own duties to avoid possible liability and will work to keep other participants equally as diligent.³⁴

The results of these recent decisions disclose neither a willingness nor a reluctance to impose sweeping liability upon defendants in securities fraud cases. Courts are closely examining the factual situations presented to them and are then amplifying earlier precedents. In the context of consequential damages and indemnity, the courts are relying upon prior decisions heretofore overlooked or ignored by other courts in assessing damages.³⁵ Consequently, a gradual broadening of potential liability without immediate or dramatic impact upon the professional securities or financial communities is taking place.³⁶ Rule 10b-5 damage theories do not point decisively toward

³¹ See *Green v. Wolf Corp.*, 406 F.2d 291, 303 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969). See also note 11 *supra*.

³² See Securities Act § 11, 15 U.S.C. § 77k (1970).

³³ See Securities Act § 12(2), 15 U.S.C. § 77l(2) (1970).

³⁴ See note 26 *supra*. While this development may have beneficial effects in discouraging wrongdoing, there are also some disturbing implications for non-direct participants in the fraud, or aider-abettors, and in particular, accountants, attorneys and directors. Recent developments in private actions against aider-abettors have indicated that liability will result from negligent violations of Rule 10b-5. See text accompanying notes 22-63 at 757-63. The net result of such liability, coupled with an indemnity right against peripheral or secondary wrongdoers, will be to discourage membership on corporate boards of directors, as well as to significantly reshape the roles of attorneys and accountants who advise or audit corporate clients.

³⁵ See text accompanying notes 15-20, 27-28 *supra*.

³⁶ Compare *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (liability of corporate director); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (liability of corporate officers and employees for inside trading). Broader damage recovery may, however, be offset by stricter standards of