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Securities - 10b-5 - Scienter is Required in a Private Action Under Rule 10b-5 - Ernst & Ernst v. Hochfelder, 96 S.Ct. 1375 (1976)

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RECENT CASE

Securities—10b-5—SCIENTER IS REQUIRED IN A PRIVATE ACTION UNDER RULE 10b-5—*Ernst & Ernst v. Hochfelder*, 96 S.Ct. 1375 (1976)

In the last few years professionals have been the target of numerous suits brought by the public. Courts have shown a willingness to hold doctors, lawyers, accountants, and other professionals liable for their torts, including negligence. However, the Supreme Court has chosen to throw a protective cloak over professionals involved with the securities industry in their recent decision in *Ernst & Ernst v. Hochfelder*.[1] The suit was based on a negligence theory of liability brought under Section 10(b)[2] and Rule 10b-5[3] of the Securities Exchange Act of 1934. The Supreme Court held that the basis of liability in a private action for damages under Section 10(b) and Rule 10b-5 is limited to intentional wrongdoing.[4] This Note will discuss the development of the liability

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1. 96 S.Ct. 1375 (1976).
2. 15 U.S.C. §78j (1970), which provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
3. 17 C.F.R. §240.10b-5 (1975) provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
4. 96 S.Ct. 1375, 1391 (1976). The Supreme Court did not discuss whether there should be a varying standard of liability depending upon whether the defendant was a participant, conspirator, or aider-abettor. The issue was resolved without discussion, however, since the Court made it clear that a single standard of liability, intentional conduct, would be applied in all cases.

   Previously, there were few cases on the liability of aiders-abettors, but courts and commentators seemed to agree that aiding and abetting in civil suits should require an

controversy, the *Hochfelder* case, and the ramifications of that decision.

The right of private action under Rule 10b-5 was recognized early by the courts and the SEC.[5] However, neither Congress nor the SEC[6] provided guidelines to determine the limits of liability. Consequently, a much debated issue has been the role of scienter in determining liability and whether the element required "intent" or merely "knowledge."[7]

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affirmative act of assistance or concealment, while mere failure to report or disclose should not give rise to liability. *See* Isbell, *An Overview of Accountants' Duties and Liabilities under Federal Securities Laws and a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261 (1974); Ruder, *Multiple Defendants In Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 638 (1972).

5. 2 A. BROMBERG, SECURITIES LAWS FRAUD, SEC RULE 10b-5, §2.2 (420) at 22.7 [hereinafter cited as BROMBERG].

6. A SEC commissioner recently rejected the idea that the SEC should set up guidelines or standards of liability:

> The genius and strength of Rule 10b-5 has been its hospitality to new concepts, new thinking, and new development, and its ability to be, in effect, a spokesman for the developing standards in society. Rules limiting the broad standards contained in Rule 10b-5 could have a stunting effect upon the development of the law and remove the most formidable means that society now has to assure that corporate law meets its expectations . . . .
>
> The diversity of our society and its business relationship is too rich, too varied, too complex to submit wholly to specifics.

Sommer, *Professional Responsibility: How Did We Get Here?* 30 BUS. LAW. 95, 101-02 (1975).

7. According to Professor Bromberg, a definition of scienter which would be acceptable to all circuits has not yet been found, although a consensus has been reached on most of the other elements, such as standing, reliance, privity, and materiality. Bromberg, *Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 167 (1974). The common law definition of scienter, "intent to deceive, to mislead, to convey a false impression," set forth in W. PROSSER, HANDBOOK OF THE LAW OF TORTS 715 (4th ed. 1971), was rejected by all the courts until the Supreme Court's recent holding. *See* notes 30-34 and accompanying text *infra*. One commentator stated:

> While all courts have rejected the strict common law definition of scienter, they have differed in their interpretation of the precise state of mind requirement for liability. Some courts have held negligence sufficient, while others have required more than negligent conduct.

Comment, *Development of a Flexible Duty Standard of Liability Under SEC Rule 10b-5*, 32 WASH. & LEE L. REV. 99, 101 (1975). In another analysis of the subject the author took a firmer stance:

> /S/cienter should be interpreted to mean knowledge of the facts, either actual or constructive. The latter is found when a defendant's lack of knowledge is the result of conduct sufficiently careless that knowledge will be attributed. Although a court in such a case may not be convinced that the defendant did actually know the facts, his lack of knowledge is inexcusable. Negligence, in contrast, refers to conduct not wholly innocent but not so careless as to be inexcusable.

Comment, *Scienter and Rule 10b-5*, 67 Nw. U.L. REV. 562, 570 (1972).

Courts first employed various common law principles of misrepresentation to assist them.[8] In the 1960's several circuits began to reexamine their approach to Section 10(b), turning to a duty analysis which enabled courts to avoid the common law requirement of reliance.[9] The duty analysis was better adapted to the spectrum of fraudulent activities alleged under Rule 10b-5 because it allowed the court to determine on a case-by-case basis whether the defendant had a duty to the plaintiff and whether that duty was breached.[10]

The Seventh Circuit, in the early 1960's, adopted a theory that negli-

8. Three general requirements of liability have been defined by the courts: (1) misrepresentation or nondisclosure of a material fact; (2) damage to the plaintiff as a result of reliance, causation or privity; and (3) a closed transaction in which the plaintiff was either a buyer or seller of securities. BROMBERG, *supra* note 5, at 194.9.

9. Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931); Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922).

10. *See* text accompanying note 16 *infra*. Since only some circuits reexamined their approach, the result was substantial conflict in the imposition of liability under 10b-5.

The Seventh, Eighth and Ninth Circuits adopted a form of duty analysis and liberalized the requirements of liability to include negligence. The Eighth Circuit in Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968), held that negligence alone is sufficient on the basis that the common law concept of fraud was enlarged under 10b-5 to include innocent disclosures. *See also* Vanderboom v. Sexton, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970). For Ninth Circuit cases holding that common law fraud need not be proved in a 10b-5 action, *see* Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1961). For a Seventh Circuit decision holding that negligence will suffice, *see* Kohler v. Kohler, Inc., 319 F.2d 634 (7th Cir. 1963). *See also* Comment, *Development of a Flexible Duty Standard of Liability under SEC Rule 10b-5*, 32 WASH. & LEE L. REV. 99 (1975).

The Second, Sixth and Tenth Circuits showed little change in their approach to 10b-5 and refused to extend liability to negligent conduct.

In Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951), the court held that stockholders must show proof of fraud, or intentional conduct, to recover. This decision has been called the "outer limit" in stringency of the scienter requirement. *See* Comment, *Scienter and Rule 10b-5: Development of a New Standard*, 23 CLEV. ST. L. REV. 493, 501 (1974); Isbell, *Overview of Accountants' Duties and Liabilities under Federal Securities Laws and a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261 (1974). The Second Circuit has slowly modified its position since *Fischman*. In Securities Exch. Comm'n v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), the court reduced its requirement from strict intent to defraud to a minimum of "lack of diligence, constructive fraud, or unreasonable or negligent conduct." In Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971), the court concluded that an allegation of scienter is required or, in effect, that the allegation must involve more than ordinary negligence. In Leasco Corp. v. Taussig, 473 F.2d 777 (2d Cir. 1972), the court held that mere negligence is insufficient and that there must be a showing of falsity or reckless disregard for truth in making misstatements to support a private right of action. This position was reaffirmed the following year in Lanza v. Drexel, 479 F.2d 1277 (2d Cir. 1973). For the court's most recent decisions, *see* notes 21-25 *infra*.

gence alone could establish liability under Rule 10b-5.[11] In several later decisions the court broadened the scope of liability. It held that fraud could be proved by silence and inaction,[12] or constructive fraud,[13] and that scienter was not a required element of fraud.[14] Finally, the Seventh Circuit, in *Hochfelder v. Ernst & Ernst*,[15] set forth what it termed a "flexible standard" of liability. The court defined the elements necessary for making a prima facie case of aiding and abetting under Rule 10b-5:

> (1) the defendant had a duty of inquiry
> (2) the plaintiff was a beneficiary of that duty of inquiry
> (3) the defendant breached the duty of inquiry
> (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure
> (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention.[16]

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11. Kohler v. Kohler, Inc., 319 F.2d 634 (7th Cir. 1963) (court found no breach of duty on the part of the accountant retained to negotiate sale of stock between the plaintiff and corporation).

12. Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d. 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (corporation found to be aider-abettor in fraud by consistently referring customers to a broker before referring them to the State Securities Commission while the corporation was engaged in a proxy fight).

13. Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969). *Buttrey* was followed in Hochfelder v. Midwest Stock Exch., 503 F.2d 364 (7th Cir. 1974), in which the court said, in dictum, that a claim for aiding and abetting solely by inaction can be maintained by a showing:

> [that] the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of duty of disclosure.

Id. at 374.

14. Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123 (7th Cir. 1972) (court based its holding on Vanderboom v. Sexton, 422 F.2d 1233 (8th Cir. 1970) in which the court held that the plaintiff could recover for negligent misrepresentation).

15. 503 F.2d 1100, 1104 (7th Cir. 1974).

16. *Id.* at 1104. *See also* Note, *Securities Law-Fraud—Rule 10b-5 Private Actions—Adoption of a Flexible Duty Standard—White v. Abrams*, 16 B.C. IND. & COM. L. REV. 515 (1975).

Applying this analysis to the facts of *Hochfelder*, the court found that plaintiffs had stated a claim of aiding and abetting. 503 F.2d at 1111. The court said the issues to be decided at trial were:

> (1) whether Nay's "mail rule" constituted a material inadequacy in First Securities' system of internal accounting control; and (2) whether Ernst & Ernst failed

There was no element of scienter in the Seventh Circuit's new standard of liability.[17]

The Seventh Circuit was not the first to use the "flexible standard" approach. Earlier in 1974, the Ninth Circuit enunciated its own "flexible standard" of liability in *White v. Abrams*.[18] However, its duty analysis

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to exercise the due care required of a professional auditor in that it did not discover a material inadequacy in internal accounting control. An affirmative finding on both issues will therefore satisfy the third element of plaintiffs' claim of aiding and abetting, namely a showing of a breach of duty of inquiry.

Id. The court said the professional standards of the accounting industry, the generally accepted accounting standards of the American Institute of Certified Public Accountants, should be the measure of that duty. Given the liberal holding of the case, this is surprising since many other courts prior to *Hochfelder* have not felt compelled to accept the standards of care established by a professional group. *See, e.g.*, Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847 (4th Cir. 1972) (Generally Accepted Accounting Principles held to be minimum standards); United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970) (fulfillment of professional standards may not be sufficient); Herzfeld v. Laventhol, Kreckstein, Horwath & Horwath, 378 F. Supp. 1127 (S.D.N.Y. 1974) (adherence to Generally Accepted Accounting Principles will not insulate accountants); Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967) (higher standard of responsibility attributable to an accountant with special expertise). *See also* Comment, *Securities Law Rule 10b-5—Compliance with Generally Accepted Accounting Principles Will Not Insulate Accountants From Civil Liability for Fraud*, 24 CATH. U. L. REV. 343 (1975).

17. 503 F.2d 1100 (1974).

18. 495 F.2d 724 (9th Cir. 1974). The court explained its "flexible standard:"

> Without limiting the trial court from making additions or adaptations in a particular case, we feel the court should, in instructing on a defendant's duty under rule 10b-5, require the jury to consider the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question. . . . The standard we have set forth here does not impose absolute liability for misrepresentations regardless of the person's knowledge of falsity. . . . While rejecting scienter and state of mind . . . itself, it requires the court to consider state of mind as an important factor in determining the scope of duty that rule 10b-5 imposes.

Id. at 735-36.

Two important Ninth Circuit cases that preceded *White* are Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962) and Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). In both cases the court held that common law fraud need not be proved.

See Miller & Subak, *Impact of Federal Securities Laws: Liabilities of Officers, Directors and Accountants*, 30 BUS. LAW. 387, 394 (1975) in which the authors discuss the impact of the *White* holding. They conclude that the Ninth Circuit "transforms that portion of the rule into an equitable remedy that permits the trier of fact to remedy wrongs in accordance with the trier's notion of fairness." *See also* Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. REV. 1206 (1970).

still required the court to consider scienter, or state of mind, as an important factor in that analysis.

The Second Circuit developed a more conservative form of duty analysis.[19] In *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*,[20] the court held that some sort of knowledge or culpability must be alleged for a private action under Rule 10b-5.[21] In *Cohen v. Franchard*,[22] the court stated:

> Although it is unnecessary to prove the specific fraudulent intent essential to state a claim of common law fraud, it must be established that the defendant was to some extent cognizant of the misstatement or omission . . . . It is not enough for plaintiff to show that defendant failed to detect certain material facts when he had no reason to suspect their existence.[23]

In *SEC v. Spectrum*,[24] the Second Circuit made a distinction between private actions and SEC enforcement actions, holding that negligence is sufficient in an SEC action but not in a private action for damages.

When the *Hochfelder* case came before the Supreme Court, these divergent circuit court views were proposed as precedent. The factual pattern in *Hochfelder* presented a perfect opportunity to determine the issue of scienter. A Chicago securities broker had collected money from investors and had told the investors that the money was in a special

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The Missouri Court of Appeals set forth a four-part test in Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. Ct. App. 1973):

> (1) the extent to which the transaction was intended to affect the plaintiff; (2) the foreseeability of harm to him; (3) the degree of certainty that the plaintiff suffered injury; and (4) the closeness of the connection between defendant's conduct and the injury suffered.

Id. at 383. *See also* Note, *Torts—Negligence—Accountants Held Liable to a Third Party Not in Privity*, 22 KANSAS L. REV. 289 (1974); Comment, *Development of a Flexible Duty Standard of Liability Under SEC Rule 10b-5*, 32 WASH. & LEE L. REV. 99 (1975).

19. The Second Circuit's standard for liability fell "between an actual showing of an intent to defraud and a showing of mere negligence." For a comparison of the Ninth and Second Circuits' positions, see Comment, *Scienter and Rule 10b-5: Development of a New Standard*, 23 CLEV. ST. L. REV. 493, 510 (1974).

20. 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). *Chris-Craft* involved a contest between two corporations for the control of a third, Piper Aircraft Corp. The Second Circuit examined congressional policy behind the securities laws and said the laws were intended to protect the investors who rely on the completeness and accuracy of information made available to them. *Id.* at 363.

21. The court stated that "A knowing or reckless failure to discharge . . . obligations constitutes sufficiently culpable conduct to justify a judgment under Rule 10b-5 . . . for damages . . . ." *Id.*

22. 478 F.2d 115 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973).

23. *Id.* at 123.

24. 489 F.2d 535 (2d Cir. 1973).

escrow fund. There was, in fact, no escrow fund, and all of the money had been spent by the broker. This fraud had been concealed for over twenty years by use of a special mail rule—mail was opened only by the broker and no one else. Ernst & Ernst, the broker's accountant, was aware of the mail rule but never questioned its purpose. The issue presented to the appellate court was whether Ernst & Ernst was liable for negligent failure to inquire as to the reason for the "mail rule" as part of its review of internal accounting procedures and controls.[25] The appellate court found that negligence in failing to inquire was sufficient,[26] and Ernst & Ernst sought review.[27] Since the element of intent or scienter[28] was not present, the Supreme Court had the opportunity to resolve the conflict in the circuit courts as to whether scienter is necessary to a finding of liability or whether negligence alone is sufficient.

The Supreme Court rejected a negligence standard and held that scienter was required in a private action for damages under Rule 10b-5.[29] The Court defined "scienter" as a mental state embracing intent to deceive, manipulate or defraud.[30] This definition is reminiscent of the common law definition of scienter, which was "intent to deceive, to mislead, to convey a false impression,"[31] and is in contrast to most appellate court decisions which had broadened scienter to include actual knowledge,[32] and in some cases, constructive knowledge.[33]

The Court reached its conclusion by analyzing the language of Section 10(b), relating the language of that section to other sections of the Securities Exchange Act of 1934, and discussing the relationship of SEC Rule 10b-5 to Section 10(b) itself. The Court found that the language of the statute clearly indicated congressional intent, stating:

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25. 503 F.2d 1100, 1109 (7th Cir. 1974).

26. *Id.* at 1111.

27. 421 U.S. 909 (1975).

28. BLACK'S LAW DICTIONARY 1512 (4th ed. 1968) defines *scienter*:

> Knowingly. . . . to signify an allegation . . . setting out the defendant's previous knowledge of the cause which led to the injury complained of, or rather his previous knowledge of a state of facts which it was his duty to guard against, and his omission to do which has led to the injury complained of. . . . And the term is frequently used to signify the defendant's guilty knowledge.

By 1975 most courts and commentators had accepted scienter to mean "knowledge," either actual or constructive. *See* note 8 *supra*.

29. 96 S.Ct. 1375, 1381 (1976).

30. *Id.* at 1381 n.12.

31. W. PROSSER, HANDBOOK OF THE LAW OF TORTS 715 (4th ed. 1971). *See* note 8 *supra*.

32. *See* notes 8 & 29 *supra*; note 41 *infra*.

33. Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

> In each instance that Congress created express civil liability in favor of purchasers or sellers of securities it clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake. . . . The express recognition of a cause of action premised on negligent behavior in §11 stands in sharp contrast to the language of §10(b). . . .[34]

The procedural limitations set forth in Sections 11, 12(2), and 15, which expressly allow negligence as a cause of action, were compared to the lack of such limitations in Section 10(b). Thus, the Court inferred that Congress did not intend 10(b) to establish a cause of action based on negligence.[35] The SEC, therefore, could not implement a rule based on 10(b) which would change the meaning of the section.[36] To allow the Commission to alter the congressional intent would be to allow it to overstep its congressionally-granted authority.[37]

The Court in *Hochfelder* made clear, for the second time in less than a year,[38] that it favors a conservative interpretation of the language and intent of Section 10(b) and Rule 10b-5. The decision represents a significant change from the prior trend of litigation under 10b-5.

In the first decisions concerning 10b-5, the Supreme Court interpreted the language of the rule liberally. The Court felt that securities legislation should be construed flexibly rather than technically in order to effectuate its remedial purpose of avoiding fraud.[39] The *Hochfelder* decision is in sharp contrast to this prior policy of liberal interpretation.[40]

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34. 96 S.Ct. 1375, 1388 (1976).

35. *Id.*

36. *Id.* at 1390. The SEC had argued that subsections (b) and (c) of Rule 10b-5, if read separately, would seem to imply a negligence standard. Brief for Securities and Exch. Comm'n at 15, Ernst & Ernst v. Hochfelder, 96 S.Ct. 1375 (1976).

37. The Court stated "The rule making power granted to an administrative agency charged with the administration of a federal statute is not the power to make law." 96 S.Ct. at 1391.

38. Blue Chip Stamps Co. v. Manor Drug Stores, 421 U.S. 723 (1975), limited the plaintiff in a 10b-5 action to one who was a buyer or seller of securities. *See* Note, *Birnbaum: Revisited and Triumphant—Blue Chip Stamps v. Manor Drug Stores*, 25 DE PAUL L. REV. 132 (1976).

39. *See* Securities and Exch. Comm'n v. Nat'l Securities, Inc., 393 U.S. 453 (1969) (Court refused to apply a narrow construction to the words "in connection with" and held that they encompassed an exchange of shares as the result of a proxy solicitation); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971) (Court interpreted liberally the "in connection with" phrase to extend 10b-5 protection to corporate as well as individual sellers); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (Court held that proof of reliance is not a prerequisite to recovery where there is a failure to disclose facts that a reasonable investor might have considered important).

40. The Court in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), also

Certainly the *Hochfelder* decision, by requiring a more difficult and absolute standard of proof regardless of the situation, will serve to discourage suits under 10b-5. While unstated, this turnabout reflects a policy to limit the number of suits brought in the future[41] and to alleviate somewhat the backlogging on court dockets, which is caused, in part, by the multitude of cases brought each year under 10b-5.[42]

The *Hochfelder* decision effectively dispenses with the entire "flexible standard" analysis approach. The Supreme Court, in adopting a rigid standard, has hindered the courts' ability to deal with widely-varying fact situations on an equitable basis.[43] Whether recklessness or gross negligence would satisfy the Court's scienter requirement was not determined.[44] The Court did note, however, that in some areas of the law recklessness is considered to be a form of intentional conduct.[45]

Also left unanswered was the question whether the SEC may continue

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gave a narrow construction to the language of Rule 10b-5, and held that only a buyer or seller of securities has standing under the rule.

41. Telephone interview with Willard L. King, attorney for respondents, Chicago, Ill., June 9, 1976. *See* BNA (1976) TAXATION AND FINANCE (Daily Reporter June 6, 1976).

Justice Stevens, who took no part in the decision, was appointed to the Court after oral argument. If he had been able to participate, it is likely he would have sided with the minority. That would not have been enough to change the vote, however. Just prior to his appointment, Justice Stevens wrote the decision in Sanders v. John Nuveen, 524 F.2d 1064 (7th Cir. 1975), which involved an underwriter who was charged with aiding and abetting the fraud of a securities issuer. In this parallel case to *Hochfelder*, Judge Stevens wrote: the issuer "is under a duty to make at least some investigation directed at the question whether the ever present possibility of fraud is in fact a reality." *Id.* at 1071.

Shortly after *Hochfelder* was decided the Supreme Court vacated *Nuveen* and remanded the case to the appellate court for further consideration in light of *Hochfelder*. 96 S.Ct. 1375 (1976).

42. Another policy reason for the holding is suggested in a footnote to the decision. 96 S.Ct. 1375, 1391 n.33 (1976). After stating that the negligence standard urged by respondents would have had an "extreme reach," the Court concluded:

> The class of persons eligible to benefit from such a standard, though small in this case, could be numbered in the thousands in other cases. Acceptance of respondents' view would extend to new frontiers the "hazards" of rendering expert advice under the Acts . . . .

43. Justice Blackmun's dissent in *Hochfelder* notes that the shareholder who is the victim of a fraud

> . . . can be victimized just as much by negligent conduct as by positive deception, and . . . it is not logical to drive a wedge between the two, saying Congress clearly intended the one but certainly not the other.

96 S.Ct. 1375, 1392 (1976) (Blackmun, J., dissenting).

44. *Id.* at 1381 n.12. Furthermore, the Court denied respondents' request to amend their complaint to allege gross negligence and thus provide the Court with an opportunity to settle that question. *Id.* at 1391.

45. 96 S.Ct. 1375, 1381 n.12 (1976).

to apply a negligence standard in its own enforcement proceedings.[46] The SEC argued in its brief that different standards should not be used in private and public actions.[47] Justice Blackmun, in his dissent, agreed with the SEC, stating:

> [S]urely the question whether negligent conduct violates the rule should not depend upon the plaintiff's identity. If negligence is a violation factor when the SEC sues, it must be a violation factor when a private party sues.[48]

Ironically, as a result of the *Hochfelder* decision, it is likely that the SEC's use of the negligence standard in its enforcement proceedings may soon be challenged. The differing standards may be upheld, however, on the basis of the differing purposes for private and public actions. The purpose of a private action is to seek money damages for an alleged wrong, while that of an SEC action is to protect the public by enjoining violations of the federal securities laws.[49] Consequently, it is arguable that a lesser standard of liability is required in SEC actions than in private actions.[50]

Hochfelder's holding, of course, is limited to Rule 10b-5 actions. Thus, shareholders who feel they have been victimized, but cannot meet the difficult standard of proof set forth in *Hochfelder*, may turn to the various states' "blue sky" laws for protection.[51] Many of those laws accept negligence as a test of legal misconduct.[52]

There are salutory effects in the *Hochfelder* decision for both professionals who serve the securities industry and the stockholding public. First, the reversal relieves professionals from the fear of liability for negligence under Rule 10b-5. Therefore, they should be more willing to provide their clients with services requiring a greater amount of subjective judgment.[53] Second, professionals also may be more willing to accept the obligation to uncover management fraud.[54]

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46. *Id.*

47. Brief for Securities and Exch. Comm'n at 16-17, Ernst & Ernst v. Hochfelder, 96 S.Ct. 1375 (1976).

48. 96 S.Ct. 1375, 1392 (1976) (Blackmun, J., dissenting).

49. BNA (1976) TAXATION AND FINANCE (Daily Reporter June 6, 1976).

50. *Id.*

51. Griffin, *The Beleaguered Accountants: A Defendant's Viewpoint*, 62 A.B.A.J. 759, 763 (1976). Mr. Griffin is chairman of the board of Touche Ross and Company, one of the Big Eight public accounting firms.

52. *Id.*

53. Opinion of James Strother, general counsel to Alexander Grant & Co., a public accounting firm, and former counsel to the AICPA.

54. *See* Griffin, *supra* note 51, at 762.

The Supreme Court reached its decision in *Hochfelder* by scrutinizing the language of Section 10(b) to determine congressional intent. In construing the section's words narrowly to limit liability to intentional conduct, the Court ignored the basic purpose for the section's existence—the protection of the public. It also ignored its own admonition that securities legislation aimed at avoiding fraud should be construed "not technically and restrictively, but flexibly to effectuate its remedial purpose."[55]

Lynn Taylor

55. Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971); Securities and Exch. Comm'n v. Capital Gains Research Bureau, 376 U.S. 180, 195 (1963).