

Spring 1977

## Securities Regulation-Rule 10b-5-Scienter Required for Private Action

Timothy W. Triplett

Follow this and additional works at: <https://scholarship.law.missouri.edu/mlr>



Part of the [Law Commons](#)

---

### Recommended Citation

Timothy W. Triplett, *Securities Regulation-Rule 10b-5-Scienter Required for Private Action*, 42 Mo. L. REV. (1977)

Available at: <https://scholarship.law.missouri.edu/mlr/vol42/iss2/11>

This Note is brought to you for free and open access by the Law Journals at University of Missouri School of Law Scholarship Repository. It has been accepted for inclusion in Missouri Law Review by an authorized editor of University of Missouri School of Law Scholarship Repository. For more information, please contact [bassettcw@missouri.edu](mailto:bassettcw@missouri.edu).

One can argue with Manfield's evaluation of the balance.<sup>39</sup> The most serious criticism of his approach is that it brings little in the way of analytic guidelines to the trial court level. Ultimately each case presents a new balancing process with prior case law only providing an analogy.

One can sympathize with the *Bronstein* court's refusal to characterize the use of the marijuana sniffing dogs as a search. Such an approach preempts many difficult and ambiguous problems concerning the balancing of society's interests against an individual's interest. Analytically, the use of the dogs is a search within the meaning of the fourth amendment. In evaluating the legality of that search, a *Terry* type sliding scale approach would produce a result more consistent with society's reasonable needs of crime detection and the individual's fourth amendment rights.

Should *Bronstein* find acceptance with other courts, it will inevitably lead to increased police use of marijuana sniffing dogs and other techniques not yet developed. *Bronstein* represents a substantial departure from the line of Supreme Court cases from *Katz* through *Terry* and its acceptance would constitute an entirely new approach to the fourth amendment.

ROBERT S. BOGARD

## SECURITIES REGULATION—RULE 10b-5— SCIENTER REQUIRED FOR PRIVATE ACTION

### *Ernst & Ernst v. Hochfelder*<sup>1</sup>

The customers of First Securities Company of Chicago, a small brokerage firm, invested in a fraudulent securities scheme perpetrated by Leston B. Nay, the president and owner of 92% of the firm's stock. Nay induced the customers to invest their funds in "escrow" accounts that he represented would yield a high rate of return. In fact, there were no escrow accounts, nor were any such escrow accounts reflected on the books of First Securities.<sup>2</sup> Nay had converted the customer's money to his own use immediately upon receipt. Ernst & Ernst, an accounting firm, had been retained by First Securities for the purpose of performing periodic audits of their books and records, and filing with the Securities and Exchange Commission the annual reports required of First Securities under section

---

39. Still troublesome is the fact that the agent had no knowledge of a specific crime. See note 33 *supra*.

1. 425 U.S. 185 (1976).

2. The transactions between Nay and the defrauded customers were not in the customary form of dealings; checks were made payable to Nay or a designated bank for his account. The escrow accounts were not shown on First Securities' periodic accounting to these customers, nor were they included in reports to the Securities and Exchange Commission. *Id.* at 189.

17(a) of the Securities and Exchange Act of 1934.<sup>3</sup> After the fraud came to light in 1968, the customers filed suit against Ernst & Ernst<sup>4</sup> for damages, claiming a violation of Securities and Exchange Commission rule 10b-5.<sup>5</sup> They charged that Ernst & Ernst had "aided and abetted" Nay in his violation of rule 10b-5 by failing to utilize appropriate auditing procedures in their audit of First Securities, thereby negligently failing to discover certain questionable internal practices of the firm.<sup>6</sup> The customers specifi-

---

3. 15 U.S.C. § 78q(a) (1934). Section 17(a) "requires that securities brokers or dealers 'make . . . and preserve . . . such accounts . . . books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate . . .'" 425 U.S. at 188 n.1. In force at the time of the alleged violation was Commission Rule 17a-5, 17 C.F.R. § 240.17a-5 (1975), requiring that "First Securities file an annual report of its financial condition that included a certificate stating 'clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein.'" 425 U.S. at 188 n.1.

4. The first count of the customer's complaint was actually directed toward the Midwest Stock Exchange, charging that through its acts and omissions it has also aided and abetted Nay's fraud. Summary judgment in favor of the Exchange was affirmed on appeal. *Hochfelder v. Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974). Two separate but substantially identical complaints were originally filed by different customers. The district court had treated the complaints as if consolidated, and they were formally consolidated on appeal. 425 U.S. at 189 n.2. Nay committed suicide in 1968 leaving a note describing First Securities as bankrupt and the escrow accounts as "spurious." *Id.* at 189. Although the customers did file suit against First Securities, *SEC v. First Securities Co.*, 463 F.2d 981 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1973), we are left with the impression that Nay's estate was insolvent. This explains why the estate was neither sued separately nor made a party to this action.

5. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1969), 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 statement made, in 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.

Rule 10b-5 was promulgated under § 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), which provides:

It shall be unlawful for any person, directly or indirectly . . .

- (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security and not so registered, any manipulative or deceptive device or contrivance of such rules and regulations as the commission may proscribe . . . .

6. More specifically, the customers claimed that Ernst & Ernst's inadequate accounting procedures failed to discover Nay's "mail rule," the rule that only Nay could open mail addressed to him at First Securities, even if it arrived in his absence. The customers contended that a proper audit of First Securities would have brought this unusual practice to light, would have been reported by Ernst &

cally disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst.<sup>7</sup>

The United States District Court for the Northern District of Illinois granted Ernst & Ernst's motion for summary judgment and dismissed the action, holding that there was no genuine issue of material fact with respect to whether Ernst & Ernst had conducted its audits in accordance with generally accepted auditing standards.<sup>8</sup> The Court of Appeals for the Seventh Circuit reversed and remanded, concluding that there were genuine issues of fact to be resolved.<sup>9</sup> The Supreme Court granted certiorari and held that a private cause of action for damages would not lie under section 10(b) and rule 10b-5 in the absence of any allegation of "scienter."<sup>10</sup>

The Supreme Court's decision in *Ernst & Ernst* that a private cause of action for damages would not lie under rule 10b-5 absent allegations of "scienter"—an intent to deceive, manipulate, defraud<sup>11</sup>—is supported on three bases: the wording of section 10(b) of the Securities and Exchange Act of 1934, under which rule 10b-5 was promulgated; the legislative history of section 10(b); and a comparison of section 10(b) with the procedural requirements and substance of other sections of the 1933 and 1934 Acts.

The Court relied primarily upon the plain meaning rule of statutory interpretation as applied to section 10(b). It emphasized Congress' use of the words "manipulative or deceptive" in conjunction with "device or contrivance" to describe the type of conduct prohibited by section 10(b).<sup>12</sup>

---

Ernst to the Midwest Stock Exchange as an "irregular procedure" preventing a truly effective audit, and therefore, would have lead to an investigation of Nay by the Exchange that would have revealed the fraudulent scheme. 425 U.S. at 190.

7. *Id.*

8. In doing so, however, the district court rejected the proffered claim of Ernst & Ernst that a cause of action for aiding and abetting a rule 10b-5 violation could not be stated merely on allegations of negligence. *Id.* at 191.

9. *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974). The court held that one who breaches a duty of inquiry or disclosure owed to another is liable in damages for aiding and abetting a third party's violation of rule 10b-5 if the fraud would have been discovered or prevented but for the breach. For support, the court cited its decision in *Hochfelder v. Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974), where it stated on page 374 that in order to state a claim under rule 10b-5 based on a defendant's aiding and abetting, a plaintiff must show "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 a duty of disclosure." The court's emphasis on the defendant's "duty" and the breach of that duty might have signaled the Seventh Circuit's adoption of the "new" rule 10b-5 standard. *See* text accompanying notes 30-32 *infra*.

10. 425 U.S. at 193. The Court defined scienter as an intent to deceive, manipulate or defraud. *Id.*

11. *Id.*

12. *Id.* at 197.

The majority opinion considered the definitions and connotations of these words, especially the word "manipulative," which Justice Powell suggested is almost a term of art in the securities field, connoting "intentional or willful conduct designed to deceive or defraud investors . . ."<sup>13</sup> Responding to the argument that remedial legislation should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes,"<sup>14</sup> the Court said that Congress had *not* adopted a uniform negligence standard for all civil remedies in the securities laws, and therefore, congressional intent with respect to section 10(b) must be ascertained from the language of that particular section.<sup>15</sup> The majority found that the language of section 10(b) clearly connotes intentional misconduct, and that the clear language of the statute must control.<sup>16</sup>

Although the Court said that further inquiry past the wording of the statute was unnecessary, it turned to the legislative history of section 10(b) to support its decision. The legislative history of section 10(b) is scant,<sup>17</sup> but the majority succeeded in finding support for its decision especially from the Senate and House Reports<sup>18</sup> on what became section 10(b). They surmised from the legislative history an overall congressional intent to prevent manipulative and deceptive practices which have been demonstrated to fulfill no useful function.<sup>19</sup> The Court emphasized that the Senate Report indicated that with *specified* illicit practices, good faith was always a defense. The majority concluded that section 10(b), a catch-all provision of the 1934 Act, should be interpreted no more broadly.<sup>20</sup>

Finally, the Court made a comparison of other sections of the 1933 and 1934 Securities Acts which imposed liability, noting that everywhere Congress created an express civil liability, they clearly expressed the standard (*i.e.*, knowing or intentional conduct, negligence, or innocent mistake) of conduct upon which liability would attach. Congress also included certain significant procedural restrictions and safeguards within each section creating an express civil remedy allowing recovery for *negligent* conduct. Such safeguards are noticeably absent from section 10(b).<sup>21</sup> The Court laid

---

13. *Id.* at 199.

14. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963). See text accompanying notes 44-46 *infra*.

15. 425 U.S. at 200.

16. *Id.* at 201.

17. See 2 A. BROMBERG, SECURITIES LAW: FRAUD § 8.4(505) (1975), wherein Bromberg contends that the legislative history of § 10(b) is simply insufficient to firmly answer the question of whether Congress intended "scienter" to be an element of a violation of § 10(b).

18. S. Rep. No. 792, 73d Cong., 2d Sess. (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934).

19. S. Rep. No. 792, 73d Cong., 2d Sess., (1934).

20. 425 U.S. at 206.

21. *Id.* at 206-11. See also 2 A. BROMBERG, *supra* note 17, § 8.4(505), where Professor Bromberg notes that the reason Congress did not specify a standard of liability, or the elements of such an action is because Congress did not specifically

great emphasis upon this argument, especially in light of the absence of support from the legislative history for a negligence standard.<sup>22</sup>

Justice Blackmun dissented, joined by Justice Brennan. They conceded the technical consistency of the majority opinion, but pointed out that investors can be "victimized" just as much by negligent conduct as they can by positive deception.<sup>23</sup> Noting that negligence is a violation of 10b-5 when the SEC seeks an injunction,<sup>24</sup> the dissent reasoned that the standard should be the same when a private party sues for damages.<sup>25</sup> Justice Blackmun concluded that the initial inquiry into whether Ernst & Ernst had violated rule 10b-5 had been unjustly thwarted, especially in light of the auditing accountant's role in insuring a full disclosure of material facts needed to "safeguard the public interest."<sup>26</sup>

After an implied private cause of action under rule 10b-5 was recognized in *Kardon v. National Gypsum Co.*<sup>27</sup> the question of whether one could state such a cause of action under rule 10b-5 without averring scienter<sup>28</sup>

---

provide for private actions under § 10(b). This action was subsequently implied by the courts. See text accompanying note 27 *infra*.

22. *Id.* at 210-11. The Court also dismissed a contention of the SEC that subsections (2) & (3) of rule 10b-5, if standing alone, could encompass both negligent and intentional behavior, by pointing out that rule 10b-5 was promulgated pursuant to § 10(b) of the Securities and Exchange Act of 1934, and that the administrative agencies were not empowered to make law, but rather to carry into effect the will of Congress, and therefore could not exceed the scope of the statutory authority granted to the Commission by Congress. *Id.* at 212-14. There were, however, commentators who attempted an analysis of the standard to be applied in rule 10b-5 by a breakdown of the rule by its sections. See, e.g., Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. REV. 482, 491 (1970); and 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, 1207 (1970).

23. 425 U.S. at 216.

24. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-55 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

25. 425 U.S. at 217-18, where Justice Blackmun said:

I see no real distinction between that situation and this one, for surely 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.

26. *Id.* at 218.

27. 69 F. Supp. 512 (E.D. Pa. 1946).

28. One commentator has pointed out the confusion that has existed in the courts over the exact meaning of "scienter" in rule 10b-5 cases. He attributes a large part of this confusion to a similar confusion over the definition of scienter as an element of the common law action of deceit. A partial list of the definitions include: knowledge, guilty knowledge with intent to deceive, such knowledge as charges a person with the consequences of his act, a false representation made with knowledge of its falsity, and simply a fraudulent intent. Comment, *Scienter and Rule 10b-5: Development of a New Standard*, 23 CLEV. ST. L. REV. 493, 495-97 (1974).

Prosser, while listing the elements of the tort action of deceit, defines scienter as "Knowledge or belief on the part of the defendant that the representation is false—or . . . that he has not a sufficient basis of information to make it." W. PROSSER, LAW OF TORTS § 105, at 685-86 (4th ed. 1971).

became the topic of an extensive amount of scholarly comment and controversy.<sup>29</sup> The courts of appeals had taken relatively divergent views on the subject. Until recently, the Second and the Ninth Circuits have been characterized as representing the opposite ends of the negligence versus scienter spectrum.<sup>30</sup>

The leading case in the Second Circuit standing for the proposition that some form of scienter is an essential element of a rule 10b-5 violation is *Fischman v. Raytheon Mfg. Co.*<sup>31</sup> The court in *Fischman* stated that in order for a plaintiff to state a cause of action under rule 10b-5, proof of an "ingredient of fraud" would be necessary.<sup>32</sup> However, the court did not state explicitly its reasons for requiring proof of this additional element, nor did it attempt to define "fraud" in this context.<sup>33</sup>

---

Professor Bromberg suggests that "probably the most important step toward clarifying the law of scienter would be to ban the word." 2 A. BROMBERG, *supra* note 17, at § 8.4 (503) n.14.

29. See generally, 2 A. BROMBERG, *supra* note 17, at § 8.4; Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562 (1972); Epstein, *supra* note 22; Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5*, 62 NW. U.L. REV. 809 (1968); Mann, *supra* note 22; 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 (1968).

30. Comment, *supra* note 28, at 499. See text accompanying notes 40-42 *infra*. In other circuits besides the Second and Ninth, the courts began introducing and defining the standard to be applied in rule 10b-5 cases. Almost without exception, the circuits chose to adopt a standard of either negligence or some degree of scienter, thus following either the Second or Ninth Circuits respectively. See *Parent v. Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972) (seemingly adopting a negligence standard); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (adopting a negligence standard as sufficient to state a private cause of action under 10b-5); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971) (following the Second Circuit's standard by requiring "some degree of scienter").

31. 188 F.2d 783 (2d Cir. 1951).

32. While distinguishing rule 10b-5 and § 11 of the Securities Exchange Act of 1934, the court stated:

We think that when, to conduct actionable under section 11 of the 1933 Act, there is added the ingredient of fraud, then that conduct becomes actionable under § 10(b) of the 1934 Act and the Rule . . . .

*Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786-87 (2d Cir. 1951).

33. For cases in the Second Circuit following the "scienter" standard, see *Shemtov v. Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971); *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *SEC v. Great American Indus., Inc.*, 407 F.2d 453 (2d Cir. 1968), *cert. denied*, 395 U.S. 920 (1969); *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968). See also what many consider to be the most important case in the entire 10b-5 area, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). Although language in the majority opinion of *Texas Gulf* has been cited as lending support to the proposition that the standard to be applied in private actions under rule 10b-5 should be negligence, it is important to note that Judge Waterman later in the opinion stated that with respect to private actions, "some form of the traditional scienter requirement . . . is preserved." 401 F.2d at 855. Commentators

In juxtaposition to the Second Circuit's stand is the Ninth Circuit's leading case, *Ellis v. Carter*.<sup>34</sup> *Ellis* has been most often cited as standing for the proposition that in the Ninth Circuit negligent conduct is sufficient to impose liability for damages in a private action under rule 10b-5.<sup>35</sup> It has also been interpreted as imposing some form of a strict liability standard.<sup>36</sup>

Although several courts espoused allowing liability to attach for negligent acts in private actions under 10b-5, such propositions have been largely dicta.<sup>37</sup> One commentator's extensive studies failed to reveal a single case that actually imposed liability for negligent conduct.<sup>38</sup> While the courts and the commentators were advancing theories that courts were moving farther and farther away from requiring any type of scienter, these movements have been recognized as largely superficial.<sup>39</sup>

More recent cases in both the Second and Ninth Circuits had started to place emphasis on the "duty" of the defendant in a given set of circumstances involving alleged rule 10b-5 violations.<sup>40</sup> In doing so, the circuits began to reject the traditional scienter versus negligence language,<sup>41</sup> opting

---

have suggested that *Texas Gulf* did little but compound the existing confusion regarding the scienter requirements of a rule 10b-5 violation. Comment, *supra* note 28, at 503.

34. 291 F.2d 270 (9th Cir. 1961). The court's logic for not believing scienter in any form is required for a violation of rule 10b-5 is summed up by the court's statement at 274:

Section 10(b) speaks in terms of the use of "any manipulative device or contrivance" in contravention of rules and regulations as might be prescribed by the Commission. It would have been difficult to frame the authority to prescribe regulations in broader terms. Had Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so. We see no reason to go beyond the plain meaning of the word "any," indicating that use of manipulative or deceptive devices or contrivance of whatever kind may be forbidden, to construe the statute as if it read "any fraudulent" devices.

For a criticism of this logic, and the failure of the court to come "to grips with the problem," see 6 L. LOSS, SECURITIES REGULATIONS 3886 (1969 Supp.).

35. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 855, 868 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). See also *Mann*, *supra* note 22 at 1206.

36. See 2 A. BROMBERG, *supra* note 17, at § 8.9 n.102. For cases in the Ninth Circuit following the lead of *Ellis*, see *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962).

37. See *Bucklo*, *supra* note 29 at 563; *Dykstra*, *Civil Liability Under Rule 10b-5*, 1967 UTAH L. REV. 207, 219.

38. *Bucklo*, *supra* note 29 at 563.

39. *Id.* at n.5, citing R. JENNINGS & H. MARSH, SECURITIES REGULATION (1968).

40. This new movement toward a "flexible duty" is represented in the Second Circuit by three cases: *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); *Cohen v. Franchard Corp.*, 478 F.2d 115 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973); *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973); and in the Ninth Circuit by *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974).

41. See generally, as to the development by the circuits of this new standard for rule 10b-5, Comment, *supra* note 28 at 514.



instead for a "flexible duty" standard. This shift in emphasis might be due at least in part to the confusion surrounding the use and implementation of the term "scienter."<sup>42</sup> Criticism of inflexible and arbitrary characterizations of 10b-5 conduct as falling into categories of either negligence or scienter had also mounted. One commentator concluded that a "continuum of conduct" approach should be used by the courts as a guide for determining when liability should attach.<sup>43</sup> Whether these recent decisions had in fact changed the substantive standard for a 10b-5 violation as opposed to simply changing the syntactical formulation of that standard is open to speculation.

Before *Ernst & Ernst*, the Supreme Court had decided relatively few cases dealing with rule 10b-5 and never had reached the scienter versus negligence question as a standard for the imposition of liability. In *SEC v. Capital Gains Research Bureau, Inc.*<sup>44</sup> the Court discussed the Investment Advisors Act of 1940.<sup>45</sup> It stated that Congress intended this Act, like other securities legislation enacted to avoid frauds in the securities field, to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."<sup>46</sup> The Court reiterated this language in *Superintendent of Insurance v. Bankers Life & Cas. Co.*,<sup>47</sup> this time with direct reference to rule 10b-5.<sup>48</sup> The Court's most recent decision in the rule 10b-5 area is *Affiliated Ute Citizens v. United States*.<sup>49</sup> This case, which was cited extensively by the Ninth Circuit in its decisions developing the "flexible duty" standard,<sup>50</sup> discussed rule 10b-5 in terms of the duty that the rule imposes, rather than in terms of common law fraud.<sup>51</sup>

A major criticism of the majority opinion is its failure to deal with the question of whether a negligence standard as opposed to a scienter standard for rule 10b-5 would best serve the interests of the small investor. If the purpose of section 10(b) and rule 10b-5 is to reduce the perils of caveat emptor in the securities market,<sup>52</sup> then, in theory, the negligence standard

42. See note 28 *supra*.

43. Mann, *supra* note 22 at 1208-09, where the author suggests that such factors as fiduciary relationships whether defendants are from upper or lower management, whether one actively participates in the initiation of a securities transaction, or whether a person receiving information and claiming to be damaged was himself an insider, are and have been important in deciding whether liability will attach in certain cases. He concludes that the practice of discussing scienter and negligence as absolutes capable of objective application should be discontinued.

44. 375 U.S. 180 (1963).

45. 54 Stat. 847, as amended, 15 U.S.C. § 80b-1 *et seq.* (1970).

46. 375 U.S. at 195.

47. 404 U.S. 6 (1971). See also *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969).

48. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971), where Justice Douglas said, "Section 10(b) must be read flexibly, not technically and restrictively."

49. 406 U.S. 128 (1972).

50. 495 F.2d 724 (9th Cir. 1974). See text accompanying notes 40-42 *supra*.

51. See text accompanying notes 57-58 *infra*.

52. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

could have best accomplished this goal.<sup>53</sup> The higher the standard of care, the higher the probability that buyers and sellers of securities will be more willing to release material facts concerning securities involved, rather than risk imposition of liability for a negligent oversight or omission.<sup>54</sup> By opting for a scienter standard, the Court decided instead to protect the interests of accountants<sup>55</sup> and corporate insiders by supplying them with the ready defense of "good faith."

The discussion in *Ernst & Ernst* as to whether Congress intended rule 10b-5 to be enforced with a negligence standard or a scienter standard is of itself somewhat of an anomaly. The majority opinion in *Ernst & Ernst* discusses at length congressional intent in determining what standard is to be applied in private causes of action under rule 10b-5. In truth and fact, the courts, not Congress, "legislated" this private cause of action into being by inferring a private right of action for damages in *Kardon v. National Gypsum*.<sup>56</sup> If the Court had indeed been interested in serving the wishes of Congress with respect to rule 10b-5, that intent probably would have been better surmised by looking to the overall purpose of securities fraud legislation. The Court chose instead to look for some congressional legislative intent for a private action created solely by the judiciary.

Whether the "flexible duty" standard that had recently been developed by the Second and Ninth Circuits is still applicable to rule 10b-5 violations is open to question. The Court failed to discuss the exact degree of scienter that will be required for a rule 10b-5 violation. The Second

53. For a discussion of how the decision in this case may prompt congressional reaction to amend rule 10b-5 to allow recovery in private suits for non-intentional misconduct, see Note, *Securities Law—Private Cause of Action for Damages Under Rule 10b-5 Requires Scienter*, 25 EMORY L. REV. 465 (1976).

54. Some commentators have suggested, however, that a negligence standard would have the opposite effect—*i.e.*, the higher standard of care would cause buyers and sellers to become more apprehensive about negligently releasing misleading information, and thus actually reduce the free flow of information. Epstein, *supra* note 22 at 504.

55. For a discussion praising the Supreme Court's decision in this case expressing the view that a negligence standard would have "demanded a degree of perfection which is very difficult to achieve" in the complex field of accounting, see Note, *Securities—Accountant's Liability—United States Supreme Court Holds Accountant Not Liable Under Rule 10b-5 Unless Defendant Intended to Deceive, Manipulate or Defraud Investor*, 9 CREIGHTON L. REV. 775 (1976). For a discussion of this case at the court of appeals level discussing accountants' liability for aiding and abetting a violation of rule 10b-5, see Note, *Securities Law—Accountants' Liability*, 44 GEO. WASH. L. REV. 158 (1975). One case subsequent to the decision in *Ernst & Ernst* holding accountants liable for a violation of rule 10b-5 is *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976).

It is interesting to note that the question of whether civil liability for aiding and abetting is actually appropriate under rule 10b-5 was not reached in this decision. However, the Court arguably sanctioned such aiding and abetting, at least in the case of accountants, by reaching the scienter question instead of dismissing the action as inappropriate under rule 10b-5.

56. 69 F. Supp. 512 (E.D. Pa. 1946). See text accompanying note 27 *supra*.

Circuit, which had imposed a scienter standard, stated that the degree of scienter required under rule 10b-5 was not as great as that for common law fraud.<sup>57</sup> Whether the Court in *Ernst & Ernst* redefined scienter to the extent that this decision has been overruled is a critical question. If overruled, it is possible to read *Ernst & Ernst* as reducing rule 10b-5 to little more than a method of evoking federal jurisdiction for a common law tort action of fraud.<sup>58</sup> In addition, state courts may now prove to be a more advantageous forum for securities litigation if the common law action for negligent misrepresentation is still recognized.<sup>59</sup>

*Ernst & Ernst* represents another step in the Supreme Court's narrowing of the scope of rule 10b-5—a continuation of the process begun by *Blue Chip Stamps v. Manor Drug Stores*<sup>60</sup> to define and delimit the ever-increasing scope of rule 10b-5. In *Blue Chip* the Court retreated to the *Birnbaum* Rule, limiting the class of possible plaintiffs in 10b-5 actions to buyers and sellers of securities. Now, in *Ernst & Ernst*, the Court has chosen to limit the class of possible defendants by requiring allegations of scienter in private actions under rule 10b-5.

The total effect of *Ernst & Ernst*, especially when considered in connection with *Blue Chip*, will no doubt be to reduce the number of cases litigated in the securities fraud area. With only dicta to support a negligence standard in the thirty year history of private actions under rule 10b-5,<sup>61</sup> the only practical effect of the decision in *Ernst v. Ernst*, standing alone, may be to shift the controversy in the 10b-5 area from scienter versus negligence to the degree of scienter required for a rule 10b-5 violation.

TIMOTHY W. TRIPLETT

---

57. *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1291 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970).

58. Arguably, the need to formally prove reasonable reliance is not necessary for a prima facie case under rule 10b-5 but is necessary under common law fraud. However, because one must now be a buyer or seller under the *Birnbaum* Rule and because of the necessity of proving materiality under rule 10b-5, proof of reliance will probably always be present to some degree.

59. Such a cause of action is recognized in Missouri. For a Missouri case holding accountants liable for negligent misrepresentations to plaintiffs who were "forseeable" users of the auditor's report, see *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378 (Mo. App., D. St. L. 1973).

60. 95 S. Ct. 1917 (1975). See also, Evans, *Securities Regulations—Standing To Sue Under Rule 10b-5—Supreme Court Adopts Birnbaum Doctrine*, 41 MO. L. REV. 296 (1976).

61. See text accompanying notes 37-39 *supra*.