

RECENT DEVELOPMENTS IN CORPORATE AND SECURITIES LAW

CULPABILITY IN IMPLIED PRIVATE ACTIONS UNDER § 17(a): IS SCIENTER REQUIRED AFTER *AARON V. SEC*?

In *Aaron v. SEC*,¹ the United States Supreme Court held that the Securities and Exchange Commission must only allege *negligence* in an administrative enforcement proceeding under sections 17(a)(2) and (a)(3) of the 1933 Securities Act.² The *Aaron* court also held, however, that the Commission, like private litigants,³ must allege *scienter* in a rule 10b-5⁴ civil enforcement proceeding.⁵ Although the Commission promulgated rule 10b-5 pursuant to section 10(b) of the 1934 Securities Exchange Act, the Commission derived the specific language of rule 10b-5 “in significant part” from section 17(a).⁶ The court rationalized rule 10b-5’s more strin-

1. 446 U.S. 680 (1980).

2. *Id.* at 696-97. The Court also held that the Commission must allege scienter under § 17(a)(1). *Id.* at 695-96. Section 17(a), 15 U.S.C. § 77q(a) (1985), states:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

3. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n.12 (1976) (requiring private litigants to allege scienter, “something more than negligence,” in implied rule 10b-5 private actions).

4. 17 C.F.R. § 240.10b-5 (1985). Rule 10-5 states:

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

- (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.

Id.

5. 446 U.S. at 689-95.

6. *See Hochfelder*, 425 U.S. at 212-13 n.32, citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 767 (1975) (Blackmun, J., dissenting); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969).

gent scienter requirement by focusing on “the plain meaning of section 10(b),” which clearly evinces an intent to censure only “knowing or intentional misconduct.”⁷

The Supreme Court, however, left two important issues unresolved. First, the Court declined to decide whether an implied private cause of action exists under section 17(a).⁸ The First,⁹ Second,¹⁰ Fourth,¹¹ Sixth,¹² Seventh,¹³ and Ninth¹⁴ Circuits have filled this void by holding an implied private cause of action exists under section 17(a). The Fifth¹⁵ and Eighth¹⁶ Circuits, however, have concluded that no private cause of action exists under section 17(a). Federal district courts are also divided on this issue.¹⁷

Second, assuming that the Supreme Court approves of an implied pri-

7. 446 U.S. at 690-91.

8. *See, e.g., Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.2 (1983) (the Court reserved decision whether § 17(a) affords a private remedy).

9. *See, e.g., Cleary v. Perfectune, Inc.*, 700 F.2d 774, 779-80 (1st Cir. 1983) (requiring scienter on the assumption that § 17(a) private action exists).

10. *See, e.g., Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978), *cert. denied*, 442 U.S. 909 (1979) (language of § 17(a) broad enough to encompass private course of action).

11. *See, e.g., Newman v. Prior*, 518 F.2d 97, 99 (4th Cir. 1975) (Fourth Circuit “committed” to implied § 17(a) private action); *Johns Hopkins Univ. v. Hutton*, 488 F.2d 912, 914 (4th Cir. 1973) (evidence supplied elements required of private § 17(a) action).

12. *See, e.g., Kellman v. ICS, Inc.*, 447 F.2d 1305, 1308-09 (6th Cir. 1971) (implicitly finding private action, but restricting standing under § 17(a)); *Simmons v. Wolfson*, 428 F.2d 455, 456 (6th Cir. 1970) (same), *cert. denied*, 400 U.S. 999 (1971).

13. *See, e.g., Lincoln National Bank v. Herber*, 604 F.2d 1038, 1039-40 & 1040 n.2 (7th Cir. 1979) (§ 17(a) prohibits fraud in offer or sale of securities); *Daniel v. International Bhd. of Teamsters*, 561 F.2d 1223, 1244-45 & n.44 (7th Cir. 1977) (fraudulent sale actionable under § 17(a)), *rev'd on other grounds*, 439 U.S. 551 (1979); *Surowitz v. Hilton Hotels Corp.*, 342 F.2d 696, 603-04 (7th Cir. 1965) (§ 17(a)'s plain language supports finding implied private action); *rev'd on other grounds*, 383 U.S. 363 (1966). A three-judge panel, however, recently declared that the existence of a private cause of action under § 17(a) is an open question. *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 530-31 (7th Cir. 1985). As a result, one district court within the Seventh Circuit held that no implied cause of action exists under § 17(a). *Beck v. Cantor, Fitzgerald & Co., Inc.*, 621 F. Supp. 1547, 1558-60 (N.D. Ill. 1985).

14. *See, e.g., Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808, 815 (9th Cir. 1981) (cannot deny § 17(a) private action after § 10(b) private action established).

15. *See, e.g., Landry v. All American Assurance Co.*, 688 F.2d 381, 387-91 (5th Cir. 1982) (plaintiff did not meet test for implied actions enunciated in *Cort v. Ash*, 422 U.S. 66 (1979)).

16. *See, e.g., Shuil v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152, 155 (8th Cir. 1977) (purchaser's private remedy must be found in § 12(2), not § 17(a)), *cert. denied*, 434 U.S. 1086 (1978); *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 788-90 (8th Cir. 1967) (private civil liability under § 17(a) circumvented by § 12(2)'s express remedy).

17. *See T. HAZEN, THE LAW OF SECURITIES REGULATION* 508-09 nn.15 & 22 (1985) (collecting federal court cases). *Compare Masri v. Wakefield*, 602 F. Supp. 404, 405-06 (D. Colo. 1985) (noting Tenth Circuit's “considerable doubt” as to whether implied private right of action exists

vate cause of action under section 17(a), the Court must decide between two conflicting standards of culpability. The Court could impose a negligence standard for private actions under sections 17(a) and (a)(3) consistent with the *Aaron* standard in administrative enforcement proceedings.¹⁸ Alternatively, the Court could require proof of scienter in all section 17(a) private actions, consistent with the scienter requirement imposed on private actions under section 10(b) and rule 10b-5 of the 1934 Act.¹⁹ Because rule 10b-5 encompasses most activity actionable under section 17(a), a scienter requirement would not add to the alternatives already available to aggrieved purchasers.²⁰ As a practical matter, therefore, requiring scienter is tantamount to disallowing private actions under section 17(a).

Although Professor Hazen emphasizes that recent restrictive interpretations of rule 10b-5 have "opened the door for a more expansive use of section 17(a),"²¹ few aggrieved purchasers have pursued the window of vulnerability created by *Aaron's* negligence standard. Only one post-*Aaron* federal circuit court directly addressed the culpability issue for private actions under section 17(a). In *Cleary v. Perfectune, Inc.*,²² the First Circuit required scienter on the assumption that an implied private cause of action exists under section 17(a).²³ In addition, only three federal district courts have addressed the post-*Aaron* scienter-negligence dilemma, with conflicting results.²⁴

Ironically, the late Judge Friendly provided the most coherent ap-

under § 17(a)) with *Wilkinson v. Paine, Webber, Jackson & Curtis, Inc.*, 585 F. Supp. 23, 27 (N.D. Ga. 1983) (private cause of action exists under § 17(a) antifraud provisions).

18. See *supra* notes 1 & 2 and accompanying text. See also Scholl & Perkowski, *An Implied Right of Action Under Section 17(a): The Supreme Court Has Said "No," But Is Anybody Listening?*, 36 U. MIAMI L. REV. 41, 48-50 (1981) (Supreme Court's "*Hochfelder-Aaron* progression" militates in favor of negligence standard for private § 17(a) actions).

19. See *supra* notes 3-5 and accompanying text.

20. See T. HAZEN, *supra* note 17, at 448 (rule 10b-5 includes fraudulent purchases and sales while § 17(a) is limited to sales only). The Supreme Court sanctions application of both rule 10b-5 and § 17(a) to similar types of misconduct. See *United States v. Naftalin*, 441 U.S. 768, 777-78 (1979) (both rule 10b-5 and § 17(a) apply to fraud in securities aftermarkets). But see *Roskos v. Shearson/American Express, Inc.*, 589 F. Supp. 627, 629-30 (E.D. Wis. 1984) ("naked" § 17(a) claim "not . . . slender enough to remain in shadow of" plaintiff's § 10(b) claims); *North Am. Fin. Group, Ltd. v. S.M.P. Enter., Inc.*, 583 F. Supp. 691, 695-97 (N.D. Ill. 1984) (same).

21. T. HAZEN, *supra* note 17, at 509.

22. 700 F.2d 774 (1st Cir. 1983).

23. *Id.* at 779-80. *Cleary* involved a charge of aiding and abetting a violation of § 17(a).

24. Only one federal court has extended *Aaron's* negligence standard to private civil actions under § 17(a). *Spatz v. Borenstein*, 513 F. Supp. 571, 578 & n.9 (N.D. Ill. 1981) (*Aaron* reveals basis for holding that scienter requirement is absent in private civil actions under §§ 17(a)(2) and (3)).

proach to private actions under section 17(a) more than fifteen years ago in *SEC v. Texas Gulf Sulphur*.²⁵ In a concurring opinion, Judge Friendly noted that policy considerations should play an instrumental role in a court's resolution of the section 17(a) scienter dilemma.²⁶ The *Aaron* Court, citing *Ernst & Ernst v. Hochfelder*,²⁷ refused to consider policy rationales because the language of section 17(a) was "sufficiently clear in its context" to mandate a negligence standard for administrative enforcement proceedings.²⁸ As Judge Friendly noted, however, imposing a negligence standard for *private* actions under section 17(a) is not sufficiently clear in its context. Congress, in sections 11 and 12(2) of the 1933 Act, provided private litigants with *express* remedies for *negligent* misconduct, predicated upon significant procedural requirements.²⁹ Thus, the *Hochfelder* Court, citing Judge Friendly's concurrence,³⁰ held that scienter is necessary under section 10(b), and consequently rule 10b-5, to avoid rendering the 1933 Act's *express* remedies and congressionally mandated procedural requirements mere surplusage.³¹ The Court in *Hochfelder* thereby recognized the need to construe the 1933 and 1934 Acts as "interrelated components."³²

But see *Beck v. Cantor, Fitzgerald & Co., Inc.*, 621 F. Supp. 1547, 1558-60 (N.D. Ill. 1985) (no implied cause of action under § 17(a)). *See supra* note 13.

Two district courts, however, have required proof of scienter in private actions under § 17(a). *Dannenberg v. Dorison*, 603 F. Supp. 1238, 1241-42 n.5 (S.D.N.Y. 1985) (relying on policy distinctions between private damage actions and SEC enforcement actions to distinguish *Aaron* and require scienter); *Wright v. Schock*, 571 F. Supp. 642, 662 (N.D. Cal. 1983) (§ 17(a)'s scienter requirement is coextensive with that of § 10(b) in private actions). *But see* *Morgan Stanley & Co. v. Archer Daniels Midland Co.*, 570 F. Supp. 1529, 1536 (S.D.N.Y. 1983) (although scienter is usually required, § 17(a) plaintiffs may need only prove negligence in "certain cases").

25. 401 F.2d 833, 864 (2d Cir. 1968) (Friendly, J., concurring).

26. *See infra* notes 29-31 and accompanying text.

27. 425 U.S. 185 (1976).

28. 446 U.S. at 695. *Hochfelder* held that because the language and history of § 10(b) were "dispositive of the appropriate standard of liability, there was no occasion to examine additional considerations of 'policy' . . ." 425 U.S. at 214 n.33. *But cf.* *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) (consideration of policy considerations in § 10b and rule 10b-5 action "proper" when it is clear that Congress could not have foreseen "the present state of the law with respect to Rule 10b-5").

29. 401 F.2d at 866-68. Section 11 delineates a cause of action for misstatements or omissions in a registration statement, but affords registrants a "due diligence" exception for many experts. 15 U.S.C. § 77k(b)-(c) (1982). Section 12(2) renders offerors and sellers liable for incorrect or misleading prospectuses unless the offeror or seller proves "he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." 15 U.S.C. § 77l(a) (1982).

30. 425 U.S. at 211, *citing* 401 F.2d at 867-68 (Friendly, J., concurring).

31. 425 U.S. at 208-11.

32. *Id.* at 206. *See also* *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380-87 (1983) (avail-

This same logic applies to private actions under section 17(a), but with even greater force. Although the language of section 10(b) may indicate a stronger scienter standard,³³ section 17(a) and sections 11 and 12(2) are provisions of the 1933 Act. Only the most spurious legal reasoning would predicate *implied* private actions under section 17(a) on a negligence standard when the practical effect is to nullify sections 11 and 12(2), *express* remedies of the *same* Act.³⁴ As Judge Friendly observed,

there is unanimity among the commentators, including some who were in a peculiarly good position to know, that . . . § 17 . . . was intended only to afford a basis for injunctive relief and, on a proper showing, for criminal liability, and was never believed to supplement the actions for damages provided by §§ 11 and 12(2). When the House Committee Report listed the sections that “define the civil liabilities imposed by the Act” it pointed only to §§ 11 and 12(2) and stated that “[t]o impose a greater responsibility [than that provided by §§ 11 and 12(2)] *** would unnecessarily restrain the conscientious administration of honest business with no compensating advantage to the public.”³⁵

Moreover, policy considerations indicate that courts should either adopt a scienter requirement for private actions under section 17(a) or refuse to imply private actions. In situations involving conduct falling under both rule 10b-5 and section 17(a),³⁶ litigants would have no incentive to pursue a rule 10b-5 action because a section 17(a) negligence standard would be much easier to meet. Any competent pleader could draft a negligence complaint sufficient to survive a motion to dismiss. The potential for strike suits would increase exponentially along with the lawsuit’s settlement value.³⁷

Judge Friendly noted that vexatious litigation creates two potentially negative consequences. First, Judge Friendly stressed that corporations facing potential liability for negligent disclosures would be prone to err

ability of express remedy under § 11 of 1933 Act does not preclude action under § 10(b) of 1934 Act; precluding action under 1934 Act would conflict with the purpose of 1933 Act).

33. See *supra* note 7 and accompanying text.

34. See T. HAZEN, *supra* note 17, at 511.

35. 401 F.2d at 867-68 (Friendly, J., concurring), *citing* 3 L. LOSS, *SECURITIES REGULATION* 1785 (1961) (other citations omitted).

36. See *supra* note 20 and accompanying text.

37. See Comment, *Section 17(a) of the Securities Act of 1933: Implication of a Private Right of Action*, 29 UCLA L. REV. 244, 265 (1981) (recognizing propensity for strike suits, but doubting that defendants will prefer paying settlements to fighting merits of “contingent” claims).

on the side of nondisclosure,³⁸ contrary to the express intent of both the 1933 and 1934 Acts.³⁹ Second, because innocent investors ultimately bear the burden of negligent disclosures, vexatious litigation could have a substantial "chilling" effect on venture capital formation.⁴⁰

In conclusion, expanding *Aaron's* negligence standard to implied section 17(a) actions for damages is not sufficiently clear in the context of conduct covered by the 1933 Act. A negligence standard, by effectively eliminating the express remedies of sections 11 and 12(2), is contrary to Congress' express intent.⁴¹ Policy considerations indicate that the increased transaction costs of a negligence standard for implied section 17(a) actions for damages clearly outweigh any benefits. Courts should look to Judge Friendly's 1968 concurrence in *SEC v. Texas Gulf Sulphur* in resolving private actions under section 17(a).

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38. 401 F.2d at 866-67 (imposing a negligence standard for civil damages actions under rule 10b-5(2) and § 17(a) would cause corporations to remain silent).

39. Judge Friendly recognized that "commendable and growing recognition . . . of the importance of informing security holders and the public generally with respect to important business and financial developments." *Id.* at 867 (citation omitted).

40. Judge Friendly added that "the risk that a slip of the pen or failure properly to amass or weight the facts—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers. . . ." *Id.* See also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 747 (1975) (fearing strike suits in pursuit of "retrospectively golden opportunities").

41. See *supra* note 35 and accompanying text.