Negligence Sufficient to Establish Aiding and Abetting Liability in SEC Enforcement Actions Under § 17(a) of the Securities Act of 1933 (SEC v. Coven)

John R. Calcagni
NEGLIGENCE SUFFICIENT TO ESTABLISH AIDING AND ABETTING LIABILITY IN SEC ENFORCEMENT ACTIONS UNDER § 17(a) OF THE SECURITIES ACT OF 1933

SEC v. Coven

Section 17(a) of the Securities Act of 1933 prohibits individuals from employing “any device, scheme or artifice to defraud” or engaging in “any transaction, practice or course of business which . . . would operate as a fraud or deceit” in the offer or sale of securities. The statute provides:

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.

Section 20(b) of the 1933 Act, 15 U.S.C. § 77t(b) (1976), which grants the SEC authority to commence an action to enjoin violations of any of the provisions of the Act, provides in pertinent part:

Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond . . .


In order to obtain an injunction under § 20(b), the SEC must demonstrate a "reasonable likelihood" that the defendant will commit future violations. See SEC v. Management Dy-
tions for damages. In light of the recent Supreme Court decision in Ernst & Ernst v. Hochfelder, which established a requirement of scienter in private actions brought under section 10(b) of the Securities Exchange Act of 1934, a question has arisen concerning the

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level of culpability which Congress intended to address in section 17(a). Recently, in SEC v. Coven, the Second Circuit concluded that an injunction may be issued against an attorney whose negligent conduct aided and abetted a violation of section 17(a).

The defendant in Coven, an attorney specializing in securities law, was retained by the president of Dennison Personnel, Inc. to facilitate a public offering of its common stock. Under the terms of the registration statement the first 3,000,000 shares were to be sold on an “all-or-none” basis, with the proceeds to be returned to the investors if the entire lot was not sold before the closing date. Although he was aware that the funds had not been handled in accordance with the registration statement’s terms and had no informed basis for believing that the “all-or-none” requirement had been met, Coven provided written assurances that the required number of shares had been sold. After investigating several irregu-
larities surrounding the offering, the SEC instituted a proceeding against the appellant and eleven others to enjoin future violations. The district court found that the securities laws had been violated by the improper closing of the all-or-none portion of the offering, the underwriters' failure to use best efforts to sell the entire issue, and the trading by one underwriter in the securities while a participant in their distribution. On the basis of his written assurances and his failure to investigate certain of the underwriters' activities, Coven was held liable for aiding and abetting violations of section 17(a).

On appeal, the Second Circuit affirmed in part and reversed in part. Judge Mansfield, who authored the unanimous panel opinion, sold. It was in response to this demand that Coven drafted a letter to the escrow agent stating that 3,075,000 shares had been sold. Id. at 1023.

Id. at 1021. The complaint alleged violations of §§ 5(b) and 17(a) of the 1933 Act, 15 U.S.C. §§ 77e(b), 77q(a) (1976), §§ 10(b) and 15(c)(2) of the 1934 Act, 15 U.S.C. §§ 78j(b), 78u(c)(2) (1976), and Rules 10b-5, 10b-6, 10b-9 and 15c2-4 promulgated under the 1934 Act, 17 C.F.R. §§ 240.10b-5, 240.10b-6, 240.10b-9, 240.15c2-4 (1978).

Id. at 1021. The district court found that Carlton failed to produce its records of sales transactions from the all-or-none portion of the offering, id. at 1023 n.5, and had ordered 1,000,145 shares in its own "street name." The court concluded, therefore, that the entire lot of 3,000,000 shares had not been sold before the closing and that Rule 10b-9 had been violated. Id. at 1023.

Id. at 1021. The district court found that Carlton had terminated its efforts to sell the Dennison stock well before the anticipated closing date. Id. at 1024. This cessation of solicitations violated the terms of the registration statement, which required the underwriter to use "best efforts" to sell the shares. Id. at 1022. A "best efforts" underwriting is to be contrasted with a "firm commitment" underwriting in which the underwriter assumes the risk of loss on the unsold portion of the distribution. R. Jennings & H. Marsh, Securities Regulations Cases and Materials 75 (3d ed. 1972). See also Securities and Exchange Comm'n, Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. 494-95 (1963).

Id. at 1025. Before the closing date, Carlton purchased 35,000 shares of Dennison through a proxy from M.S. Wein, a trading house which Carlton had fraudulently induced to "make a market" in Dennison stock. Id. at 1024. This conduct violated Rule 10b-6, 17 C.F.R. 240.10b-6 (1978), which makes it unlawful for an underwriter "to bid for or purchase for any account in which he has beneficial interest" or "to attempt to induce any person to purchase any such security or right, until after he has completed his participation in such distribution."

Id. at 1028. The district court found that Coven's letter to the escrow agent had facilitated the improper release of escrow funds in violation of Rule 10b-9. Since a violation of the specific provisions of Rule 10b-9 also constitutes an unlawful act under § 17(a), see SEC v. Manor Nursing Centers, 458 F.2d 1082, 1097 (2d Cir. 1972), the court held that Coven aided and abetted violations of both provisions. 581 F.2d at 1021. In addition, Coven was found secondarily liable for Carlton's improper trading because he failed to make inquiries despite his awareness that over-the-counter marketing activities had been initiated. Id. at 1024; see note 17 supra. Finally, the court held Coven liable for aiding and abetting the underwriter's failure to use "best efforts," see note 16 supra, on the ground that he was negligent in monitoring Carlton's sales efforts. 581 F.2d at 1024.

581 F.2d at 1021.
ion,20 rejected the appellant's contention that under the decision in *Ernst & Ernst v. Hochfelder,*21 liability could not be imposed in the absence of a showing of scienter.22 Noting that *Coven* involved an SEC proceeding to enjoin violations of 17(a) of the 1933 Act while *Hochfelder* was a private damages action brought under section 10(b) of the 1934 Act,23 the court concluded that the language24 and legislative history25 of section 17(a) justified application of a negli-

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20 The panel consisted of Judges Mansfield, Moore and Smith.
21 425 U.S. 185 (1976); see note 7 supra.
22 581 F.2d at 1026-27.
23 Id. at 1026. The *Hochfelder* Court expressly left open the question whether evidence of scienter is required in SEC enforcement proceedings under § 10(b). 425 U.S. at 194 n.12. Moreover, the Court stated that the standard governing actions arising under § 17(a) of the 1933 Act and other provisions of the securities laws must be determined by analyzing the underlying legislative intent. Id. at 200. Thus, the Second Circuit concluded that the *Hochfelder* ruling was not determinative in *Coven.* 581 F.2d at 1026-27. It should be noted that the *Coven* court found it unnecessary to resolve the question whether scienter is required in § 10(b) injunctive suits, since it found the appellant culpable under § 17(a). 581 F.2d 1026 n.10 (citations omitted). At least one lower court, however, has determined that scienter is the requisite standard of culpability in § 10(b) enforcement proceedings. See SEC v. Wills, No. 77-0097 (D.D.C. Dec. 14, 1978).

24 The *Hochfelder* Court based its decision on the language of § 10(b) of the 1934 Act which prohibits the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities. 15 U.S.C. § 78j(b) (1976); see 425 U.S. at 197. Finding no comparable language in § 17(a), Judge Mansfield concluded that fraudulent intent is not a necessary element of an enforcement action under the statute. 581 F.2d at 1026-27. In support of this conclusion, Judge Mansfield observed that the language of § 17(a) is virtually identical to that of Rule 10b-5, which the *Hochfelder* Court implied "could encompass both intentional or negligent behavior," 425 U.S. at 212, if its scope were not limited by the scienter requirement in the enabling statute, § 10(b). 581 F.2d at 1026.

25 Significantly, the *Coven* panel acknowledged that some courts have held that the § 17(a)(3) prohibition on any practice which "operates or would operate as a fraud" mandates a showing of unlawful intent. Id. at 1026 n.11. Judge Mansfield, however, reasoned that Congress used this language to "focus attention on the effect of potentially misleading conduct on the public, not on the culpability of the person responsible." Id. at 1026. (emphasis in original) (footnote omitted). This interpretation is consistent with the Supreme Court's construction of § 206(2) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(2) (1976), a provision almost identical to § 17(a)(3). SEC v. Capital Gains Research Bureau, Inc., 376 U.S. 180 (1963). The *Capital Gains* Court stated:

Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit" upon a client, did not intend to require proof of intent to injure and actual injury to the client. Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation "enacted for the purpose of avoiding frauds," not technically and restrictively, but flexibly to effectuate its remedial purposes.

Id. at 195 (footnote omitted); accord, SEC v. Universal Major Indus. Corp., 546 F.2d 1044 (2d Cir. 1976); SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975).

26 581 F.2d at 1027. Judge Mansfield noted that an early version of § 17(a) passed by the Senate, S. 875, 73d Cong., 1st Sess. § 13 (1933), required the SEC to prove willfulness and intent to defraud to obtain an injunction. The House version, H.R. 5480, 73d Cong., 1st Sess. § 8 (1933), however, did not contain such a requirement. In conference, the House version was adopted and eventually became law. H.R. Rep. No. 152, 73d Cong., 1st Sess. 12
gence standard in cases involving violations of that statute.\footnote{581 F.2d at 1026-27.}

Additionally, Judge Mansfield held that, at least in the context of SEC enforcement actions, the standard of culpability applicable to direct violators of section 17(a) should be applied to those who are charged with aiding and abetting violations.\footnote{Id. at 1028; accord, SEC v. Universal Major Indus. Corp., 546 F.2d 1044 (2d Cir. 1976).} In particular, the \textit{Coven} court reaffirmed its adherence to the test previously formulated by the Second Circuit: whether the alleged aider and abettor "should have been able to conclude that his act was likely to be used in furtherance of illegal activity."\footnote{See generally Douglas & Bates, \textit{The Federal Securities Act of 1933}, 43 \textit{Yale L.J.} 171, 181-82 (1933).} Applying this test to the facts


in *Coven*, Judge Mansfield concluded that the appellant’s conduct with respect to the improper closing of the all-or-none portion of the offering aided and abetted those principally responsible for violating section 17(a).29 The appellant’s failure to investigate the underwriters’ activities, however, was deemed insufficient to establish liability for aiding and abetting the improper trading and breach of duty to use “best efforts,” “[a]lthough the circumstances may well have prompted a reasonable man to investigate. . . .”20

The Second Circuit traditionally has adhered to the view that the SEC need not establish scienter in order to obtain an injunction under the securities laws.21 Thus, its decision to permit the use of a

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29 581 F.2d 1028. The *Coven* court also noted that the appellant’s written assurances, drafted after he was “on notice” that the entire all-or-none portion of the offering may not actually have been sold, indicated “reckless disregard” sufficient to constitute scienter for the purpose of establishing a violation of Rule 10b-5. *Id.* at 1029 (citing *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47-48 (2d Cir. 1978)).

20  *Id.* at 1029.

21 In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193 (1963), discussed in note 33 infra, the Supreme Court held that “[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages.” The Court reasoned:

> To impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute.

375 U.S. at 200. This reasoning subsequently became the basis for the dual approach to culpability announced in Judge Friendly’s famous concurring opinion in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). In *Texas Gulf Sulphur*, the Second Circuit, sitting en banc, held that an injunction was properly issued against several parties who had been negligent in drafting a press release in violation of § 10(b) of the 1934 Act and Rule 10b-5. 401 F.2d at 864. Judge Friendly concurred, but stated that he would not apply a negligence standard in private damages actions under § 10(b) and Rule 10b-5. *Id.* at 867 (Friendly, J., concurring). He justified application of a negligence standard in SEC injunctive suits as follows:

> In an enforcement proceeding for equitable or prophylactic relief the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent . . . conduct has become unlawful.

*Id.* at 854-55 (Friendly, J., concurring).

Judge Friendly’s view that the elements of fraud should vary with the kind of relief sought has been applied consistently by the Second Circuit. *See SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044 (2d Cir. 1976); *SEC v. Geon Indus.*, Inc., 531 F.2d (2d Cir. 1976); *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1304-05 (2d Cir. 1973) (en banc); *SEC v. Manor Nursing Centers*, 468 F.2d 1082 (2d Cir. 1972); *Shemtob v. Shearson Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971); *SEC v. Galaxy Foods, Inc.*, 417 F. Supp. 1225 (E.D.N.Y. 1976), aff’d mem., 556 F.2d 559 (2d Cir. 1976). Despite the Supreme Court’s decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), see note 7 *supra*, the Second Circuit has appeared reluctant to abandon the negligence standard in SEC enforcement suits under § 10(b). Although the court had the opportunity to review its position in *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8 (2d Cir. 1977), *aff’g on other grounds* 420 F. Supp. 1226 (S.D.N.Y. 1976), it expressly declined to do so. 565 F.2d at 14. It should be noted that the SEC has taken the position that a negligence standard should be applied uniformly in
less demanding standard in Coven, a section 17(a) case, is not surprising.\textsuperscript{32} Moreover, the decision seems sound in light of the prophylactic policy implicit in the enforcement provisions of the securities laws.\textsuperscript{33} The precise contours of the standard applied in Coven, how-

\textsuperscript{32} Prior to the Hochfelder decision, the Seventh Circuit held that evidence of scienter or fraudulent intent is not "essential in a suit for injunctive relief" under § 17(a)(2)-(3). SEC v. Van Horn, 371 F.2d 181, 186 (7th Cir. 1966); accord, SEC v. Dolnick, 501 F.2d 1279, 1284 (7th Cir. 1974); SEC v. Pearson, 426 F.2d 1339, 1343 (10th Cir. 1970). Since Hochfelder, the federal courts have been divided on the question whether the scienter requirement is applicable to SEC enforcement actions brought under § 17(a). Compare SEC v. World Radio Mission, Inc., 544 F.2d 535, 541 n.10 (1st Cir. 1976), SEC v. Southwest Coal & Energy Co., 439 F. Supp. 820, 826 (W.D. La. 1977), SEC v. Shiel, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,150 (N.D. Fla. 1977), and SEC v. Geotek, 426 F. Supp. 715, 726 (N.D. Cal. 1976) (scienter not required), with SEC v. Cenco, Inc., 436 F. Supp. 193, 199-200 (N.D. Ill. 1977), and SEC v. American Realty Trust Co., 429 F. Supp. 1148, 1171 (E.D. Va. 1977) (scienter required). Illustrative of the approach taken by courts applying a negligence standard is SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976). In World Radio Mission, the Commission initiated proceedings to enjoin a religious organization and its leaders from committing further violations of § 17(a), § 10(b) and Rule 10b-5 in the sale of interest-bearing notes. As a defense, the appellants asserted their lack of deceptive intent. \textit{Id.} at 540. Reasoning that the language and legislative history of § 17(a) is significantly different from that which the \textit{Hochfelder} Court found dispositive, the First Circuit held that § 17(a) does not require scienter in an SEC action for remedial relief. \textit{Id.} at 540-41.

In contrast, at least one court has held that, in view of the "similarity" in language and purpose of § 17(a) and § 10(b), \textit{Hochfelder} requires proof of scienter in SEC actions brought under the former. See SEC v. American Realty Trust, 429 F. Supp. 1148, 1171 (E.D. Va. 1977). In dismissing an injunctive action brought against a real estate trust which had neglectedly omitted information in a document subject to SEC regulation the \textit{American Realty} court reasoned:

\textit{If the language and history of 10(b) is dispositive as to a scienter requirement in private actions, it must also be so for SEC enforcement actions since such suits are creatures of statute rather than implied rights of action.}

\textit{Id.} at 1171.

\textsuperscript{33} \textit{See SEC v. Management Dynamics, Inc., 515 F.2d 801, 808 (2d Cir. 1975)} wherein the court stated:

\textit{[T]he SEC appears in these [injunctive] proceedings . . . as a statutory guardian charged with safeguarding the public interest in enforcing the securities laws. Hence, by making the showing required by statute that the defendant "is engaged or about to engage" in illegal acts, the Commission is seeking to protect the public interest . . . .}

\textit{Id.}

The courts generally have drawn a clear distinction between the prophylactic effects of enforcement actions and the compensatory purposes of private damages suits. \textit{E.g.}, List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965); \textit{see Painter, Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5, 65 Colum. L. Rev. 1361 (1965). Thus, a strong argument may be made that the \textit{Hochfelder} rationale is not applicable to enforcement suits under the securities law. It also has been argued that the \textit{Hochfelder} decision is illustrative of a trend in recent Supreme Court decisions to limit the availability of private actions for damages. SEC Gen. Counsel's Memorandum Regarding Ernst & Ernst v. Hochfelder, reprinted in SEC. REG. & L. REP.
ever, are somewhat unclear. Although the court stated that negligent conduct is enough to establish an aiding and abetting violation, it expressly declined to find liability where an attorney failed to make inquiries in the face of circumstances sufficient to place a reasonable man on notice that irregularities might be present. Significantly, despite the Second Circuit's professed adherence to a negligence standard, since Hochfelder it has not actually upheld an injunction against a secondarily liable defendant in the absence of an alternative finding of "recklessness."

It is submitted that such results are inevitable under the Second Circuit's articulated test for "negligent" aiding and abetting liability. A requirement that the defendant knew or should have known that his conduct "was likely to be used in furtherance of illegal activity" seems calculated to exclude from liability all but those who deliberately close their eyes to palpable illegalities in wanton disregard of the truth and of their role in advancing the illegal scheme. Yet, it is clear that such individuals may be enjoined under the Second Circuit's scienter standard without having to...


One commentator has noted that the Second Circuit's decision in Coven makes it difficult to predict whether a district court will issue an injunction when an attorney is charged with secondary liability. Brodsky, Attorney's Liability as Aider and Abettor in SEC Injunction Actions, N.Y.L.J., Aug. 2, 1978, at 1, col. 1.

See note 30 and accompanying text supra.

See note 27 and accompanying text supra.

SEC v. Universal Major Indus. Corp., 546 F.2d 1044 (2d Cir. 1976); see Berdahl v. SEC, 572 F.2d 643, 647 n.6 (2d Cir. 1978).


When the courts began to recognize a civil damage action for aiding and abetting, see cases cited in note 27 supra, they looked to the law of torts for guidance in establishing the elements of a cause of action. RESTATEMENT OF TORTS § 876 (1939) provides:

For harm resulting to a third person from the tortious conduct of another, a person is liable if he

(a) orders or induces such conduct, knowing of the conditions under which the act is done or intending the consequences which ensue, or
resort to a less demanding negligence theory.

The problem underlying the Second Circuit’s test may lie in its emphasis on the issue of the defendant’s mental state and its concomitant neglect of another critical element of aiding and abetting liability: the requirement that the defendant actually “give substantial assistance to the [primary wrongdoer] in accomplishing” the illegal result.40 An analysis of the facts in Coven in light of this variable could have led the court to similar conclusions without the need to make fine distinctions concerning the defendant’s mental state. Clearly, a defendant who fails to investigate suspicious circumstances and consequently is not in a position to expose a securities fraud cannot be said to have materially furthered the illegality.41 On the other hand, when an attorney furnishes a false or misleading statement which induces innocent parties to act, he may be deemed to have rendered substantial assistance to the fraud.

Although the Coven court’s negligence test appears to reach only reckless conduct, it is submitted that, where the defendant has provided affirmative assistance to the primary wrongdoer, mere negligence will be deemed sufficient to establish liability.42 Where,

(b) knows that the other’s conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
(c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to a third person.


40 RESTATEMENT OF TORTS § 876(c) (1939).
41 In interpreting the “substantial assistance” element, the courts have differed on the question whether mere silence or inaction is sufficient to impose liability. Compare Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 740 (10th Cir. 1974), and Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147, 154 (7th Cir.), cert. denied, 397 U.S. 989 (1969), with Landy v. FDIC, 486 F.2d 139, 161-62 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974), and Wessel v. Buhler, 437 F.2d 279, 383 (9th Cir. 1971).

We do not believe . . . that imposition of a negligence standard with respect to the conduct of a secondary participant is overly strict . . . . The legal profession plays a unique and pivotal role in the effective implementation of the securities laws . . . . [T]he smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he
however, all that is established is a mere failure to investigate, evidence of recklessness would seem to be required. While the Second Circuit has never expressly differentiated between active and passive conduct, such a distinction may be useful in evaluating aiding and abetting cases.

John R. Calcagni

renders an opinion on such matters.

Id. at 541-42.

* In Coven, the court stated:
Absent some concrete indication of knowledge by appellant that an underwriter was engaged in wrongful trading, we do not think that as attorney for the issuer he was under an obligation to investigate . . . .

581 F.2d at 1030 (emphasis added).