New Light on an Old Debate: Negligence v. Scienter in an SEC Fraud Injunctive Suit

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INTRODUCTION

The federal securities laws have as fundamental objectives "[t]he maintenance of fair and honest markets in securities and the prevention of inequitable and unfair practices in such markets." To attain these goals, the Securities and Exchange Commission (SEC) is empowered by section 10(b) of the Securities Exchange Act of 1934 to enact rules and regulations protecting investors from fraudulent and deceitful practices in the sale and purchase of securities. Section 10(b) has been implemented through the pro-

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2 Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), which was enacted to prohibit fraud in the purchase and sale of securities, provides in part:
   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.
Section 10(b) has become so widely used that it has been declared "the most litigated [provision] in the federal securities laws." SEC v. National Sec., Inc., 393 U.S. 453, 465 (1969).

The original federal anti-fraud provision is § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1970), which 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.
Since § 17(a) refers to the "offer or sale of any securities," it is applicable only to purchasers victimized by fraudulent sellers. 3 L. Loss, SECURITIES REGULATIONS 1424 (2d ed. 1961) [hereinafter cited as Loss]; Jacobs, The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management, 59 CORNELL L. REV. 27, 29 n.7 (1973). This limitation left a void in the make-up of the federal securities laws which § 10(b) was created to fill.

Adopted pursuant to § 10(b) by the Commission in 1942, rule 10b-5 proscribes fraud in both the purchase and sale of securities and thus covers situations left unregulated by § 17(a).
mulgation of rule 10b-5, which prohibits fraudulent practices "in connection with the purchase or sale of any security." 73

In the ongoing effort to free securities markets of fraudulent activities, section 10(b) and rule 10b-5 have become the focal points of both SEC injunctive actions and private suits commenced by investors seeking to recover damages.4 A much litigated question has been whether scienter, usually defined as an intent to defraud, deceive, or manipulate,5 must be established as a prerequisite to

See 3 Loss, supra at 1426. Rule 10b-5 contains language almost identical to that used in § 17(a):

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 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 deceive upon any person, in connection with the purchase or sale of any security.


A judicially-created action for damages occasioned by the violation of § 10(b) and rule 10b-5 was first recognized in Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) and subsequently was accepted by other courts in the federal judicial system. See, e.g., Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), cert. denied, 422 U.S. 1007 (1975); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

5 In the realm of the securities law, scienter has proven to be an elusive concept. Consequently, it has long been the subject of controversy and discussion. See, e.g., Bucklo, Scientist and Rule 10b-5, 67 Nw. U.L. Rev. 562 (1972) [hereinafter cited as Bucklo]; Campbell, Elements of Recovery Under Rule 10b-5: Scientist, Reliance, and Plaintiff's Reasonable Conduct, 26 S.C.L. Rev. 653 (1975); Mann, Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scientist, 45 N.Y.U. L. Rev. 1205 (1970); Note, Scientist and Rule 10b-5, 69 Colum. L. Rev. 1057 (1969); Comment, Negligent Misrepresentations under Rule 10b-5, 32 U. Chi. L. Rev. 824 (1965); 82 Harv. L. Rev. 938 (1969); Note, Proof of Scientist Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5, 63 Mich. L. Rev. 1070 (1965).

Dean Prosser has characterized "scienter" as "the intent to deceive, to mislead, to convey a false impression." W. Prosser, THE LAW OF TORTS § 107, at 700 (4th ed. 1971). According to Prosser, the intent required for a common law action of deceit may be established by demonstrating the existence of any one of three states of mind. The first and most familiar is where "the speaker believes his statement to be false." Id. at 701. The second exists when the statement "is made without any belief as to its truth, or with reckless disregard whether it be true or false." Id. The third is where the individual does not know if the fact asserted is
obtaining relief. With respect to private damage actions premised upon rule 10b-5, the United States Supreme Court, in the landmark case of Ernst & Ernst v. Hochfelder, recently held that scienter is a required element. The Court has not as yet determined, however, whether scienter must be established in suits brought by the SEC to enjoin violations of rule 10b-5.

This Note will examine the open question of a scienter requirement in 10b-5 injunctive actions. The Hochfelder decision will be analyzed, in an attempt to ascertain its impact upon the SEC injunction suit. Post-Hochfelder cases in which the federal courts have grappled with the problem whether scienter is a necessary element in a 10b-5 injunctive suit will then be examined. Finally, this Note will weigh the merits of imposing a scienter requirement and evaluate the effects that such a requirement might have upon the SEC fraud injunction action.

THE SEC INJUNCTION ACTION

Pursuant to section 20(b) of the Securities Act of 1933 and section 21(d) of the Securities Exchange Act of 1934, the SEC may commence an action to enjoin violations of the federal securities laws. Since the SEC's power to pursue a fraud injunction is conferred by statute, the Commission does not bear the same burden upon a defendant as it does in a civil damage action. Id. at 127. Prosser argued that the SEC's power to enjoin is derived not from the need to protect the plaintiff's interest, but from a broader mandate "to protect the public from the fraudulent practice." Id. at 128.

One commentator contended that the Hochfelder Court has read the common law fraud standard into § 10(b) actions. Haimoff, Holmes Looks at Hochfelder and 10b-5, 32 Bus. Law. 147, 148-49 (1976). Haimoff asserted that, in so doing, the Court has merely worked "a minor revision in the verbal formulation of the rules heretofore applied." Id. at 147. The author believed that, despite the difficulties in verbalizing the rule in the past, the standards prevailing prior to Hochfelder were in reality forms of common law deceit. Id. at 148. Therefore he concluded that the earlier standards very much resemble the one established by Hochfelder.

6 15 U.S.C. § 78u(d) (Supp. V 1975). The two sections which allow the SEC to seek injunctive relief are virtually identical. Section 21(d) provides:

Wherever it shall appear to the Commission that any person is engaged or is about to engage in any acts or practices constituting a violation of any provision of this chapter, [or] the rules or regulations thereunder . . . it may in its discretion bring an action . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. 15 U.S.C. § 78u(d) (Supp. V 1975).
as a private party seeking an injunction\(^9\) and thus need not establish irreparable harm\(^10\) or the absence of an adequate remedy at law\(^11\) to obtain injunctive relief. For an injunction to issue, it is sufficient that the SEC demonstrate that a ""person is engaged or about to engage in any acts, or practices which constitute or will constitute a violation’ of the” securities laws.\(^12\)

The SEC fraud injunction is not a sanction for a past violation of the federal securities laws;\(^13\) rather, it was created to enjoin ongoing and future violations.\(^14\) As a practical matter, however, the Commission encounters ongoing violations infrequently.\(^15\) More often, it is faced with a situation where a person allegedly has violated the anti-fraud statutes in the past,\(^16\) giving rise to the inference that he will do so in the future.\(^17\) Accordingly, a court considering an SEC request for an anti-fraud injunction usually must determine whether a past violation has occurred, and if so, whether there is a reasonable likelihood of recurrence.\(^18\) The presence or absence of scienter generally is considered in assessing whether a past violation has occurred,\(^19\) but an injunction may not be issued under the statute unless there is a likelihood of further infractions.\(^20\) As a result, the focal issue in an SEC fraud injunctive suit is whether, under all the circumstances, there is a reasonable likelihood of a future violation.\(^21\) The defendant’s past conduct is important in resolving this issue, however, since courts often view the nature and severity of a prior violation as probative of the possibility of recurrence.\(^22\)

\(^9\) 3 Loss, supra note 2, at 1979.
\(^10\) See SEC v. Torr, 87 F.2d 446, 450 (2d Cir. 1937).
\(^11\) See SEC v. Jones, 85 F.2d 17 (2d Cir.) (per curiam), cert. denied, 299 U.S. 581 (1936);
3 Loss, supra note 2, at 1979.
\(^12\) SEC v. Torr, 87 F.2d 446, 450 (2d Cir. 1937) (quoting Securities Act of 1933, § 20(b), 15 U.S.C. § 77t(b) (1970)).
\(^13\) See SEC v. Geon Indus., Inc., 531 F.2d 39, 56 (2d Cir. 1976).
\(^14\) See notes 8-12 and accompanying text supra.
\(^16\) Id.
\(^19\) See, e.g., SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1101-02 (2d Cir. 1972).
For some years the courts had indicated that scienter is not a required element in an SEC action to enjoin fraudulent conduct.\textsuperscript{23} This viewpoint was adopted by the Supreme Court in \textit{SEC v. Capital Gains Research Bureau, Inc.},\textsuperscript{24} wherein it was held that proof of scienter is not necessary in an SEC injunctive suit brought under the Investment Advisors Act of 1940.\textsuperscript{25} The \textit{Capital Gains} Court reasoned that the Act should be construed broadly and flexibly to promote its remedial purpose and concluded that requiring proof of scienter would run counter to this strong policy.\textsuperscript{26} In the course of its opinion the Supreme Court observed that "[i]t is not necessary in a suit [by the SEC] for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."\textsuperscript{27}

The reasoning of \textit{Capital Gains} was applied by the Seventh Circuit in \textit{SEC v. Van Horn}.\textsuperscript{28} There, the SEC sought injunctive relief pursuant to section 17(a) of the Securities Act of 1933,\textsuperscript{29} an anti-fraud provision which predates and was the source of much of rule 10b-5's language.\textsuperscript{30} In determining that scienter was not required for a section 17(a) injunction, the \textit{Van Horn} court reasoned


\textsuperscript{24} 375 U.S. 180 (1963).

\textsuperscript{25} In \textit{Capital Gains}, suit was brought pursuant to § 209(e) of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-9(e) (1970), a provision similar to § 20(b) of the Securities Act of 1933 and § 21(d) of the Securities Exchange Act of 1934, empowering the SEC to seek an injunction for violations of the Act. \textit{See note} 8 \textit{supra.} The SEC charged that the defendants had violated § 206 of the Investment Advisors Act, 15 U.S.C. § 80b-6 (1970), the language of which is similar to rule 10b-5:

\begin{quote}
It shall be unlawful for any investment advisor, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.
\end{quote}

\textit{Id.}

\textsuperscript{26} 375 U.S. at 195. Interestingly, the \textit{Capital Gains} Court expressly found the defendant's conduct to have been "purposeful." \textit{Id.} at 192 n.39.

\textsuperscript{27} \textit{Id.} at 193.

\textsuperscript{28} 371 F.2d 181 (7th Cir. 1966).


\textsuperscript{30} \textit{See} note 2 \textit{supra.}
that the Securities Act of 1933, like the Investment Advisors Act of 1940, was enacted to safeguard the investor. To further this purpose, the court held that it "is no defense to an action for an injunction . . . that the admittedly false statements were uttered without knowledge or that there was no intention to omit the disclosure of material facts."31

The Court of Appeals for the Second Circuit became the first tribunal to apply this analysis in an injunctive suit commenced under section 10(b) and rule 10b-5 in SEC v. Texas Gulf Sulphur Co.32 In that seminal case, the SEC sought injunctive relief against the Texas Gulf Sulphur Company and several of its directors, management personnel, and employees, alleging that the individual defendants had tipped and traded on material inside information,33 and that the company had issued a deceptive press release.34 Judge Waterman, writing for the majority, initially determined that the federal securities laws, in the context of an SEC enforcement proceeding, had modified the common law concept of fraud to include negligent activity by corporate insiders.35 Finding this to comport "with the administrative and the legislative purposes underlying"36 rule 10b-5, the court utilized a negligence standard in adjudging the liability of the individual defendants.37

In considering the corporation's liability for the deceptive press release, the Second Circuit noted:

Of even greater relevance to the Congressional purpose of investor protection is the fact that the investing public may be injured as much by one's misleading statement containing inaccuracies caused by negligence as by a misleading statement published intentionally to further a wrongful purpose.38

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31 Id. at 186.
33 See note 77 infra.
34 401 F.2d at 840-42.
35 Id. at 854-55.
37 401 F.2d at 856.
38 Id. at 860. The Texas Gulf Sulphur majority, in its treatment of the press release, greatly expanded the scope of the "in connection with the purchase or sale of any security" clause of rule 10b-5 and thus widened the scope of the rule itself. The Court found that the clause embraced any device "that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities." Id. In so holding, the Second Circuit reversed the finding of the district court that
Accordingly, the majority held that an injunction may be issued if the misleading statement was the result of a failure on the part of the defendant corporation to use due diligence in ascertaining the facts. In the Texas Gulf Sulphur opinion, Judge Waterman expressed approval of a negligence standard for private damage actions brought under section 10(b) and rule 10b-5. This position encountered resistance in the concurring opinions, which voiced concern about the possible adverse impact of a negligence standard upon the policy favoring full disclosure of relevant corporate developments. The view expressed in the concurring opinions prevailed, as subsequent case law in the Second Circuit created a distinction with respect to the standard of liability applied in SEC fraud injunctive suits and private damage actions. Some form of intent generally was deemed necessary to recover in a private cause of action for

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[In the absence of a showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders, the issuance of the press release did not constitute a violation of Section 10(b) or Rule 10b-5 since it was not issued "in connection with the purchase or sale of any security." 258 F. Supp. 262, 294 (S.D.N.Y. 1966) (quoting rule 10b-5, 17 C.F.R. § 240.10b-(5) (1976)), rev'd, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). The district court's interpretation of the clause was in accord with earlier authority. See, e.g., Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 345 U.S. 956 (1952). The view expressed by the Texas Gulf Sulphur majority would appear questionable in light of the Supreme Court's recent reaffirmance of the Birnbaum rule. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

21 Judge Waterman observed that "a similar standard has been adopted in private actions . . . for policy reasons which seem perfectly consistent with the broad Congressional design . . . ." 401 F.2d at 855.

22 The beneficial aspects of a negligence standard in private damage actions was disputed by Judge Friendly in his concurring opinion, id. at 864 (Friendly, J., concurring), on which point he was joined by Judges Kaufman, id. at 869 (Kaufman, J., concurring), and Anderson, id. (Anderson, J., concurring). Noting that "any remedy imposed against the issuer itself is indirectly imposed on all holders of the common stock" and that a negligence standard of liability would contravene the policy toward full disclosure of important developments affecting corporate business, id. at 867 (Friendly, J., concurring), Judge Friendly argued that the consequences of such a standard in private actions would be "frightening." Id. at 866 (Friendly, J., concurring).

damages based on section 10(b) and rule 10b-5. In contrast, courts within the circuit employed negligence as the standard in determining whether an injunction should be issued. The adoption of the negligence standard was premised on the SEC’s status as guardian of the public interest and the belief that an injunction is a mild sanction intended to be prophylactic rather than punitive in nature.

The dichotomy developed within the Second Circuit was not universally accepted by other circuits. While the federal courts were in general accord that negligence should be the standard in SEC injunctive suits, disagreement existed among the circuits as to whether intent or mere negligence was the appropriate standard in rule 10b-5 damage actions.

Often, however, the standard actually applied by a court appeared to differ from the standard expressly adopted by that court. For example, the circuits that had articulated a negligence standard for private damage actions generally denied recovery in the absence of a willful past violation. Thus, in most rule 10b-5 damage ac-

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15 See, e.g., SEC v. Management Dynamics, Inc., 515 F.2d 801, 808-09 (2d Cir. 1975).
16 See, e.g., SEC v. Dolnick, 501 F.2d 1279 (7th Cir. 1974); SEC v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972); SEC v. Pearson, 426 F.2d 1339 (10th Cir. 1970).
18 See, e.g., SEC v. Pearson, 426 F.2d 1339 (10th Cir. 1970). In contrast, that circuit required a showing of more than mere negligence in a private damage action. See, e.g., Clegg v. Conk, 507 F.2d 1351, 1361-62 (10th Cir. 1974), cert. denied, 422 U.S. 1007 (1975).
19 Several circuits required scienter in a private action based on rule 10b-5, see, e.g., Woodward v. Metro Bank, 522 F.2d 84, 93 (5th Cir. 1975) (scienter required), Clegg v. Conk, 507 F.2d 1351, 1361-62 (10th Cir. 1974) (“scienter or conscious fault”), cert. denied, 422 U.S. 1007 (1975), while others had indicated that negligence would suffice, see, e.g., White v. Abrams, 495 F.2d 724, 730-36 (9th Cir. 1974) (“flexible duty” standard), Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967) (negligence), cert. denied, 390 U.S. 951 (1968). In the Third Circuit, the standard was unclear. Compare Thomas v. Duralite Co., 524 F.2d 577, 583 (3d Cir. 1975), with Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir.), cert. denied, 409 U.S. 874 (1972). For further discussion of the standards used in the various circuits at this time, see Bucklo, supra note 5.
20 It was recognized in Bucklo, supra note 5, at 563, that many courts espousing negli-
tions, regardless of the purported state of mind requirement, it appears that the conduct of the defendant must have been the equivalent of actual fraud before liability for damages would ensue. 19 Even within the Second Circuit, courts faced with SEC injunctive suits, while claiming to apply a negligence standard, often made specific findings of willfulness in connection with the past violation before issuing an injunction. 50

This subtle displacement of the negligence standard in injunction actions, it is submitted, is related to the nature of the injunctive suit. 51 Since the issuance of an anti-fraud injunction is dependent

gence as the proper standard of liability refused to grant damages in the absence of proof of scienter. The author noted that "damage awards to private plaintiffs have been confined to cases where either knowing or reckless conduct was the cause of injury." Id. (footnote omitted).

19 As one circuit judge has observed: "[I]n every case where liability was found, conduct tantamount to actual fraud existed, despite the fact that the reviewing court may have used language broader than necessary." Kohn v. American Metal Climax, Inc., 458 F.2d 255, 286 (3d Cir.) (Adams, J., concurring in part and dissenting in part), cert. denied, 409 U.S. 874 (1972).

50 Immediately after Texas Gulf Sulphur, the Second Circuit purportedly utilized a negligence standard in SEC v. Great Am. Indus., Inc., 407 F.2d 453 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 920 (1969). Yet, in reversing the district court's denial of injunctive relief, the court stated that the activity of certain of these defendants "constituted common law fraud . . . and [as a result] the SEC was entitled to an injunction against them . . . ." 407 F.2d at 461 (emphasis added); cf. Bucklo, supra note 5, at 580-81 ("relaxation of the scienter requirement [for SEC injunctive suits] does not yet appear to have been necessary"). Thereafter, despite expressions of allegiance to the negligence standard, many decisions contained express findings of willful or reckless conduct. See, e.g., SEC v. Management Dynamics, Inc., 515 F.2d 801, 810 (2d Cir. 1975) ("high degree of carelessness in failing to comply with registration provisions"); SEC v. Shapiro, 494 F.2d 1301, 1308-09 (2d Cir. 1974) (finding of "driving cupidty and lack of principle and restraint"); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1100-03 (2d Cir. 1972) (the defendants' conduct was "willful, blatant, and often completely outrageous"); SEC v. North Am. Research & Dev. Corp., 424 F.2d 63, 80 (2d Cir. 1970) (recklessness). In other situations, the violations were at least arguably willful. See, e.g., SEC v. Geon Indus., Inc., 531 F.2d 39 (2d Cir. 1976); SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973); SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973). Conversely, where nonwillful violations were found, injunctions were often refused. See, e.g., SEC v. Bangor Punta Corp., 331 F. Supp. 1154 (S.D.N.Y. 1971), modified on other grounds sub. nom. Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 924 (1973); SEC v. Harwyn Indus. Corp., 326 F. Supp. 943 (S.D.N.Y. 1971).

The tendency of courts to withhold injunctions absent willful conduct was recognized by a noted commentator:

[A] survey of the cases would indicate that for the most part injunctive relief has not been granted without an indication by the Court that the past conduct was willful. Therefore, no matter what the articulated standard, Courts seem generally to search for willful conduct upon which to base an injunction.


51 See notes 7-22 and accompanying text supra.
upon the probability of a future infraction, courts look for strong proof of such likelihood. If it could be demonstrated that a past violation of the anti-fraud provisions had been willful, the possibility of a future violation would be enhanced. Consequently, despite the fact that negligence was the standard purportedly applied, the SEC’s ability to show willfulness in a past infringement of section 10(b) of the Securities Exchange Act of 1934 often was crucial to its success in obtaining an anti-fraud injunction.

THE IMPACT OF Hochfelder AND ITS PROGENY

Hochfelder

In Ernst & Ernst v. Hochfelder, private investors who had been swindled in a fraudulent scheme concocted by Leston Nay, the president of First Securities Company of Chicago, commenced an action against Ernst & Ernst, an accounting firm. For a period of twenty-four years, the plaintiffs placed funds in escrow accounts which Nay had represented as being capable of yielding a high return. In fact, money contributed to these accounts had been diverted to Nay’s own use. Following Nay’s suicide in 1968, the scheme was discovered and the suit against the defendant was commenced. The complaint alleged, inter alia, that Ernst & Ernst had negligently aided and abetted Nay’s violations of rule 10b-5 by failing to discover a company “mail rule” which prohibited the opening of Nay’s personal mail. The plaintiffs asserted that the defendant’s failure to list this “mail rule” in the annual audit as an irregular practice prevented an investigation of Nay which would have uncovered his fraudulent escrow scheme. The district court granted the defendant’s motion to dismiss for failure to state a claim. Finding that the defendant accounting firm had violated a statutory duty to investigate and disclose any material irregularities, the Seventh Circuit reversed the lower court’s decision and remanded the case for trial.

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52 See notes 15-22 and accompanying text supra.
54 425 U.S. 185 (1976), rev’g 503 F.2d 1100 (7th Cir. 1974).
55 425 U.S. at 189.
56 Id.
57 Id.
58 Id.
59 Id. at 190.
60 Id. at 191.
The Supreme Court, reasoning that the statutory language and legislative history of section 10(b) dictate that scienter be established in rule 10b-5 damage actions, reversed the Seventh Circuit and dismissed the complaint.\(^4^1\) The Hochfelder majority analyzed the language of section 10(b) and found that “[t]he words ‘manipulative or deceptive’ used in conjunction with ‘device or contrivance’ strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct.”\(^6^2\) The Court also reasoned that the statute’s use of the words “manipulative,” “device,” and “contrivance,” evinces “a congressional intent to proscribe a type of conduct quite different from negligence.”\(^6^3\) In rejecting the SEC’s suggestion, made in an amicus brief, that rule 10b-5 may be interpreted to proscribe negligent as well as intentional behavior, the Hochfelder Court noted that “such a reading cannot be harmonized with the administrative history of the Rule, a history making clear that when the Commission adopted the Rule it was intended to apply only to activities that involved scienter.”\(^6^4\) Moreover, the

\(^{4^1}\) 503 F.2d at 1119. The Seventh Circuit discussed at length the question whether Ernst & Ernst had breached the common law duty of inquiry. Pointing to the fact that the plaintiffs were not in privity of contract with the defendant, the court reasoned that the plaintiffs were precluded from basing their action on the agreement between the First Securities Company of Chicago and Ernst & Ernst. Id. at 1105. Furthermore, the court ruled that a common law negligence action was foreclosed because Ernst & Ernst could not have foreseen that it had owed a duty to the plaintiffs and because the plaintiffs had not relied on the financial data accumulated by the defendant. Id. at 1107. The court believed, however, that the plaintiffs had stated a claim by alleging that Ernst & Ernst’s negligence in failing to discover Nay’s “mail rule” had aided and abetted Nay’s violation of rule 10b-5. Id. at 1104.

\(^{4^2}\) 425 U.S. at 193.

\(^{4^3}\) Id. at 197. The Supreme Court’s reasoning that the language and history of § 10(b) require scienter is not novel. It often had been argued that the language of § 10(b) necessitates a showing of scienter in an action based upon that section. See, e.g., 3 Loss, supra note 2, at 1766. Consequently, some authorities feared that absent a scienter requirement, rule 10b-5 might be beyond the scope of § 10(b). See, e.g., Lanza v. Drexel & Co., 479 F.2d 1277, 1304-05 (2d Cir. 1973) (en banc); Kohn v. American Metal Climax, Inc., 458 F.2d 255, 280 (3d Cir.) (Adams, J., conccurring and dissenting), cert. denied, 409 U.S. 874 (1972); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 888 (2d Cir. 1968) (en banc) (Friendly, J., concurring), cert. denied, 394 U.S. 976 (1969); A. Jay, THE IMPACT OF RULE 10b-5 § 13 (rev. ed. 1976); 3 Loss, supra note 2, at 1766 (some “watered-down” scienter necessary).

In a leading case, Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc), the Second Circuit, in the context of a private damage action, noted that “the actual language of Section 10(b) bars adoption of a negligence standard.” Id. at 1305. Finding that the words “manipulative” and “deceptive” used in § 10(b) “negate liability for a mere negligent omission or misrepresentation,” id., the Second Circuit concluded “that proof of a willful or reckless disregard for the truth is necessary to establish liability [in a damage suit] under Rule 10b-5.” Id. at 1306 (footnote omitted). The Sixth Circuit in SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975), found that the analysis in Lanza dictated a scienter requirement in SEC injunctive suits premised on 10b-5. 493 F.2d at 1314.

\(^{4^4}\) 425 U.S. at 199 (footnote omitted).
Court emphasized that the scope of the rule may not exceed the authority granted the Commission by section 10(b).65

The Supreme Court limited its decision to civil damage actions premised on rule 10b-5, expressly refusing to address the issue whether scienter is a required element in an injunction action under section 10(b) and rule 10b-5.66 Thus, the question remains whether the Court will uphold the distinction drawn by at least two circuits between the state of mind required for a private damage suit and that which must be shown in an SEC fraud injunction action.67 Nonetheless, it may be contended that the Supreme Court’s analysis of the language and history of section 10(b) with respect to rule 10b-5 damage actions readily is applicable to SEC enforcement actions involving the same statute.68 As Justice Blackmun observed in his Hochfelder dissent, the meaning of the language contained in section 10(b) should not be capable of a different interpretation merely because the identity of the plaintiff is different.69

As previously indicated, prior to Hochfelder many courts voiced support for a negligence standard in SEC enforcement actions.70 These decisions often were founded on policy considerations;71 the

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65 Id. at 212 (footnote omitted).
66 Id. at 193 n.12.
67 See notes 42 & 46 supra.
68 Prior to the burgeoning of the different standards for private actions and SEC suits, Justice Harlan had noted that “both private and public actions arise under the same Rule, and the legal problems involved in the two situations, while not identical, are closely related.” SEC v. National Sec., Inc., 393 U.S. 453, 471 n.4 (1969) (Harlan, J., concurring in part and dissenting in part).
69 Two commentators recently have argued that by grounding its decision on the language of § 10(b) the Supreme Court in Hochfelder left no basis for the lower federal courts to differentiate the SEC from a private plaintiff. Berner & Franklin, Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder, 51 N.Y.U. L. Rev. 769, 778 (1976) [hereinafter cited as Berner & Franklin]. The authors contend that the Hochfelder Court’s refusal to found its opinion on narrower grounds reinforces the idea that the decision’s reasoning applies when the Commission is the plaintiff in a rule 10b-5 action. Id. at 778-81.
70 425 U.S. at 215-18. (Blackmun, J., dissenting). While noting the “technical consistency” of the Hochfelder majority, Justice Blackmun, joined by Justice Brennan, expressed concern that “an investor can be victimized just as much by negligent conduct as by positive deception.” Id. at 216. Therefore, he felt it was illogical to say “that Congress clearly intended [to prevent] the one but certainly not the other.” Id. Pointing to the use of a negligence standard in SEC injunctive suits brought in the Second Circuit, the dissenters concluded that “[i]f negligence is a violation factor when the SEC sues, it must be a violation factor when a private party sues.” Id. at 217-18.
72 The courts have emphasized the status of the SEC as guardian of the individual
courts made little attempt to refute the argument urging application of a uniform standard in all rule 10b-5 actions. But the Hochfelder Court found the language and legislative history of section 10(b) dispositive and refused to entertain any policy arguments. Although the reasoning of the cases applying a negligence standard in injunction actions is thus inconsistent with Hochfelder, the Supreme Court's express reservation of the issue leaves the federal courts free to distinguish between rule 10b-5 damage actions and SEC injunctive suits in fashioning scienter requirements. There appears to be little doubt, however, that Hochfelder places added pressure on courts maintaining this distinction to justify the logical inconsistency inherent in it.

The Post-Hochfelder Cases

Shortly after Hochfelder was decided, the District Court for the Southern District of New York, confronted with an SEC enforcement action, was called upon to determine whether the Commission must establish scienter to obtain injunctive relief. In SEC v. Bausch & Lomb, Inc., the SEC alleged that Bausch & Lomb and its chief executive officer, Daniel Schuman, had violated rule 10b-5. Schuman, having received information of a rumor that he had released an earnings figure of $.60 to a financial analyst named MacCallum, immediately telephoned MacCallum to inform him that this figure was too "low and that $.70 to $.80 per share was more like it." A second telephone call was thereafter made by Schuman to MacCallum revising Schuman's previous estimate to between $.65 and $.75

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72 425 U.S. at 214 n.33.

73 Recently, in Santa Fe Indus. v. Green, 97 S. Ct. 1292 (1977), the Supreme Court has reaffirmed the principle announced in Hochfelder that in deciding whether a complaint states a cause of action for "fraud" under Rule 10b-5, "we turn first to the language of § 10(b) . . . ." In holding that a cause of action under Rule 10b-5 does not lie for mere negligence, the Hochfelder Court began with the principle that "[a]scertainment of congressional intent with respect to the standard of liability created by a particular section of the [1933 and 1934] acts must . . . rest primarily on the language of that section . . . ." The same language and the same principle apply to this case.

Id. at 1300.


75 Id. at 1238.
Upon realizing his mistake in releasing these figures, Schuman furnished the correct earnings figure to the *Wall Street Journal* for publication. The SEC alleged\(^7\) that these disclosures constituted the revelation of material, non-public information.\(^7\)

Although it agreed with the SEC's allegation, the district court refused to grant the injunction. Among the grounds for the refusal was the court's belief that *Hochfelder* must be interpreted to require proof of scienter in a rule 10b-5 injunctive suit brought by the SEC.\(^8\) Judge Ward noted that the *Hochfelder* Court had disregarded "policy" arguments since it had found "the language and history of § 10(b) dispositive."\(^7\) Thus, because the SEC did not establish that Schuman had acted with the requisite intent, the injunction was denied.\(^8\)

\(^7\) *Id.* at 1238. The SEC's complaint also accused Schuman of making improper disclosures, in violation of rule 10b-5, during personal interviews with financial analysts on March 15, 1972. The SEC claimed that in those interviews Schuman had improperly revealed earnings estimates for 1972 and other information concerning the introduction of two new products during the same year. As to these initial disclosures, the court felt that the evidence as to "the revelation of earnings estimates by Schuman . . . [was] not convincing," and that "the materiality of the time of introduction of the two products . . . [had] not been established." *Id.* The SEC further alleged that Schuman transgressed rule 10b-5 in a March 16, 1972 interview with another financial analyst, David MacCallum, in which Schuman made disclosures substantially similar to those made in his March 15th interviews. The court held that the existence of improper revelations and the materiality of any disclosures that may have been made had not been established by the SEC. *Id.* at 1236-37.

\(^8\) *Id.*. A material fact has been defined in one area of the securities laws as "an omitted fact . . . [where] there is a substantial likelihood that a reasonable shareholder would consider it important . . . ." *TSC Indus.*, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (discussing § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1970)). Similar standards have been used for determining materiality under section 10(b). *See* *SEC v. Geon Indus.*, Inc., 531 F.2d 39, 47 (2d Cir. 1976); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). In *Bausch & Lomb*, Judge Ward found that "an estimate of earnings is among the most material of all conceivable revelations." 420 F. Supp. at 1238 (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969)).

\(^9\) 420 F. Supp. at 1240. Judge Ward believed that prior law in the Second Circuit regarding the definition of scienter was still valid. 420 F. Supp. at 1242 n.4. The judge thus employed as a standard of liability "the kind of recklessness that is equivalent to wilful fraud." *Id.* at 1243 n.4 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (en banc) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969)). However stated, this standard would appear to best balance the competing interests of the individual investor and the corporate defendant. *See* Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213, 228-40 (1977). Cf. 25 EMORY L.J. 465, 476 (1976), in which it is argued that a "gross negligence" standard would best weigh "the investor's need to recover" and "the securities industry's need to leave 'breathing room' for honest errors of judgment . . . . ."

\(^10\) *Id.* at 1241 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 215 n.33 (1976)).
A district court in the Eastern District of Virginia found the Bausch & Lomb reasoning persuasive and held, in SEC v. American Realty Trust,\textsuperscript{51} that scienter must be shown by the SEC in an injunctive suit brought under sections 17(a) and 10(b). In that case, Chief Judge Kellam observed that the decision in Hochfelder was premised upon the language and history of section 10(b).\textsuperscript{82} Since SEC injunctive suits are "creatures of statute rather than implied rights of action," the chief judge reasoned, the Hochfelder rationale must be applicable in those actions.\textsuperscript{83} The court went on to observe:

Only policy considerations which have traditionally been applied to distinguish the two types of cases . . . could support a contrary result, but the Supreme Court in Hochfelder found no reason to even examine such considerations, since in its opinion the language and history of [section 10(b)] were dispositive. The District Court in SEC v. Bausch & Lomb, Inc. . . . so reasoned when it held that scienter is a necessary element in an action for injunctive relief under Section 10(b) and Rule 10b-5 of the Securities and Exchange Act.\textsuperscript{84}

The American Realty Trust court recognized that section 17(a) contains language almost identical to that in section 10(b), a fact which was conceded by the SEC.\textsuperscript{85} Accordingly, the court concluded that scienter is also an element of an injunction action based upon section 17(a).\textsuperscript{86} Shortly after American Realty Trust, a district court, in SEC v. Cenco, Inc.,\textsuperscript{87} denied the SEC an injunction due to the absence of willful or reckless conduct on the part of the defendants.\textsuperscript{88} In so ruling, the Cenco court expressly followed the holding of Bausch & Lomb.\textsuperscript{89}

For the most part, however, the Bausch & Lomb reasoning has not been adopted in subsequent decisions. The Court of Appeals for violation, the court realized that the issuance of an injunction largely depends on the likelihood of a future violation. Assuming that a past violation had occurred, Judge Ward stated, the SEC had failed to impress the court as to the likelihood of such a recurrence. \textit{Id.} at 1244.

\textsuperscript{82} \textit{Id.} at 91,439-40.
\textsuperscript{83} \textit{Id.} at 91,440.
\textsuperscript{84} \textit{Id.} (citations and footnote omitted).
\textsuperscript{85} \textit{Id.}
\textsuperscript{86} \textit{Id.}
\textsuperscript{88} \textit{Id.}
\textsuperscript{89} \textit{Id.} Judge Crowley felt that reckless conduct would be sufficient to satisfy the scienter requirement. \textit{Id.} at 92,100.
the First Circuit, in SEC v. World Radio Mission, Inc.,\(^{90}\) ordered the issuance of a preliminary injunction against a religious organization and its leader to prevent violations of section 17(a) of the Securities Act of 1933 and rule 10b-5.\(^{91}\) The defendant, a worldwide evangelical organization, was constructing a housing development for its members in Lancaster, New Hampshire. To finance this project, the defendant established two investment programs which involved the sale of interest-bearing notes. Satisfied that these loan plans were within the purview of the securities acts, Judge Aldrich, writing for a unanimous panel, found that the defendant had employed a false and misleading advertising campaign which failed to disclose a substantially increasing operating deficit and thereby had violated the federal anti-fraud statutes.\(^{92}\) In reaching its decision, the court stated that in an SEC enforcement action as long as conduct was "injurious to the public, good faith, however much it may be a defense to a private suit for past actions . . . should make no difference."\(^{93}\) The First Circuit dismissed the contention that Hochfelder mandates a showing of scienter in an SEC injunction action brought under section 17(a), reasoning that section 17(a) was not affected by the ruling in Hochfelder.\(^{94}\) Although the World Radio Mission court did not reach the issue whether intent must be proven in an action

\(^{90}\) 544 F.2d 535 (1st Cir. 1976).

\(^{91}\) Id. at 543.

\(^{92}\) Id. at 539-40.

\(^{93}\) Id. at 540 (citations omitted). The court recognized that prior to Hochfelder the Second Circuit had distinguished between the state of mind requirement in private damage actions and those in SEC enforcement proceedings predicated on § 10(b). Accordingly, the court implied that despite Hochfelder it would adhere to a negligence standard for SEC injunctive suits based on rule 10b-5. Id. at 540-41; see note 95 infra. Nevertheless, the First Circuit questioned the good faith of the World Radio Mission defendants, observing that it was "difficult to think they believed that everything they said was accurate." 544 F.2d at 540. More importantly, the court noted that "their demonstrated intent to continue evidences, at the least, an intent to do what they now know a federal court, as well as the SEC, has found deceptive." Id. at 541 (footnote omitted).

\(^{94}\) Id. at 541 n.10. The defendants had argued that since the language of § 17(a) and rule 10b-5 is virtually the same, Hochfelder requires that intent must be read into § 17(a). Id. The First Circuit stated that Hochfelder had determined that the language of 10b-5 did not itself require scienter but rather that, absent intent, the rule would surpass the authority allowed the SEC by § 10(b). Reasoning that this problem did not arise with § 17(a), which is a congressional enactment rather than a Commission rule, the court dismissed the defendants' contention as a "non sequitur." Id.

The SEC has also observed that § 17(a) is seemingly immunized from the application of the Hochfelder logic, as that section does not contain language implying a need for scienter. See SEC General Counsel's Memorandum Regarding Ernst & Ernst v. Hochfelder, reprinted in SEC. REG. & L. REP. (BNA) No. 354, at F-1 (May 26, 1976). For this reason, the general counsel of the SEC has recommended that allegations of § 17(a) violations be included in SEC injunctive complaints whenever possible. Id. at F-3.
based solely on rule 10b-5, it intimated that scienter need not be established in such a suit.\textsuperscript{55}

In \textit{SEC v. Geotek},\textsuperscript{93} however, the district court for the Northern District of California expressly rejected a scienter requirement in rule 10b-5 injunctive suits. Jack Burke, a defendant in \textit{Geotek}, had managed the JB and Geotek oil exploration operations.\textsuperscript{97} In a 1972 affidavit filed with the SEC, Burke failed to disclose all his prior involvements in the oil and gas business.\textsuperscript{98} The most notable omission was his connection with four companies which he secretly had established and with which his exploration programs previously had dealt.\textsuperscript{99} As a result, the SEC sought an injunction based on section 10(b) and section 17(a),\textsuperscript{100} alleging that material misstatements and omissions had been made in the "basic documents"\textsuperscript{101} of the programs by Jack Burke and other individuals in several companies under his control. The SEC also named Arthur Young & Company, a certified public accounting firm, and four of its accountants as defendants, asserting that they had aided and abetted the illegal activity.\textsuperscript{102}

In determining the standard for adjudging whether a violation had occurred, Judge Sweigert reiterated the belief of the First Circuit, expressed in \textit{World Radio Mission}, that the \textit{Hochfelder} analysis did not apply to the language of section 17(a).\textsuperscript{103} Thus, the

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\textsuperscript{55} In regard to \textit{Hochfelder}'s effect on SEC injunctive actions, Judge Aldrich stated in a footnote that the First Circuit felt it "implausible to suppose that Congress intended to provide a mechanism for the SEC to protect the public from the injurious schemes of those of evil intent and yet leave the public prey to the same conduct perpetrated by the careless or reckless." \textit{SEC v. World Radio Mission, Inc.}, 544 F.2d 535, 541 n.10 (1st Cir. 1976).

\textsuperscript{93} \textit{Id.}\textsuperscript{93} at 90,720.

\textsuperscript{94} \textit{Id.}\textsuperscript{94} at 90,721.

\textsuperscript{97} Since the JB programs had not been registered with the SEC, the Commission's suit against the defendants connected with those programs was predicated solely on §§ 10(b) and 17(a). \textit{Id.}\textsuperscript{97} at 90,723; see note 2 supra. Because the Geotek programs had been registered, the SEC's action against those defendants was premised upon these general anti-fraud provisions and, in addition, §§ 13(a) and 15(d) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78n(a), 78o(d) (1970), which deal with proxy solicitations and yearly statements for registered security issuers. \textit{See SEC v. Geotek}, [1976-1977 Transfer Binder] \textit{Fed. Sec. L. Rep. (CCH)} \textsuperscript{100} 95,756, at 90,723 (N.D. Cal. 1976).

\textsuperscript{98} The "basic documents" of the JB exploration programs were "the JB Offering Circulars and Oil Exploration Program Agreements." \textit{Id.}\textsuperscript{98} at 90,723 n.6. As for the Geotek operations, the "basic documents" included "the Prospectuses, Limited Partnership Agreements, and Management Agreements." \textit{Id.}\textsuperscript{102}

\textsuperscript{99} \textit{Id.}\textsuperscript{99} at 90,722.

\textsuperscript{100} \textit{Id.}\textsuperscript{100} at 90,724.
Geotek court followed the course traveled in World Radio Mission and utilized a negligence standard in an injunction action based on section 17(a). Unlike the World Radio Mission court, however, Judge Sweigert found the negligence standard applicable to all the SEC's allegations, including those based solely upon rule 10b-5. Interestingly enough, in granting injunctions against some of the "Jack Burke" defendants, the court observed:

With respect to the several charges as to which the Court has found against the Jack Burke defendants, the Court has . . . found that the misrepresentations and/or omissions were made by those defendants, not merely negligently due to their failure to use ordinary care, but deliberately and with intent to deceive—i.e., "scienter" within the meaning of Ernst & Ernst v. Hochfelder. . . .

Finding that no violation had been committed by Arthur Young and its individual accountants, and observing that their conduct would have merited immediate dismissal of the case had scienter been the standard of liability, Judge Sweigert refused to issue an injunction against them. In addition, the court recognized that Arthur Young had conducted its activity with "good faith and judgment." Thus, despite Judge Sweigert's acceptance of negligence as the proper standard of liability, the existence of scienter on the part of certain defendants appears to have influenced his decision.

Recent decisions of the Court of Appeals for the Second Circuit would appear to indicate that a negligence standard will continue to be used by that circuit in SEC enforcement actions. In Arthur Lipper v. SEC, the Second Circuit modified an SEC disciplinary order revoking the broker-dealer registration of the defendants for violations of rule 10b-5. Due to the punitive nature of SEC disciplinary proceedings, the court reasoned, the Hochfelder scienter standard was applicable in those proceedings. In likening SEC

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104 Id.
105 Id.
106 Id. at 90,726.
107 Id.
108 Id. at 90,727. Judge Sweigert found "not a scintilla of evidence that anything was misstated or omitted by [Arthur Young] in its audit report certifications consciously, intentionally or with fraudulent purpose to deceive either investors, the SEC or anyone else."
109 Id. (emphasis added).
110 Id.
112 Id. at 90,868 n.6.
disciplinary proceedings to private damage actions, the Second Circuit explained that both of these actions were distinguishable from SEC fraud injunctive suits. The court intimated that since SEC fraud injunctive actions are prophylactic rather than punitive in nature, the Hochfelder standard did not apply in such actions.

The continuation of the Second Circuit's distinction between rule 10b-5 damage actions and SEC fraud injunctive suits for purposes of a scienter requirement is more clearly evidenced by its decision in SEC v. Universal Major Industries. There, the Second Circuit affirmed the issuance of an injunction against an attorney for aiding and abetting violations of section 5 of the Securities Act of 1933. The court rejected the appellant's principal argument that Hochfelder mandates scienter be proven to establish a violation of section 5. In reaffirming its position that "in SEC proceedings seeking equitable relief, a cause of action may be predicated upon negligence alone, and scienter is not required," the Second Circuit emphasized that "Hochfelder . . . does not undermine our prior holdings."

Thus, it seems that the Bausch & Lomb court's extension of the Hochfelder reasoning to require scienter in an SEC injunction action represents a minority position. Other federal courts appear to disagree with the Bausch & Lomb decision, indicating a belief that the policies underlying the SEC enforcement action override the reasoning in Hochfelder. As a result, it appears that many federal courts will utilize the pre-Hochfelder negligence standard in ascer-
taining whether a violation of section 10(b) has occurred in an SEC injunctive suit. It is notable, however, that in employing the negligence standard, at least one court has demonstrated an inclination to follow the pre-Hochfelder practice of denying an injunction unless the likelihood of future violations is supported by evidence of a willful past infraction.\textsuperscript{121}

AN ALTERNATIVE TO THE NEGLIGENCE STANDARD

The Need for Guidelines

If, as is indicated by the decisions subsequent to Hochfelder, the courts adhere to a negligence standard in rule 10b-5 injunctive suits, the establishment of guidelines for corporate insider conduct would be highly desirable. A corporate official is faced with the responsibility of making numerous decisions. Among the most difficult are determinations as to whether to release important information to the public and as to what particular moment is best to make the information known. These decisions are complicated by the fact that the subject of the pertinent information often may be in an executory stage. Many times, it is impossible to ascertain the proper time to release information regarding such vulnerable transactions as the progress of merger negotiations, the development of a new product, or the discovery of a new mineral strike.\textsuperscript{122} Despite the good faith of the corporate official at the time the decision was made, an unfavorable change in circumstances may result in subsequent litigation.

The fact that SEC-instituted injunction proceedings may ensue if conduct performed in good faith later appears to have been unreasonable illustrates the need for adequate guidelines for such conduct.\textsuperscript{123} Appropriate directives would permit corporate officials to pursue a course of conduct without fear of liability.\textsuperscript{124} The promulgation...
tion of such guidelines by the Commission would mitigate some of the injustice occasioned by the continued use of a negligence standard in injunction actions.

The Policy Aspects: Negligence v. Scienter in SEC Fraud Injunction Actions

Even if guidelines are promulgated, implementation of the negligence standard in SEC injunctive suits based on sections 10(b) and 17(a) may well be unworkable. The primary motivation for applying a negligence standard in SEC injunction actions lies in the widely held view that the SEC is the "statutory guardian" of the public interest.\textsuperscript{125} Since the public may be injured as much by a negligent violation of the securities laws as by an intentional transgression,\textsuperscript{126} and because the injunction is remedial rather than retributive in nature,\textsuperscript{127} the argument for a negligence standard has been persuasive.\textsuperscript{128} Recognizing that a negligence standard may result in prejudice to the defendant, its advocates have argued that any such unfairness will be weighed by the court in the exercise of its equitable discretion to issue the injunction.\textsuperscript{129} A negligence standard of liability, therefore, has been advanced as being best capable of insulating the public investor from mismanagement in the financial sphere.\textsuperscript{130}

The advocates of a negligence standard, however, consistently have failed to recognize the punitive aspects of the SEC fraud injunction. An order enjoining fraud results in a certain amount of embarrassment to the defendant that may have an adverse effect

the subject through a case-by-case method. Ruder, supra at 191-214.

In January 1976, the SEC organized an advisory committee to study the entire SEC disclosure system. See Sommer, Disclosure Committee Sifting Many Sources for Its Final Report, N.Y.L.J., Dec. 13, 1976, at 36, col. 1, at col. 2. It is hoped that in the course of its study the SEC Advisory Committee on Corporate Disclosure will formulate concrete guidelines concerning what information should be disclosed and at what point it should be revealed. See generally Kripke, An Unusual Opportunity for Rethinking Concepts on a Fundamental Level, N.Y.L.J., Dec. 13, 1976, at 27, col. 2, at 35, cols. 3-5.

\textsuperscript{125} See, e.g., SEC v. Management Dynamics, Inc., 515 F.2d 801, 808-09 (2d Cir. 1975).

\textsuperscript{126} See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 216 (1976) (Blackmun, J., dissenting).


\textsuperscript{130} See Note, Scienter and Rule 10b-5, 69 COLUM. L. REV. 1057, 1076 (1969).
on his reputation and ability to thrive in the financial community. Additionally, a fraud injunction may lead to corollary sanctions for both individual and corporate defendants. For an individual defendant, these corollary sanctions may include disqualification from professional practice before the SEC, suspension or revocation of broker-dealer registration, civil and criminal contempt proceedings in the event of a future violation, and certain disqualifications under the Securities Act of 1933 and the Investment Advisors Act of 1940. With respect to a corporate defendant, the remedies which may accompany an injunction include disgorgement of profits, imposition of special corporate procedures, and appointment of a receiver, special counsel, or interim director to bring the corporation into compliance with the securities laws. The severity of these remedies supports the view that they should only be implemented where there exists a willful violation of the anti-fraud provisions of the federal securities laws.

In addition to the damage inflicted by the issuance of the injunction, the mere filing of a suit by the Commission may have a deleterious effect on the defendant. SEC investigations and suits can last for several years, during which time the individual and company sued must do business under the accusation of fraudulent conduct. As a matter of course, this can have a detrimental effect

131 See Lipton, 'Bausch & Lomb' and Securities Analysts, N.Y.L.J., Sept. 23, 1976. at 1, cols. 2-3. Courts are beginning to focus more on the adverse impact that an injunction may have upon activities of the defendant. See, e.g., SEC v. Petrofunds, Inc., 414 F. Supp. 1191, 1198 (S.D.N.Y. 1976) (noted "harmful impact of a receiver and an injunction on the legitimate activities of the defendants").

132 See SEC Rule of Practice 2(e), 17 C.F.R. § 201.2(e) (1977).


135 Berner & Franklin, supra note 68, at 785-86.


140 Id. at 1204-07.

141 One author has stated: "An SEC injunction can be very serious: it must be reported on government forms, and it can destroy a business . . . ." 25 EMORY L.J. 465, 473 (1976). Other commentators have argued that an SEC fraud injunction does more harm to a professional's business and reputation than a money judgment in a private damage action. Mathews, Liabilities of Lawyers Under the Federal Securities Laws, 30 BUS. LAW. 105, 106 (1975); Berner & Franklin, supra note 68, at 785-86.

SEC INJUNCTIVE SUITS

on business, reputation, and stock prices. Consequently, upon commencement of an SEC fraud suit, the defendant often enters into a consent decree. Moreover, the legal costs of defending against an SEC fraud suit are usually exorbitant. This fact was strikingly exemplified in Geotek, where Arthur Young & Company incurred legal costs of one million dollars and was exonerated from liability. The possibility that these burdens will be placed upon a defendant solely because he may have negligently transgressed rule 10b-5 highlights the unfairness of employing a negligence standard to determine the existence of a past violation. In fact, the refusal of some courts to issue an injunction solely upon the basis of a past negligent violation may stem from an awareness of the injustice of the negligence standard.

Beyond the unfairness of the negligence standard, it may be argued that negligent violations of the securities laws are incapable of being controlled by injunction. In most instances, the “SEC fraud injunction restrains the defendant from making any untrue statement of a material fact concerning a number of specific matters.” It is submitted, however, that an injunction is no more effective in preventing future negligent misstatements than an injunction seek-

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143 Lipton, ‘Bausch & Lomb’ and Securities Analysts, N.Y.L.J., Sept. 23, 1976, at 1, col. 2, at col. 3. The consent decree is widely-used by the government in regulating particular activities most notably in the securities and antitrust fields. See 1 T. Lindstrom & K. Tighe, Antitrust Consent Decrees ix (1974). The feature of a consent decree most advantageous to the defendant is that it implies no admission of an infringement of the law. Id. On the other hand, the government is given the right to inspect books and closely regulate compliance with the terms of the decree. Id. at x.


146 See note 50 supra.

147 The plight of defendant Schuman in Bausch & Lomb graphically points up the unfairness of a negligence standard, particularly in the absence of specific guidelines. In the Bausch & Lomb opinion Judge Ward highlighted various statements by past and present SEC officials indicating the desirability of frequent and topical discussions between corporate officials and financial analysts. See SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226, 1231-32 n.1 (S.D.N.Y. 1976). In the event that extraordinary information is inadvertently released in the midst of these interviews, the commissioners advocated the immediate publication of this information. Id. These statements appear specifically to cover the situation in which Mr. Schuman found himself enmeshed. In the course of a conversation with a financial analyst, he inadvertently mentioned Bausch & Lomb’s earnings figures. Id. at 1238. His reaction was to publish the information. 420 F. Supp. at 1238. Yet, several years later, Mr. Schuman was a defendant in an SEC injunctive suit which alleged that his actions were fraudulent. See also Lipton, ‘Bausch & Lomb’ and Securities Analysts, N.Y.L.J., Sept. 23, 1976, at 1, col. 2-4.

148 3 Loss, supra note 2, at 1978.
ing to restrain negligence on the highways. Moreover, since an anti-fraud injunction premised upon negligent conduct may be so easily undermined by an unintentional act, the issuance of such injunctions might tend to erode judicial authority.

It appears that the imposition of a scienter requirement would not bring about a relaxation of individual and corporate diligence. Individuals and entities in the financial sphere have a significant number of reasons to avoid inflicting negligent damage on investors, including the desire to insulate themselves from multi-million dollar common law negligence actions and the need to protect their reputations. The application of a scienter standard of liability to all rule 10b-5 suits also would provide greater freedom of action to the financial community. The absence of injunctive liability for unintentional and nonreckless acts would encourage members of the financial world to disclose important information to the public—information that may now be withheld due to a fear of liability.

118 See note 118 supra.

155 An injunction usually is enforced by resort to contempt proceedings. It has been indicated that the state of mind required to sustain a contempt citation is no greater than that required to prove the initial violation of the statute. See United States v. Hill, 298 F. Supp. 1221, 1236 (D. Conn. 1969). Therefore, use of a negligence standard in an injunction action could result in the issuance of a contempt citation founded on mere negligence. See SEC v. Universal Major Indus., Inc., 546 F.2d 1044, 1047 n.1 (2d Cir. 1976) (argument of the defendant).


152 See Lipton, 'Bausch & Lomb' and Securities Analysts, N.Y.L.J., Sept. 23, 1976, at 1, col. 2, at 4, col. 3. A major argument against a negligence standard for SEC fraud injunctive suits is that the risk of liability is too great. This expansive liability is likely to produce a fear of numerous suits, culminating in a severe reduction in the availability of financial information. As Judge Moore stated in Texas Gulf Sulphur: "If press releases have to read like prospectuses to guard against possible 10b-5 liability, it is safe to predict that they will quickly fall out of favor with corporate management." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 882 (2d Cir. 1968) (en banc) (Moore, J., dissenting), cert. denied, 394 U.S. 976 (1969). See also Symposium, Insider Trading in Stocks, 21 Bus. Law. 1009, 1012 (1966) (remarks of Professor Cary); Note, Scienter and Rule 10b-5, 69 COLUM. L. REV. 1057, 1076 (1969). It is hoped that a scienter requirement would constrict the imposition of liability, reduce the fear of suit, and result in the release of more information.

153 Lipton, 'Bausch & Lomb' and Securities Analysts, N.Y.L.J., Sept. 23, 1976, at 4, col. 1. Interestingly, it has been argued that the language of § 17(a) also requires a showing of scienter. Berner & Franklin, supra note 68, at 796 n.221.

This view, however, has not been accepted by the courts. See, e.g., SEC v. World Radio Mission, Inc., 544 F.2d 535, 541 n.10 (1st Cir. 1976). Despite the disinclination of the courts to accept the argument that a literal reading of § 17(a) dictates that scienter be established in an action under that section, the arguments in favor of a scienter standard in 10b-5 actions apply with equal force to suits brought under § 17(a). Requiring scienter in actions based on
The Practical Effect of a Scienter Requirement on SEC Fraud Injunctive Suits

The circumstances under which injunctive relief is sought by the SEC may be reduced to the following general factual settings: (1) the discovery of a single past violation; (2) the uncovering of a series of distinct infringements; (3) the detection of an ongoing infraction. An analysis of the impact of a scienter requirement in each of these situations will serve to illustrate that a scienter standard would not create any hardship for the SEC in its role as the public guardian.

Requiring proof of scienter in an action based on a single past violation would impose no new disability upon the SEC since courts usually have denied injunctions in the absence of a willful past violation. Thus, requiring the SEC to plead and prove scienter in such a situation would merely serve to prevent the waste and unfairness of an unsuccessful suit.

Imposition of a scienter requirement in an action based on a series of distinct infringements poses a more difficult problem. Even if the repeated actions are capable of being characterized as negligent, the defendant's frequent injury to innocent individuals argues in favor of issuing an injunction. The possibility of a future infraction certainly is present. The issuance of an injunction in the face of a series of negligent transgressions, however, may be justified under a scienter standard. Since the defendant has repeatedly harmed the public investor, it is submitted that he has manifested that lack of care and recklessness that many courts have held to be tantamount to intent. Moreover, the arguments of unfairness to

§ 17(a) would prevent an illogical distinction from being made between the scienter standards of § 10(b), which applies to fraud in both purchase and sale situations, and § 17(a), which applies only to fraud occurring in connection with a sale. See note 2 supra. Such a dichotomy would arise if the SEC, pursuant to the reasoning in Hochfelder, is required to prove scienter in § 10(b) injunctive actions but not in § 17(a) injunctive suits.


Even some of those who advocate the adoption of a negligence standard in SEC fraud actions have recognized the potential unfairness of a fraud injunction based merely on a single negligent "violation." See Note, Scienter and Rule 10b-5, 69 COLUM. L. REV. 1057, 1076 (1969); 82 HARV. L. REV. 938, 947 (1969).

The idea that repeated infractions lead to the inference of purposeful conduct was recognized by Judge Moore in his Texas Gulf Sulphur dissent. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 886 (2d Cir. 1968) (en banc) (Moore, J., dissenting), cert. denied, 394 U.S. 976 (1969).
the defendant are not as strong in the face of repeated injury to the
public, reinforcing the propriety of issuing an anti-fraud injunction
under such circumstances.

The situation involving a continuing infraction more readily
comports with a scienter standard. Since the alleged violation is
ongoing, the SEC would move instantly to force its cessation. Nor-
maally, the activity would be discontinued upon receipt of a warning
from the Commission. Under these circumstances, even if the re-
cipient believed the notice to be unwarranted, the continuance of
the activity while awaiting judicial resolution of the question
whether the acts violated the law could hardly be characterized as
negligent. Additionally, the unfairness of an SEC action based
solely on negligence would be lacking since the defendant would
have brought the suit upon himself by continuing the practice. An
injunction against such an individual would not only be just and
effective, but necessary.

CONCLUSION

Prior to the Supreme Court decision in Hochfelder, the federal
courts were reluctant to issue an SEC injunction based solely upon
negligent conduct. This attitude appears to have survived the
Hochfelder decision prompting courts to make findings of willful-
ness before issuing an injunction. In view of this tendency, appli-
cation of Hochfelder's construction of section 10(b) and rule 10b-5
to SEC fraud injunction suits apparently would not alter the ulti-
mate outcome reached in such actions.

Admittedly, strong policy considerations, particularly the
SEC's status as public guardian, weigh heavily in favor of a negli-
gence standard. The significance of these considerations, however,
is tempered by certain countervailing factors. Since the adoption of
a scienter standard apparently would cause little, if any, difference
in the results reached in SEC fraud injunctive suits, utilization of
such a standard in all likelihood would not impair the Commission
in its role as public protector. Moreover, the adverse effects of the
negligence standard upon individual and corporate defendants mili-

138 See Brodsky, SEC Enforcement Weapon May Be Blunted, N.Y.L.J., Sept. 22, 1976,
 at 1, col. 2, at 26, col. 2.
 139 See SEC v. World Radio Mission, Inc., 544 F.2d 535, 540-41 (1st Cir. 1976); SEC
General Counsel's Memorandum Regarding Ernst & Ernst v. Hochfelder, reprinted in Sec.
 140 See note 50 supra.
 141 See notes 96-109 and accompanying text supra.
tate in favor of a scienter requirement. Finally, a scienter standard might serve the interests of both the SEC and the investing public by promoting fuller disclosure of information by the financial community.

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