Ernst & Ernst v. Hochfelder: A Critique and an Evaluation of Its Impact upon the Scheme of the Federal Securities Laws

By James D. Cox*

Ernst & Ernst v. Hochfelder1 presented to the Supreme Court the most perplexing issue yet to arise from the implied right of action under section 10(b) of the Securities Exchange Act of 19342 and Rule 10b-5:3 whether the standard of culpability imposed by those provisions includes a duty to exercise reasonable care. After nearly thirty years of private litigation,4 no consensus had developed among the cir-


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1. 96 S. Ct. 1375 (1976), rev'd 503 F.2d 1100 (7th Cir. 1974).
2. 15 U.S.C. § 78j(b) (1970). "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." Id.

3. 17 C.F.R. § 240.10b-5 (1975). "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

   "(a) To employ any device, scheme, or artifice to defraud,

   "(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

   "(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." Id.

cuits whether mere negligent wrongdoing constitutes a violation of section 10(b). The Second, Third, Fourth, Fifth, Sixth and Tenth Circuits had unequivocally stated that liability requires more than negligence; only the Seventh and Ninth Circuits had reached a contrary result. In the remaining circuits no clear case had yet compelled a decision on the range of culpability embodied in section 10(b), but decisions in each of these circuits intimated that a defendant's mere negligence would not expose him to liability.\footnote{5}

The Supreme Court in \textit{Ernst \& Ernst} rejected, without qualification, a negligence standard for private litigation under section 10(b) and Rule 10b-5. However, the significance of \textit{Ernst \& Ernst} transcends this holding. Its reasoning has application to other unsettled aspects of the implied cause of action under section 10(b). In this respect, \textit{Ernst \& Ernst} quite likely portends a significant restriction of the scope of section 10(b), even in the case of intentional misbehavior. This article examines the arguments advanced in \textit{Ernst \& Ernst} in order to assess whether their application to other unsettled questions under section 10(b) is merited.

\footnote{5} Lanza v. Drexel \& Co., 479 F.2d 1277 (2d Cir. 1973). Prior decisions which stated that more than mere negligence was required either involved intentional wrongdoing or an issue unrelated to scienter. \textit{See}, e.g., Shemtob v. Shearson, Hamill \& Co., 448 F.2d 442, 445 (2d Cir. 1971); Globus v. Law Research Serv. Inc., 418 F.2d 1276 (2d Cir. 1969). Other decisions by the Second Circuit which suggested that negligence would be an appropriate standard in Rule 10b-5 damage actions also involved intentional conduct. \textit{See}, e.g., Heit v. Wiltzen, 402 F.2d 909 (2d Cir. 1968), \textit{cert. denied}, 395 U.S. 903 (1969); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), \textit{cert. denied}, 394 U.S. 976 (1969).

\footnote{6} Rochez Bros. v. Rhodeas, 527 F.2d 880 (3d Cir. 1975). In an earlier Third Circuit decision, Judge Adams expressed, in his concurring opinion, the view that mere negligence would not be sufficient. Kohn v. American Metal Climax, Inc., 458 F.2d 255, 270 (3d Cir. 1972) (Adams, J., concurring). The majority, however, agreed with the district court's finding that the conduct was intentional.

\footnote{7} Carras v. Burns, 516 F.2d 251, 256 (4th Cir. 1975).

\footnote{8} Vohs v. Dickson, 495 F.2d 607 (5th Cir. 1974); Sargent v. Genesco, Inc., 492 F.2d 750 (5th Cir. 1974); Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974).

\footnote{9} SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974).


\footnote{11} Hochfelder v. Ernst \& Ernst, 503 F.2d 1100 (7th Cir. 1974).

\footnote{12} Marx v. Computer Science, Corp., 507 F.2d 485 (9th Cir. 1974); White v. Abrams, 495 F.2d 724 (9th Cir. 1974). While not applying a precise standard to the facts before the court, the Ninth Circuit unequivocally accepted a flexible standard which included negligence.

\footnote{13} The First Circuit suggested that mere negligence is not sufficient in Stewart v. Bennett, 362 F. Supp. 605 (D. Mass. 1974). In an earlier decision, the First Circuit imposed liability under section 10(b) where the conduct was clearly intentional without
Ernst & Ernst v. Hochfelder: A Critique

The plaintiffs in Ernst & Ernst had used the services of First Securities Company of Chicago, a registered brokerage firm, from 1942 through 1966. During this time, the plaintiffs invested in escrow accounts supervised by the president of First Securities, Leston B. Nay, who owned 92 percent of the firm's stock. Nay represented that the accounts would yield the plaintiffs a high return. Upon Nay's suicide in 1968, it was discovered that the escrow accounts were fictitious and that Nay had misappropriated the plaintiffs' funds for his own use. Fundamental to Nay's ability to conceal his fraudulent acts for so many years was his rule that he alone could open mail addressed to him or to his attention. When he left the office, his employees placed his mail on his desk unopened. Through this rule, his correspondence with the plaintiffs concerning their fictitious escrow accounts bypassed the staff of First Securities, and the books of First Securities never included the escrow accounts. Ernst & Ernst, a national public accounting firm, began auditing First Securities in 1946 and continued as the firm's auditor through 1967. During this period, its staff failed to discover the fictitious escrow accounts. 14

In their private action, the plaintiffs predicated Ernst & Ernst's liability on its failure to exercise reasonable care in the audit of First Security.
curities. It was alleged that if the audit had been performed properly, it would have revealed Nay’s fictitious escrow accounts, or at least the possibility of massive fraud. Professional accounting standards require a review of the internal controls of the audited firm, and the accountant must perform the review with reasonable care in order to assess the degree to which the accountant may rely upon the corporation’s records in carrying out the audit. The defendant’s failure to comply with this professional requirement formed the gravamen of the plaintiff’s complaint. After discovery the district court granted the defendant’s motion for summary judgment. The Seventh Circuit, expanding upon its dicta in an earlier decision, reversed the trial court by holding that the defendant could be an aider and abettor under section 10(b) for negligent wrongdoing, whenever it was demonstrated:

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

The Supreme Court reversed the Seventh Circuit, holding that section 10(b) of the Securities Exchange Act could not impose liability for conduct which did not rise above negligence. The Court first


16. The district court apparently believed that negligence would not expose the auditor to liability as an aider and abettor. This belief was based upon several earlier Seventh Circuit opinions holding that knowledge was a prerequisite to liability as an aider and abettor. See Sennott v. Rodman & Renshaw, 474 F.2d 32 (7th Cir.), cert. denied, 414 U.S. 926 (1973) (defendant was not an aider and abettor where the record failed to establish knowledge); Carroll v. First Nat’l Bank, 413 F.2d 353 (7th Cir. 1969), cert. denied, 396 U.S. 1003 (1970); Butter v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1969) (suggesting that implied knowledge may be sufficient).

17. In Hochfelder v. Midwest Stock Exchange, the Seventh Circuit stated that liability for aiding and abetting required the plaintiff to prove that the defendant “had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure.” Hochfelder v. Midwest Stock Exch., 303 F.2d 364, 374 (7th Cir.), cert. denied, 419 U.S. 875 (1974). Nevertheless, the Midwest Stock Exchange was not held liable as an aider and abettor under Rule 10b-5 because the court concluded that it had no knowledge of the false escrow accounts and that it fulfilled its duty to supervise and inquire. See also SEC v. First Secs. Co., 463 F.2d 981 (7th Cir.), cert. denied, 409 U.S. 880 (1972).

18. Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1104 (7th Cir. 1974).

reasoned that by the words in the enabling statute, "manipulative or deceptive devices or contrivances," Congress clearly intended to proscribe knowing or intentional misconduct. It next decided after an examination of the legislative and administrative history, that section 10(b) and Rule 10b-5 regulated only conscious fault. In many respects the Court's analysis of the legislative history was little different from its analysis of the meaning of the enabling statute, since in both cases inferences were drawn from the "clear meaning" the Court associated with the words "manipulate" and "manipulative." A third basis for the Court's conclusion was its belief that serious disruption to the interrelated scheme of the federal securities laws would arise if section 10(b) were interpreted to reach negligence. Since the Court believed that these three bases clearly foreclosed a negligence standard, it expressly avoided any consideration of the policy implications properly involved in selecting such a standard.

The analysis which follows in the first part of this article will seek to demonstrate that the language and history of the statute are not at all clear and that the Court therefore should have resolved the question of section 10(b)'s standard of culpability by reference to the policies and goals of the federal securities laws. With the exception of section 10(b)'s legislative history, the arguments advanced by the Court in Ernst & Ernst and examined below could be applied to other regulatory provisions of the Securities Exchange Act. The following analysis, therefore, transcends the issue decided by the Court in Ernst & Ernst.

20. Id. at 1384.
21. Id. at 1385-87, 1390-91.
22. See id. at 1384.
23. Id. at 1387-89.
24. See id. at 1391 n.33.
25. Id.
26. Language paralleling section 10(b) appears in section 15(c)(1) of the Securities Exchange Act which proscribes "any manipulative, deceptive, or other fraudulent device or contrivance" employed by a broker or dealer. 15 U.S.C. § 78o(c)(1) (Supp. V, 1975). Section 14(e) of the Securities Exchange Act not only prohibits untrue statements of fact and the omission of material facts whenever the omission will cause a statement to be materially misleading, but also prohibits "fraudulent, deceptive or manipulative acts or practices in connection with any tender offer . . . ." 15 U.S.C. § 78n(e) (1970). Therefore, the court's construction of the operative language in section 10(b) will be of controlling importance in construing sections 15(c)(1) and 14(e). While the language of sections 14(a) and 20(a) of the Securities Exchange Act does not parallel section 10(b), it is likely that the contours of private relief under these two sections also will be affected by the analysis in Ernst & Ernst, particularly given its concern for harmonizing the legislative scheme.
Guidance from the Enabling Statute

The Supreme Court heavily relied upon what it perceived as the clear meaning of "manipulative or deceptive devices or contrivances" in section 10(b) in its rejection of a negligence standard. Although the common meaning of "device" or "contrivance" suggests deliberate conduct by the participants, in the context of section 10(b) both nouns definitively exclude only transactions or conduct initiated solely by accident or inadvertence. Given a course of conduct which was planned or contemplated, a requisite device or contrivance would be present. It remains, therefore, for the two adjectives to suggest what is proscribed. When considering the adjectives, if their root verbs, "manipulate" and "deceive," are examined alone for guidance, the conclusion would be inescapable that only conscious wrongdoing was intended to be within the scope of section 10(b). Intent pervades every aspect of their definitions. There are several considerations, however, which cast doubt on the lesson drawn from this examination.


28. Device has been defined as "that which is devised or formed by design." Webster's International Dictionary (2d ed. 1934). Contrivance has been defined as "an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice." Id.

29. "Deceive: To cause to believe the false, or disbelieve the truth; to impose upon; to deal treacherously with; cheat.

"Manipulate: . . . to treat, work, or operate with the hands, or by mechanical means; . . . To treat or manage with the mind or intellect; to control the action of, by management . . . Exchange. To force (prices) up or down as by matched orders, wash sales, fictitious reports, etc.; to rig." Webster's New International Dictionary (2d ed. 1956).
The word deceptive, unlike its root verb, deceive, suggests no established state of mind. It instead describes the potential impact of conduct upon a person's perception, regardless of the actor's mental state. This meaning supports the SEC's position in Ernst & Ernst. From a policy viewpoint, the SEC had argued in its amicus brief that the Court should interpret section 10(b) to reach negligent conduct because it has the same impact as intentional wrongdoing. The Court dismissed this argument, finding support in the dictionary meaning for "manipulate." In view of the Court's reaction, the SEC may have erred in assuming that the Court was aware that "deceptive" possessed a broader meaning than "manipulative." Justice Powell's opinion curiously failed to include any mention of that element of the enabling statute, suggesting that perhaps the Court attributed to "deceptive" a meaning similar to that of "manipulative." The broader meaning of "deceptive" has obvious significance for the purpose of determining whether congressional intent was clear; the enabling statute used the disjunctive, not the conjunctive, thereby leaving open the possibility of a much broader scope than that attributed to the statute in Ernst & Ernst.

30. Deceptive has been defined as follows: "Tending to deceive; having power to mislead." Id.
32. 96 S. Ct. at 1384.
33. In their brief before the Supreme Court, Ernst & Ernst made extensive use of the language in the enabling statute by reference to the meaning associated with "deceptive" and "manipulative." "Webster's New Int'l Dictionary (3rd ed. 1961) provides the following definitions of the root words manipulate and deceit: Manipulate: 'to control, manage, or play upon by artful, unfair or insidious means esp. to one's own advantage.' Deceit: 'any trick, collusion, contrivance or underhanded practice used to defraud another.'" Brief for Petitioner at 38, Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976).

To be observed in the petitioner's analysis is the statement that "deceit" is the root word. Reference to the statute readily discloses that it is "deceptive" conduct, not deceit, which is proscribed. The same source defines "deceptive" as "tending to deceive, having the power to mislead." "Deceive" in turn is defined as "to cause to believe the false" having the synonyms of "mislead" and "delude." All are expressions which describe the impact of the conduct rather than the purpose of or intent of the actor.

34. The Second Circuit, which has led the way in advocating that the language of section 10(b) foreclosed a negligence standard for Rule 10b-5, has through its interpretation of a sister provision, Rule 10b-6, 17 C.F.R. § 240.10b-6 (1974), construed both "manipulative" and "deceptive" as describing only the effect of the defendant's conduct rather than the culpability underlying the actions that produced the effect. The Second Circuit construed "manipulative" and "deceptive" as not requiring scienter. Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973). Both Chris-Craft and Bangor Punta Corporation were vying for control of Piper Aircraft. Bangor, seeking to acquire a majority interest, had offered to exchange its stock for that of Piper. During the period that its offer was outstanding, Bangor acquired through cash purchases 120,200 shares of Piper stock in three separate block purchases over a ten day period. The Second Circuit held these purchases violated Rule 10b-6's proscription against bids
The contrast between Congress's choice of words in the express liability sections of the securities laws and the language employed in

by an issuer for its own security if it was engaged concurrently in a distribution of that security. Included within this prohibition is the acquisition by the issuer of any right to purchase a security subject to a distribution. Since the Piper shares could be exchanged for those of Bangor Punta, the court, concluding that large purchases manipulated the price of Piper shares by boosting their quoted price to an artificially high level, held that the purchases gave Bangor Punta the right to purchase its own stock in violation of Rule 10b-6. This conclusion was actually reached by the Second Circuit in its earlier opinion, reversing the district court's dismissal of the Rule 10b-6 violation. Chris-Craft Indus., Inc. v. Bangor Punta Corp., 426 F.2d 569 (2d Cir. 1970). Nowhere in that decision is there any suggestion that the Second Circuit equated manipulation with intentional or reckless conduct. Although not overruling the district court's conclusion that the purchases were not intended to stimulate the price of Piper stock quoted on the exchange, a review of both district court decisions reveals that each believed Bangor Punta had committed only a technical violation of Rule 10b-6 with no intent or belief that investors would be misled. See Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 337 F. Supp. 1128, 1142 (S.D.N.Y. 1971) (Pollack, J.); Chris-Craft Indus., Inc. v. Bangor Punta Corp., 303 F. Supp. 191, 198 (S.D.N.Y. 1969) (Tenney, J.). Nevertheless, the Second Circuit imposed liability, holding that if the prohibited purchases were in fact engaged in, they were conclusively presumed to have a stimulating effect. Implicit in this conclusion is that the Second Circuit equated manipulation and deception with the impact of the defendant's conduct on Piper stock rather than with the defendant's degree of culpability in creating the appearance of investor interest in Piper stock. The following excerpt demonstrates this attitude: "Rule 10b-6 was drafted by the SEC on the basis of its considerable expertise and familiarity with market factors. It determined that a purchase that meets all the criteria set forth in the Rule will have a false prodding effect on the price of the distributed security and therefore should be outlawed... Piper shareholders presumptively were deceived by a material alteration in the value of the exchange package. They no doubt were influenced by this deception to take advantage of what seemed to be a highly favorable BPC exchange offer." 480 F.2d at 378 (emphasis added).

Earlier in the opinion the Second Circuit employed manipulation in a similar manner wherein it was satisfied manipulation had occurred when there was proof that the purchases by Bangor Punta had caused Piper shares to rise in price, creating a misleading impression. Id. See also Chris-Craft Indus., Inc. v. Bangor Punta Corp., 426 F.2d 569, 577 (2d Cir. 1970). The use of the above language to subject Bangor Punta to liability for violating Rule 10b-6, even though the conduct was not calculated to affect the price of Piper stock, is entirely at odds with the meaning attributed by the Second Circuit to the same language when construing Rule 10b-5. See cases cited note 27 supra. See also Jaffee & Co. v. SEC, 446 F.2d 387 (2d Cir. 1971). In Jaffee, a principal partner of a broker-dealer was held to have violated Rule 10b-6 through his purchase of a large block of an issuer's shares during their distribution. In holding that Jaffee might be disciplined, the Second Circuit stated: "[T]he Commission need not have shown that Jaffee actually intended to defraud the marketplace through his purchases... . Where the rule applies its prohibition is absolute." Id. at 391. See also Weitzen v. Kearns, 271 F. Supp. 616, 623 (S.D.N.Y. 1967); SEC v. Electronics Sec. Corp., 217 F. Supp. 831, 836 (D. Minn. 1963); In re Halsey Stuart & Co., 30 S.E.C. 106, 112 (1949). But see SEC v. Scott Taylor & Co., 183 F. Supp. 904, 908 (S.D.N.Y. 1959). The conclusion is inescapable that the Second Circuit's construction of Rule 10b-6 belies the significance of its own decisions have placed upon the language of section 10(b).
the enabling sections for which civil liability has been judicially recognized raises further doubt whether Congress intended to incorporate any standard of culpability in the latter group of statutes, particularly section 10(b). Congress used expressions such as “did not know,” “reasonable ground to believe,” “for the purpose,” “had no knowledge,” and “knew” to describe conscious or intentional wrongdoing, whether occurring through a false statement or conduct affecting a stock's price. A negligence standard was imposed through a variety of phrases, including “reasonable investigation” and “reasonable care.” “Good faith” appears to be the mongrel of the group, occurring in statutes requiring conscious fault or lack of diligence. Congress never employed “manipulative” and “deceptive” when establishing standards of fault for a statute which expressly provided for civil liability.

The legislative history offers no insight into why Congress used language in the express liability sections so dissimilar to that in the enabling statutes. Several considerations do support the theory that Congress may have used the operative words in the enabling statute, such as “manipulative” or “deceptive,” to describe the impact of conduct rather than any level of culpability. First, Congress in other areas of regulation employed the expressions “deceptive” and “manipulative” to proscribe conduct without proof of fault or which was merely negli-

42. The good faith requirement of section 20(a) of the Securities Exchange Act (15 U.S.C. § 78i(a) (1970)) has been interpreted variously by the courts and the commentators. A significant number of opinions have imposed liability upon the controlling person for lack of diligence in supervising subordinates. See A. Jacobs, The Impact of Rule 10b-5, in SECURITIES LAW § 40.04, at 2-75 (1976). This result has been severely criticized when applied to broker-dealers. Comment, The “Controlling Persons” Liability of Broker-Dealers for Their Employees' Federal Securities Violations, 1974 Duke L.J. 824, 839-43. Professors Loss and Bromberg both believe that the “good faith” requirement of section 20(a) does not subsume a due diligence requirement, as does the sister provision of section 15 of the Securities Act. 3 L. Loss, SECURITIES REGULATION 1747 (2d ed. 1961) [hereinafter cited as Loss]; see A. Bromberg, SECURITIES LAW FRAUD SEC RULE 10b-5 § 8.4 (504) [hereinafter cited as Bromberg].
43. Bromberg, supra note 42, at §§ 2.2(300)-(420).
gently undertaken.\footnote{44} Second, Congress contemplated only the administrative enforcement of the regulatory enabling provisions, generally through the rendition of prospective relief.\footnote{45} The abuses to be regulated by the SEC through such provisions included conduct which might not be accompanied by fault, as well as conduct which might threaten the public interest only when accompanied by some degree of fault. Accordingly, the enabling statute had to have sufficiently broad language to permit regulations to reach all types of conduct.\footnote{46} Third, unlike the express liability sections in which relief became available upon the enactment of the statute, the enabling statutes depended on further administrative actions before their prohibitions had any effect. Therefore, the thorny question of culpability may have been delegated rather than resolved.

The court’s response to these distinctions in wording was one-dimensional. It observed:

In each instance that Congress created express civil liability in favor of purchasers or sellers of securities it clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence or entirely innocent mistake.\footnote{47}

It then recognized the varying levels of fault expressed in section 11(e) of the Securities Act of 1933,\footnote{48} and their detailed descriptions, drawing the following conclusion:

The express recognition of a cause of action premised on negligent behavior in § 11 stands in sharp contrast to the language of §

\footnote{44} Section 9 of the Commodity Exchange Act employs the term “manipulate” in its prohibition of conduct undertaken to cause fluctuations in a commodity’s price. 7 U.S.C. § 9 (1970). This has been interpreted to be violated solely by conduct engaged in for the purpose and with the intent to manipulate the commodity’s price. See Volkart Bros. v. Freeman, 311 F.2d 52 (5th Cir. 1962); General Foods Corp. v. Brannan, 170 F.2d 220 (7th Cir. 1948). In contrast, the term “deception” appears in section 2(a) of the Trade Mark Act of 1946, and a violation of this provision occurs without proof of any fault. 15 U.S.C. § 1052(a) (1970). Proof that the trademark is misleading is sufficient. See Gold Seal Co. v. Weeks, 129 F. Supp. 928 (D.D.C. 1955). Section 5 of the Federal Trade Commission Act prohibits deceptive acts and has been construed to reach a broad range of situations in which the fault, if any, is slight. 15 U.S.C. § 45(b) (1970); see General Motors Corp. v. FTC, 114 F.2d 33 (2d Cir. 1940).


\footnote{47} 96 S. Ct. at 1388.

10(b), and significantly undercut the Commission's argument [that Congress was explicit whenever it required willful conduct].

To be sure, the language used elsewhere by Congress in proscribing negligence is substantially different from that in section 10(b). However, it is also true that the language employed by Congress to proscribe intentional conduct is just as dissimilar to the language of section 10(b). The contention of the SEC and the Supreme Court's response, therefore, follows the worn out fable of the blindmen and the elephant. Examination of all the parts can lead to an entirely different conclusion; namely, that Congress never intended to proscribe a specific level of culpability for any of the regulatory provisions. The cumulative weight of all the foregoing considerations should have persuaded the Court that the use of a dictionary approach was all too wooden. Construction of a broadly drafted regulatory provision inherently requires that thought be given to a broad array of factors aside from the language of the enabling statute.

Inferences from Legislative and Administrative History

The Supreme Court's examination of the legislative and administrative history of section 10(b) and Rule 10b-5 persuaded the Court that negligence was not intended to be proscribed by the drafters of either provision. The Court began its study with a review of the amendments to the antifraud provision made in both houses prior to the enactment of section 10(b) in its present form:

The original version of what would develop into the 1934 Act was contained in identical bills introduced by Senator Fletcher and

49. 96 S. Ct. at 1388.
50. Earlier the Supreme Court advocated such flexibility in the construction of section 80b-6 of the Investment Company Act of 1940, the language of which parallels the language of section 10(b). SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). The Supreme Court held that the operative terms of the statute, "fraud" and "deceit," have sufficient elasticity to include a broad range of culpable behavior. The precise standard applied would depend upon the nature of the relief sought, the relationship of the parties and the subject matter of the transaction. While believing that Congress probably intended to use the term fraud in its broadest sense, the Court, in reaching its decision, found the language of the enabling statute a secondary consideration. In selecting a standard, it assigned greater importance to the question of what standard would most likely fulfill the objectives of the Investment Company Act of 1940. The Court saw the statute's objective to be the discouragement of advice which was either consciously or unconsciously tainted by an existing conflict of interest, and it concluded that the fulfillment of this objective would be defeated if a violation arose only when the advisor intended to profit through the conflict. A due diligence standard, however, fulfilled the statute's purpose of exposing the potential for compromised advice. Id. at 192.
Representative Rayburn. . . . Section 9(c) of the bills, from which present § 10(b) evolved, proscribed as unlawful the use of "any device or contrivance which, or any device or contrivance in a way or manner which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors." The other subsections of proposed § 9 listed specific practices that Congress empowered the Commission to regulate through its rulemaking power. See § 9(a) (short sale), (b) (stop-loss order). Soon after the hearings on the House bill were held, a substitute bill was introduced in both Houses which abbreviated and modified 9(c)'s operative language to read "any manipulative device or contrivance." Still a third bill, retaining the Commission's power to regulate the specific practices enumerated in the prior bills, and omitting all references to the Commission's authority to prescribe rules concerning manipulative or deceptive devices in general, was introduced and passed in the House. . . . The final language of § 10 is a modified version of a Senate amendment to this last House bill.  

Examination of the bills introduced in each house after hearings were held reveals that dissimilar, rather than identical, language was employed in the antifraud provision appearing in each bill. The Senate version proscribed "manipulative or deceptive device or contrivance," not merely "manipulative device or contrivance" as did the House's version. The apparent contrast in language in the two bills appears deliberate; some significance may be attached to this difference, in view of the harmony otherwise maintained between House and Senate versions of other provisions. The unexplained distinction at least makes Congress's intent less discernible and raises a doubt whether the Court should have relied as much as it did upon the legislative reports. Considering the Court overlooked the contrasting language, there is the suggestion that the Court erroneously viewed the expressions "manipulative" and "deceptive" as synonymous.

Nothing in the legislative history explains this difference between the two earlier drafts of the Securities Exchange Act. The committee

51. 96 S. Ct. at 1385 (emphasis added & citation omitted).
52. S. 3420, 73d Cong., 2d Sess., § 10(b) (1934).
53. H.R. 8720, 73d Cong., 2d Sess., § 9(c) (1934).
54. A comparison of the changes appearing in H.R. 8720 and S.3420 from their predecessors supports the conclusion that the dissimilar language appearing in the bills was intended to implement differing philosophies. In many provisions, the changes were identical in each bill. See, e.g., H.R. 8720, 73d Cong., 2d Sess., §§ 5(b), 5(d), 5(e), 5(f), 8(a) (1934); S. 3420, 73d Cong., 2d Sess., §§ 6(b), 6(d), 6(e), 6(f), 9(a) (1934). On the other hand, particularly in the regulatory provisions, the changes in each house's bill after hearings strongly suggest that the dissimilar expressions were intended to cause a substantial change from that appearing in the opposite house's bill. Compare H.R. 8720, supra §§ 7(a)(2), 7(e), 8(a)(1) & (2), with S.3420, supra §§ 8(a)(2), 8(d), 9(a)(1) & (2).
reports accompanying the enactment of the antifraud provision make only one reference to section 10(b) in which the statute's language was merely paraphrased.\textsuperscript{55} Otherwise the entire legislative history is barren of any direct reference to section 10(b) which would offer definitive guidance to the provisions' scope.

The Court found its requisite authority to limit the scope of section 10(b) through the repeated use of "manipulate" and "manipulative" in the committee reports of the Senate in connection with conduct involving intentional misbehavior.\textsuperscript{56} That portion of the report included a discussion of the practices that provided the impetus for sections 9 and 16, which clearly involve intentional misbehavior. Nowhere, however, does that report discuss section 10(b). The report briefly refers to section 10(a),\textsuperscript{57} but in a manner which suggests that no level of culpability was intended to be embodied in its broad enabling language.\textsuperscript{58} In fact, the language of section 10(a) is incongruous with an interpretation that only intentional misbehavior may be proscribed.\textsuperscript{59} The statute is bare of any limiting language other than the admonition that its regulations be in the public interest and for the protection of investors. If section 10(a) is resistant to a scirent require-ment, even though described in a portion of the report otherwise pre-occupied with intentional wrongdoing, it would indeed be anomalous to ascribe a scirent requirement to section 10(b) on that basis when it is not even mentioned in that portion of the report.

\textsuperscript{55} H.R. REP. No. 1838, 73d Cong., 2d Sess. 32-33 (1934).
\textsuperscript{56} S. REP. No. 792, 73d Cong., 2d Sess. 7-9 (1934).
\textsuperscript{58} The Senate Committee on Banking and Currency which considered section 10(a) offered the following as a description of the purpose of section 10(a): "Short selling has been defended as a necessary check upon a rising market and as a stabilizing factor in the ensuing decline and attacked on the ground that it tends to unsettle the market, depress prices, and accelerate declines. The committee recommends that the practice of short selling be placed under the supervision of the commission." S. REP. No. 792, 73d Cong., 2d Sess. 9 (1934). The committee's report thereafter undertakes a description of section 16, the short-swing profits provision, thereby avoiding any mention of section 10(b).
\textsuperscript{59} Section 10(a) of the Securities Exchange Act of 1934 provides as follows: "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 effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale of any security registered on a national securities exchange, 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." 15 U.S.C. § 78j(a) (1970). The regulations promulgated under section 10(a) also suggest that no degree of culpability is necessary to establish a violation. See 17 C.F.R. § 240.10a-1 (1975).
The administrative history of Rule 10b-5 relied upon by the Court was similarly inconclusive. The Court referred to the SEC release which was issued in connection with its promulgation of Rule 10b-5. The release explained that the rule was directed toward "fraud" in the purchase or sale of stock. The Court used the release to support its conviction that Rule 10b-5 was intended to reach only intentional conduct.60 However, this construction was not compelled by the language used in the release. Earlier, in SEC v. Capital Gains Research Bureau, Inc.,61 the Supreme Court had taken an entirely opposite approach, holding that "fraud" may be construed flexibly to reach negligent nondisclosures. In further support of its equation of "fraud" with intentional misconduct, the Ernst & Ernst Court reasoned that since the incident prompting the promulgation of Rule 10b-5 was clearly intentional misbehavior, Rule 10b-5 was not intended by its drafters to reach conduct falling short of scienter.62 Reference to the nature of the wrongdoing which stimulated the SEC hastily to promulgate Rule 10b-5 in order to determine the rule's scope is a dubious use of administrative history, particularly since the language of subsection (2) of Rule 10b-5 defies limiting the rule's scope to intentional or fraudulent activities.63 In fact, the very haste with which the SEC promulgated Rule 10b-5 may more easily be interpreted as an attempt to reach a broad range of culpable behavior rather than a decision to regulate restrictively.

In conclusion, the legislative and administrative history appears too brief to provide any meaningful insight into the scope of section 10(b) and Rule 10b-5. The conduct reached through the express liability sections of the Securities Exchange Act, admittedly manipulative and intentional, is far from determinative of the scope of section 10(b), which reaches more than manipulative practices. Nowhere in the legislative records does there appear any congressional desire to proscribe any particular level of culpability with section 10(b). With the legislative reports and debates so unrevealing of congressional intent, the

60. 96 S. Ct. at 1390 n.32.
62. "Apparently the rule was a hastily drafted response to a situation clearly involving intentional misconduct. The Commission's Regional Administrator in Boston had reported to the Director of the Trading and Exchange Division that the president of a corporation was telling the other shareholders that the corporation was doing poorly and purchasing their shares at the resultant depressed prices, when in fact the business was doing exceptionally well. 'The rule was drafted and approved on the day this report was received.' 96 S. Ct. at 1390 n.32.
63. See note 3 supra.
Court’s decision to avoid the policy considerations surrounding a negligence standard was poorly supported.

Rejection of the Negligence Standard Premised upon Disruption to the Legislative Scheme

A threshold concern in adopting any standard of culpability for section 10(b) is whether the standard imposed through that provision upon conduct proscribed in other provisions of the federal securities laws will cause serious disruption of the regulatory scheme. Disruption may take one of two forms. The most pronounced disruption would occur if a plaintiff could sue for negligence under section 10(b) for an alleged injury when other provisions covering the same injury specifically require scienter. Under section 18 of the Securities Exchange Act, for example, an investor injured by a misleading report filed with the SEC has a cause of action requiring scienter, but the investor might well prefer to sue for negligence under section 10(b). Similarly, a negligence standard under section 10(b) applied to conduct governed by section 9(a) of the Securities Exchange Act would make section 10(b) more attractive than section 9(a), which includes a scienter requirement.

Disruption of provisions governing negligent behavior can also occur if a section 10(b) negligence action is allowed, since section 10(b) has more procedural advantages than other parts of the securities laws. The classic illustration is the comparison of sections 11 and 12(2) of the Securities Act with a section 10(b) cause of action operating upon a negligence standard. Several procedural advantages

65. Under section 18 the plaintiff need not prove scienter. The burden is placed on the defendant to show his good faith and lack of knowledge. Id.
66. Id. § 78i(a).
67. Id. § 77k.
68. Id. § 77l(2).
69. Professor Bromberg has recommended the selection of a Rule 10b-5 standard from the express liability provisions of the federal securities laws, especially the standard included within section 12(2) of the Securities Act. Bromberg, supra note 42, at § 8.4 (1966). Professor Loss has suggested that the greatest impediment to negligence will be the language of the enabling act, but believes that “the common law development, reinforced by the general statutory purpose, might well justify extension of clause (2) [of Rule 10b-5] to something at least approaching simple negligence.” 3 L. Loss, supra note 42, at 3885-88. See also Epstein, The Scienter Requirement in Actions Under Rule 10b-5, 48 N.C.L. Rev. 482 (1970) (the author made no recommendation, believing the legislative scheme to be inconclusive); Meisenholder, Scienter and Reliance as Elements in Buyer’s Suit Against Sellers Under Rule 10b-5, 4 Corp. Prac. Com. 27 (Feb. 1963) (recommending a negligence standard).
are gained by proceeding under section 10(b) vis-à-vis sections 11 and 12(2). Almost certainly the plaintiff will be operating under a much longer statute of limitations.\textsuperscript{70} Although the plaintiff may be compelled in an action brought under sections 11 or 12(2) of the Securities Act to post security for the defendant's expenses, this defensive maneuver does not arise under the implied right of action under section 10(b) of the Securities Exchange Act.\textsuperscript{71} Furthermore, the venue provision under section 10(b) offers a microscopic advantage.\textsuperscript{72}

The Supreme Court, in refusing to adopt a negligence standard under section 10(b), did so in part out of the feared disruption to the interdependent provisions of the federal securities laws:

We also consider it significant that each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct . . . is subject to significant procedural restrictions not applicable to § 10(b). . . .

We think these procedural limitations indicate that the judicially created private remedy under § 10(b)—which has no comparable restrictions—cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by § 11, §§ 12(2) and § 15 to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.\textsuperscript{73}

It should be observed that concerns identical to those expressed in the

\textsuperscript{70} The statute of limitations for actions brought under sections 11 and 12 of the Securities Act requires suit to be brought within one year of discovery of the wrong and in no event more than three years after the shares were offered to the public or after the sale. 15 U.S.C. § 77m (1970). The circuits uniformly provide a much longer period for actions brought under section 10(b) for the same conduct covered by sections 11 and 12. They are not, however, uniform in choosing the exact limitation period provided under state law to govern section 10(b). See generally, Comment, Statutes of Limitations in 10b-5 Actions: A Proposal for Congressional Legislation, 24 Syracuse L. Rev. 1154 (1973).


\textsuperscript{72} Venue under section 22 of the Securities Act of 1933 lies where the defendant is found, is an inhabitant, or transacts business or where the offer or sale took place. 15 U.S.C. § 77v(a) (1970). In contrast, section 27 of the Securities Exchange Act of 1934 would expand these sections to include any district in which any act or transaction constituting a violation occurred. 15 U.S.C. § 78aa (1970). Hence, if the misrepresentation occurs in a state other than the one in which the sale occurred, an action under section 10(b) could be maintained in either state while under sections 11 or 12 only the latter state would be proper.

\textsuperscript{73} 96 S. Ct. at 1388-89.
above quoted language of the Court arise even though section 10(b) is limited to intentional wrongdoing, if the comparison is to the express liability sections of the Securities Exchange Act which embody a standard of intent. Under both sections 9 and 18 of the Securities Exchange Act, the plaintiff has a much shorter statute of limitations than that applied to section 10(b) and he may also be required to post security. This disruptive effect was, in fact, acknowledged by the Supreme Court. The Court, however, stopped short of premising its narrow interpretation of section 10(b) upon this additional disruption, ostensibly because the facts in Ernst & Ernst did not pose a conflict through the imposition of liability under the antifraud provision for behavior specifically proscribed by either sections 9 or 18. Since the Court emphasized its belief that section 10(b) should be harmonized with the procedural requirements of the express liability sections of the Securities Act, it must be assumed that the Court could, in the future, construe section 10(b) to avoid any disruption. This construction, however, is not necessarily mandated by a policy of harmonizing the interdependent provisions of the federal securities laws. The recognition that disruption occurs to the express liability provisions of the Securities Act if section 10(b) operates under a standard of negligence, or to the provisions of the Securities Exchange Act if section 10(b) operates under a standard of intent, proves too much. It suggests, in fact, why the argument against a negligence standard cannot soundly be premised upon the threat of disruption to the carefully honed requirements of the express liability sections.

Contrasting section 10(b), whatever its standard of culpability, with the express liability provisions of both the Securities Act and Securities Exchange Act merely demonstrates that some disruption to the regulatory scheme is necessarily inherent whenever a cause of action is implied, as in the situation with section 10(b). The disruption does not arise from the inclusion of a negligence standard within section 10(b). This is evident upon considering the actions available to the investor who has purchased shares subject to a prospectus which is

75. See 96 S. Ct. at 1389 n.31.
76. See id.
77. The inconclusiveness of the guidance provided by the legislative scheme in developing the contours for the implied right of action under section 10(b) was recognized by the Supreme Court in Blue Chip Stamps v. Manor Drug Stores wherein the Court dismissed the approach as being ill-suited for an action judicially created for which no actual intent may logically be attributed to Congress respecting its scope. 421 U.S. 723, 737 (1975).
known by the underwriter to be false. Both section 11 of the Securities Act and section 10(b) of the Securities Exchange Act would be available to the investor. Under the former, the injured investor may possibly encounter procedural difficulties which are completely circumvented if the plaintiff proceeds under section 10(b). Disruption will occur whether the duty imposed upon the defendant is negligence or conscious fault. The presence of a negligence standard in section 10(b) merely expands the number of instances in which the disruption will occur. Even if section 10(b) were restricted to intentional wrongdoing, there still would remain a definite threat of disruption to the regulatory scheme.

A Suggested Alternative to Ernst & Ernst: Commercial Practicability

The purpose of the above analysis was to demonstrate that the arguments advanced in Ernst & Ernst did not compel an unqualified prohibition of a negligence standard for section 10(b). The decision, therefore, should have focused upon policy considerations which were completely avoided by the Court.\textsuperscript{78} The ultimate concern in the case should have been whether a negligence standard would fulfill the objectives of the federal securities laws of assuring the flow of complete, accurate information to investors without imposing an unreasonable burden upon the conduct of business. This very likely would not have changed the result on the facts of Ernst & Ernst, but it would have permitted the imposition of a duty to inquire in other instances in which the duty's burdens were outweighed by the benefits of its imposition.

Under an approach stressing the standard's commercial practicability, the standard for section 10(b) necessarily would vary from situation to situation. The considerations which would be compelling in one instance—such as the preparation of an annual report—would be absent in another—such as dissemination of a press release. Several pre-Ernst & Ernst cases have weighed policy considerations in determining whether section 10(b) should reach negligent conduct. The duty ultimately selected in those cases was designed to reinforce obligations arising outside the federal securities laws.\textsuperscript{79}

The significance of an independent duty in the adoption of a negligence standard for a given factual setting arises from two concerns.

\textsuperscript{78} 96 S. Ct. at 1391 n.33.
An outside duty carries with it the identification and limitation of the class to whom the defendant's liability under section 10(b) may extend. As is true in the law of negligent misrepresentation, restricting the duty of inquiry to an identifiable, foreseen group reduces the in terrorem effect of the standard so that the release of information is not discouraged by the threat of excessive liability. Furthermore, an independent duty to inquire and disclose serves to overcome any objection that the imposition of an identical duty under section 10(b) is commercially impracticable. In this sense, a duty under section 10(b) reinforces the preexisting duty.

The approach recommended is distinguishable from the flexible duty standard formulated by the Ninth Circuit in White v. Abrams. In White, the Ninth Circuit stated that the standard of fault should be determined case by case on the basis of many facts, including

the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.

Explaining its standard, the court concluded that the defendant owes a duty of extreme care to assure full and accurate disclosure of all material information if there is a relationship of trust and confidence between the parties which benefits the defendant and if the defendant is aware that the plaintiff, lacking ready access to the information, is


The circuit court opinion in Ernst & Ernst also required that the duty of inquiry imposed upon the defendants arise independently from any duty imposed under Rule 10b-5. Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974). The court found the independent duty to inquire in section 17(a) of the Securities Exchange Act, 15 U.S.C. § 78q(a) (1970). The Seventh Circuit did not explain the derivation of its requirement that the duty to inquire arise independent of section 10(b). However, its requirement parallels that of sections 552 and 866 of the Restatement (Second) of Torts.

In the first district court decision in the Seventh Circuit to impose liability upon an aider and abettor, the Restatement of Torts was heavily relied upon. Brennan v. Midwestern Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966), aff'd, 417 F.2d 147 (7th Cir. 1969), cert. denied, 397 U.S. 989 (1970).


81. 495 F.2d 724 (9th Cir. 1974).

82. Id. at 735-36.
relying solely upon the advice of the defendant.\textsuperscript{83} If their relationship is more distant and impersonal, the defendant is liable only if he intentionally misrepresents material facts.\textsuperscript{84}

The relative unworkability of the flexible duty standard as formulated in \textit{White} arises from its total dependence upon the factual relationship between the individual plaintiff and defendant for the selection of the appropriate standard rather than upon a concern for commercial utility which transcends the individual litigants.\textsuperscript{85} This was evident in a recent opinion of the Ninth Circuit in which liability for mere carelessness in the preparation of a press release was accepted without discussion of its effect upon commercial dealings.\textsuperscript{86} Indeed, if \textit{White} were the sole alternative to the complete rejection of a negligence standard,\textsuperscript{87} the result in \textit{Ernst & Ernst} would be more understandable. However, the demonstrated ability of the lower courts to grapple with the commercial reality underlying the selection of standards amply documents the viability of this approach as an alternative to both \textit{Ernst & Ernst's} sweeping rejection of negligence and \textit{White's} opaque flexible duty standard.

\textsuperscript{83} \textit{Id.} at 736.

\textsuperscript{84} \textit{Id.}

\textsuperscript{85} The duty imposed under \textit{White v. Abrams} is dependent entirely upon multiple factual determinations to be made only after the presentation of evidence. Prior to that time, a sense of direction is lacking at every stage of the proceeding. The actual standard, therefore, will be selected by the trier of fact. \textit{See Forsester, Rule 10b-5 Violations in the Ninth Circuit: "I Know It When I See It,"} 30 BUS. LAW. 773, 780 (1975); \textit{Loss, Summary Remarks}, 30 BUS. LAW. 163, 165 (1975). The most important factual ingredient in \textit{White's} formula is the relative access of the parties to the information. Proof of the defendant's access may as easily document that his actions were reckless as that they were intentional. \textit{See, e.g., Vohs v. Dickson, 495 F.2d 607 (5th Cir. 1974); Anderson v. Tway, 143 F.2d 95, 99 (6th Cir. 1944); Jackson v. Oppenheim, [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,894 (S.D.N.Y. 1974). \textit{See generally Vincent v. Corbitt, 94 Miss. 46, 55-56, 47 So. 641, 642-43 (1908); Watson v. Jones, 41 Fla. 241, 263, 25 So. 678, 683 (1899).}

\textsuperscript{86} \textit{See Marx v. Computer Sciences Corp., 507 F.2d 485, 490 n.8 (9th Cir. 1974).}

\textsuperscript{87} It is unclear what impact \textit{Ernst & Ernst} will have upon the continued application of a flexible duty standard in the Ninth Circuit under \textit{White v. Abrams}, 495 F.2d 724 (9th Cir. 1974). \textit{Ernst & Ernst} did not foreclose recklessness from the scope of section 10(b). \textit{See 96 S. Ct. 1375, 1381 n.12 (1976).} It would appear improbable that liability should ever depend upon the distinction between conscious fault and reckless conduct. If the conduct is reckless, it seems proper to permit the plaintiff to recover as though the conduct were intentional. \textit{See, e.g., Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), cert. denied, 422 U.S. 1007 (1975); Vohs v. Dickson, 495 F.2d 607 (9th Cir. 1974); Lanza v. Dreux & Co., 479 F.2d 1277, 1306 (2d Cir. 1972); McClean v. Alexander, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,725 (D. Del. 1976). Thus, while it may still be technically possible for a flexible duty standard to exist with the distinctions being drawn between reckless and intentional behavior, it is unlikely that the policy underpinning section 10(b) would be served by drawing such a distinction.
Injunctive Relief and Negligence After Ernst & Ernst

The author's concern for the preservation of some vestige of a section 10(b) negligence standard is unrelated to the equitable enforcement of section 10(b) against negligent misconduct by either the SEC or a private party. This notion, it is contended, is of little value, and its demise is of no import.

The case law that has developed under section 10(b) is replete with decisions authorizing the issuance of an injunction for merely negligent nonfeasance, whether the action is maintained by the SEC or a private party. The genesis of the permissive interpretation of section 10(b) was the Supreme Court's flexible construction of the Investment Company Act in SEC v. Capital Gains Research Bureau, Inc. The Supreme Court held that the inadvertent failure of an investment advisor to disclose a practice of purchasing large quantities of an issuer's securities prior to recommending that corporation's securities to his customers was a basis for prospective remedial relief under the provisions of the Investment Company Act of 1940. Ernst & Ernst's clear holding that mere negligent conduct was not reached by section 10(b), however, must be understood to foreclose obtaining equitable relief for mere negligence. To be sure, equitable enforcement of section 10(b) poses no threat of disruption to the express liability sections as does an implied action for damages. The express liability sections do not provide for injunctive relief and, therefore, no disharmony will follow by enjoining, under section 10(b), conduct which would

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88. See, e.g., SEC v. Pearson, 426 F.2d 1339, 1343 (10th Cir. 1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 863 (2d Cir. 1968); SEC v. Van Horn, 371 F.2d 181, 184-86 (7th Cir. 1966).
91. Id. at 181. See note 50 supra.
give rise to damages under one of the express liability sections. But the Court's conclusions that the language of the enabling statute and the intent of Congress did not authorize a proscription of negligence left no room for an alternative construction premised upon a different remedy being sought. In contrast, the ambiguity of the statute's scope in *Capital Gains* led to consideration of the policy implications of the standard ultimately invoked.93

Other than the loss of settlement value inherent in a negligence standard,94 *Ernst & Ernst*'s sweeping rejection of a negligence standard as applied to injunctive actions is not likely to have much effect.96 In fact, the opinion performs the important service of ridding section 10(b) of a prevalent misunderstanding of the availability of injunctive relief for mere negligence. The recognized purpose of an injunction is the deterrence of future violations.96 Therefore, injunctive relief is predicated upon a reasonable expectation of future violations. The absence

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93. 375 U.S. at 192. See note 50 supra.
95. The defendant's desire to avoid the issuance of an injunction against future violations is prompted by more than the fear that he may later be found in violation of that order. Several additional sanctions arise as a corollary to the SEC obtaining an injunction against the defendant. First, the defendant will be disqualified from use of the abbreviated registration process afforded by Regulation A, unless after full hearing the commission decides otherwise. Rule 252 of Regulation A. Second, an injunction is an automatic bar from such a person being associated with a broker or dealer. Section 15(b)(5) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o(b) (Supp. V, 1975). Third, there is similarly an automatic prohibition in section 9(a)(2) of the Investment Company Act of 1940 for such person to be an investment advisor. 15 U.S.C. § 80a-9 (1970 & Supp. V, 1975). Fourth, the possibility of a disciplinary proceeding with a full panoply of sanctions being levied arises when a person who practices before the SEC, including lawyers, accountants, or other professionals, is subject to an injunction. SEC Securities Act of 1933 Release No. 5088 (1970); SEC Securities Act of 1933 Release No. 5147 (1971). Fifth, the granting of an injunction against a corporation or its manager creates the difficult problem of its disclosure in the proxy materials, registration statement or any other communication to investors.

The requirements for obtaining an injunction in SEC enforcement proceedings are distinguishable from those applicable to private actions. The Second Circuit set forth the requirements for granting an injunction in a private action: "The settled rule is that a preliminary injunction should issue only upon a clear showing of either (1) probable success on the merits and possible irreparable injury, or (2) sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tipping decidedly toward the party requesting the preliminary relief." Sonesta Int'l Hotel Corp. v. Wellington Ass'n, 483 F.2d 247, 250 (2d Cir. 1963).
of the defendant’s intent or wilfulness is invariably considered in assessing whether there will be a possible recurrence.\textsuperscript{97} Given this equitable requirement, the lower courts’ willingness to proscribe negligent nonfeasance under section 10(b) has proven to be a somewhat hollow innovation. Research has revealed no case in which mere negligent nonfeasance alone has satisfied the equitable requirement that there be a reasonable expectation of a future violation.\textsuperscript{98}

In \textit{Capital Gains}, the question whether the negligent behavior of the defendant investment advisor could be expected to recur was not addressed. The sole issue before the Court was whether an intent to deceive was required for injunctive relief under the Investment Company Act.\textsuperscript{99} Of course, it was held that such an intent was not required, but it should be observed that it is doubtful the required proof of possible recurrence of the investment advisor’s conduct could have been established without a showing of something resembling intent. Indeed, \textit{Capital Gains} may be distinguished as conduct which in its incipient state was purely careless inadvertence, but which upon refusal of the defendant to cease and desist rose to the level of conscious fault. Hence, the violation to be enjoined was conduct beyond mere negligence.

Whether injunctions can be effectively drafted to enjoin negligence is also questionable.\textsuperscript{100} The SEC has sought to avoid this problem by requesting orders which either detail what facts the defendant


\textsuperscript{98} See, e.g., \textit{SEC v. Texas Gulf Sulphur, Inc.}, 312 F. Supp. 77, 88 (S.D.N.Y. 1970) (dismissing injunction against misleading press release disputed to have been negligently prepared because no evidence of recurrent violations), aff’d, 446 F.2d 1301, 1306 (2d Cir. 1971).


\textsuperscript{100} The unenforceability of an order against negligence would itself be a basis to dismiss the action. See \textit{Giles v. Harris}, 189 U.S. 475 (1903). “In determining whether a court of equity can take jurisdiction, one of the first questions is what it can do to enforce any order that it may make.” \textit{Id.} at 487. See also \textit{Mills v. Green}, 159 U.S. 651, 653 (1895).
must disclose at specific moments in the future\textsuperscript{101} or by proposing orders which proscribe in a very general way any further violation of the federal securities laws.\textsuperscript{102} These problems aside, however, the issuance of injunctive relief for the violation of securities laws is likely to remain unaffected by recent events. It is doubtful whether "negligent failure to disclose" will continue to be so characterized if uncorrected after challenge by the SEC or a private plaintiff.\textsuperscript{103} The unwitting, albeit careless, failure of the investment advisor in \textit{Capital Gains} to disclose his potential conflict of interest with his clients ceased being negligent once challenged by the SEC. \textit{Ernst \& Ernst}, therefore, will not affect the outcome in cases in which the SEC seeks only injunctive relief against discontinued negligent conduct.\textsuperscript{104} If the behavior is continued, it ceases to be merely negligent and therefore is not removed by \textit{Ernst \& Ernst} from the reach of section 10(b).


\textsuperscript{104} \textit{Ernst \& Ernst} will have an impact upon the SEC's power to obtain relief other than an injunction. Recently the SEC has sought in connection with its request for an injunction various forms of ancillary relief, including rescission and restitution. See, e.g., Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 392 (2d Cir.), \textit{cert. denied}, 414 U.S. 910 (1973) (rescission of fraudulent tender offer); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104 (2d Cir. 1972) (restitution of proceeds obtained through fraudulent offering of stock); SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), \textit{cert. denied}, 404 U.S. 1005 (1971) (corporate employees required to disgorge profits made through trading on inside information). See generally Malley, \textit{For Reaching Remedies under the Securities Acts and the Growth of Federal Corporate Law}, 17 WM. \& MARY L. REV. 47 (1975); \textit{Program of the Committee on Federal Regulation of Securities, SEC Civil Injunction Actions}, 30 BUS. LAW. 1303 (1975). Private actions for rescission have long been recognized. See, e.g., Errion v. Connell, 236 F.2d 447 (9th Cir. 1956). The Securities Exchange Act makes no mention of the power of the SEC to obtain any relief other than an injunction. Section 21(e) of the act provides: "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 chapter, or of any rule or regulation thereunder, it may in its discretion bring an action . . . to enjoin such acts or practices . . . ." 15 U.S.C. § 78u (e) (1970).

One court concluded that the predecessor to present section 21(e) prevented granting the SEC's request for an accounting. SEC v. National Secs., Inc., 252 F. Supp. 623, 626 (D. Ariz. 1966), \textit{aff'd}, 387 F.2d 25 (9th Cir. 1967). The Supreme Court's reversal of the decisions of the lower courts in \textit{National Securities}, expressly avoided deciding whether the SEC could obtain ancillary relief or was limited by the predecessor of section 21(e) to obtain only injunctive relief. SEC v. National Secs., Inc., 393 U.S. 453, 462 n.5 (1968). Courts outside of the Ninth Circuit have repeatedly upheld the SEC's
Implications of Ernst & Ernst's Policy of Harmony Within the Legislative Scheme

Until recently, flexible construction of the federal securities laws has been the hallmark of the Supreme Court's decisions in this area.105 *Ernst & Ernst*, however, presages an end to this principle and raises the possibility that many earlier pronouncements by the courts will be reconsidered. The most portentous aspect of *Ernst & Ernst* is the Court's unqualified policy of harmony within the legislative scheme, which seems to run contrary to the continual expansion of the implied cause of action under section 10(b). If accepted uncritically, the Court's conclusion will cause a serious constriction in the scope of sec-

power to obtain other relief whenever appropriate. This has generally been justified by reference to the inherent power of a court of equity to provide ancillary relief to fully remedy the harm caused and to provide effective remedies to protect against its recurrence.

The SEC's inability to obtain an injunction against the defendant upon the mere proof of prior negligence because of the failure to establish his proclivity to commit further violations would foreclose any relief dependent upon the award of the primary remedy, an injunction, if the sole basis for the court's power to award ancillary relief were dependent upon a strict notion of the inherent power of a court possessing equitable jurisdiction. Comment, *SEC Enforcement of the Rule 10b-5 Duty to Disclose Material Information—Remedies and the Texas Gulf Sulphur Case*, 65 Mich. L. Rev. 944, 949 (1967); Note, *Ancillary Relief in SEC Injunction Suits for Violation of Rule 10b-5*, 79 Harv. L. Rev. 656, 657-58 (1966). In each of the cases in which the SEC has sought ancillary relief, the defendant's conduct has been intentional; no authority exists on whether ancillary relief would be awarded for a lesser degree of fault.

Therefore, the narrow construction of section 10(b) in *Ernst & Ernst* would have no impact on the SEC's power to obtain such ancillary relief, for this would have been foreclosed by the independent equitable considerations for the issuance of an injunction. In several cases, however, the SEC has successfully obtained rescission and restitution of profits, even though the courts refused to issue an injunction against that defendant. See, e.g., Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 395 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973) (court ordered defendant to rescind exchange offer but did not issue injunction); SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77, 90-99 (S.D.N.Y. 1970), *aff'd*, 446 F.2d 1301, 1308 (2d Cir. 1971) (court required employees to disgorge their inside profits but denied injunction against future improprieties). Such cases suggest that the court's power to order relief other than an injunction is more broadly based, arising out of a concern that remedies be devised and employed which are in keeping with the objectives of the federal securities laws. SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307-08 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971); cf. Mitchell v. Robert DeMario Jewelry, Inc., 361 U.S. 288, 291-92 (1960). See generally Comment, *Equitable Remedies in SEC Enforcement Actions*, 123 U. Pa. L. Rev. 1188 (1975). Since these additional remedies are not dependent upon satisfying the equitable considerations which would prevent the granting of an injunction against mere negligence, *Ernst & Ernst* will in this respect have an unfavorable effect upon the SEC's enforcement of section 10(b).

tion 10(b), thereby removing from the arsenal of the federal securities laws its most flexible provision. On the other hand, the approach advanced in this article would preserve the vitality of the express liability provisions without unduly restricting the scope of the implied right of action under section 10(b), thereby preserving flexibility in the federal securities laws.

This portion of the article will consider the various approaches available to reconcile the differences between the express and implied causes of action which persist even after the rejection in *Ernst & Ernst* of a negligence standard. While the approach recommended presumes that some disharmony is inherent and indeed desirable, the permissive developments in the lower courts respecting the limitations period and the establishment of the plaintiff's reliance for the implied cause of action fall outside the approach advanced in this article for harmonizing the express and implied causes of action. These developments are also inconsistent with recent Supreme Court pronouncements. Both areas will therefore be considered separately in light of these new concerns.

**Approaches to Harmonizing Section 10(b) with the Express Liability Sections**

It has been widely recognized that the remedies provided by section 10(b) and the express liability provisions overlap so that a plaintiff may bring his action under several sections simultaneously. As a result of this construction of the federal securities laws, plaintiffs have been circumventing the narrower requirements of the express liability sections by litigating under section 10(b). The continued vitality of this principle, however, must be viewed as doubtful. The first suggestion of a retreat from such a permissive construction of section 10(b) appeared in *Blue Chip Stamps v. Manor Drug Stores* where the Supreme Court observed rather gratuitously that section 10(b) may not be applicable to misstatements appearing in a prospectus for registered securities, since that conduct is proscribed by sections 11 and 12(2) of the Securities Act. Also arguments advanced in *Ernst & Ernst* appear to require that section 10(b) be harmonized where possible with the express liability sections. *Ernst & Ernst* may therefore be interpreted to confirm the implication of *Blue Chip Stamps* that the

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108. Id. at 752 n.15,
remedies provided by section 10(b) cannot intrude upon the territory covered by the express liability provisions. Of particular interest was the Court's concern in *Ernst & Ernst* that the finely tuned procedural requirements of sections 11 and 12(2) of the Securities Act\(^\text{109}\) not be circumvented by actions in negligence brought under section 10(b)\(^\text{110}\) and that the catch-all antifraud provision of section 10(b) be no broader than sections 9 and 18 of the Securities Exchange Act.\(^\text{111}\) While these concerns were directed in *Ernst & Ernst* to the more limited question of including a negligence standard within section 10(b),\(^\text{112}\) they are relevant whenever the substantive or procedural requirements of section 10(b) would be less demanding than those of an express liability section.

A policy against disruption of the legislative scheme may give rise to any one of three judicial responses. First, section 10(b) may be construed *in pari materia* with an analogous express liability provision so that its elements are identical or nearly identical.\(^\text{113}\) Second, through the maxim *expressio unius est exclusio alterius*,\(^\text{114}\) it could be found that no cause of action under section 10(b) would exist, except in those few instances in which the behavior or transaction was not covered by one of the express liability sections. A final and preferred approach involves the recognition that statutory disruption is inherent in the implied cause of action under section 10(b) and permissible only so long as the express liability provisions are not obviated by the breadth of that section.

*In Pari Materia*

In reaching its conclusion that section 10(b) should cover only

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\(^{110}\) 96 S. Ct. at 1388-89.

\(^{111}\) Id. at 1387.

\(^{112}\) See text accompanying note 73 supra.


\(^{114}\) Expression of one thing is the exclusion of another.
acts involving an absence of good faith, the Court in *Ernst & Ernst* relied on the legislative history of sections 9 and 18 of the Securities Exchange Act. The Court's construction has in it the suggestion that section 10(b) is to be interpreted in pari materia with sections 9 and 18 so that the elements of the implied right of action are to be determined by reference to those of the express liability sections. In other words, a party injured by conduct made illegal by sections 9 and 18 would have a cause of action under section 10(b), but the elements of such a cause of action would be governed by sections 9 and 18. Parties injured by conduct not governed by other provisions of the securities laws would have a cause of action governed solely by section 10(b) jurisprudence.

This construction is not foreclosed by the Supreme Court's earlier decision in *SEC v. National Securities, Inc.*, where the SEC sought rescission of a merger approved through fraudulently solicited proxies. The defendant in that case was an insurance company and was therefore exempted from the provisions of section 14(a) of the Securities Exchange Act by the provisions of section 12(g). Therefore, the SEC proceeded under section 10(b), alleging that the merger was a fraudulent sale of securities. The defense argued that section 10(b) did not cover misrepresentations in proxy solicitations. Noting that at the time of the defendant's violation it was exempt from the provisions of section 14(a), the Supreme Court stated that whether section 14(a) could be made to apply or not was irrelevant in determining the scope of section 10(b):

But the existence or nonexistence of regulation under § 14 would not affect the scope of § 10(b) and Rule 10b-5. The two sections of the Act apply to different sets of situations. Section 10(b) applies to all proscribed conduct in connection with a purchase or sale

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115. 96 S. Ct. at 1387. The Court clearly construed "good faith" as having no broader meaning than the state of mind just short of that associated with "manipulative" practices. *See id.*, 1388-89 n.28, 1389-90 n.31. A more prevalent view has been that "good faith" has a variable meaning which includes lack of diligence in appropriate cases. *See, e.g., Zweig v. Hearst Corp.*, 521 F.2d 1129, 1135 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975).


119. *Id.* § 78l(g).
of any security; § 14 applies to all proxy solicitations, whether or not in connection with a purchase or sale. The fact that there may well be some overlap is neither unusual nor unfortunate.\textsuperscript{120}

This holding is not inconsistent with a construction of in pari materia. Since section 14(a) could not be made to apply to the defendant, the Court did not face the issue of whether the section 10(b) action would be governed by the substantive provisions of section 14(a) as would be required under an in pari materia construction. Thus, National Securities is not inconsistent with the apparent concern in Ernst & Ernst that a section 10(b) action could be used to avoid the substantive provisions of other sections of the securities laws.

Although the Court in Ernst & Ernst invoked many of the concerns which would support the limitation of section 10(b)’s scope by construing it as being in pari materia with other provisions of the Securities Act and Securities Exchange Act, it stopped short of advocating such a drastic limitation of section 10(b). A threshold requirement for statutes to be in pari materia is that each relate to the same subject.\textsuperscript{121} The prevalent view has been that the Securities Act and the Securities Exchange Act are in pari materia,\textsuperscript{122} but that the antifraud provision, by definition, has not been so easily categorized. The courts have properly avoided any sweeping comparison of section 10(b) to any of the express liability sections.\textsuperscript{123} What appears to have been decided by the Court in Ernst & Ernst was not that the scope of section 10(b) should be limited by the substantive and procedural requirements of the express liability provisions, but rather that both of those sections identified generally the culpable behavior Congress believed to be manipulative and deceptive. Hence, in this part of its opinion the Court does not foreclose the possibility of using section 10(b) to avoid the substantive and procedural difficulties awaiting the plaintiff under the express liability provisions of the securities laws. A blanket in pari materia construction of section 10(b) would have so limited the antifraud provision as well as preventing its application to other abusive practices.

\textsuperscript{120} 393 U.S. at 468.

\textsuperscript{121} See United States v. Stewart, 311 U.S. 60, 64 (1940); 2A C. Sands, Sutherland Statutory Construction § 51.03, at 298-99 (4th ed. 1973).


\textsuperscript{123} Donlon Indus., Inc. v. Forte, 402 F.2d 935, 936 n.2 (2d Circ. 1968); Jordan Bldg. Corp. v. Doyle, O'Connor & Co., 401 F.2d 47 (7th Circ. 1968) (reversing trial court's dismissal of 10b-5 action on grounds that section 12(2) was exclusive avenue of relief).
An advantage of continuing to permit disharmony between the express and implied actions whenever the former are not rendered a nullity by the developments occurring under the latter is the relative impracticability of construing section 10(b) in pari materia with the express liability sections. The incorporation of the requirements of any given express liability section into section 10(b) will depend upon whether the challenged conduct is specifically proscribed by that section. This inquiry will turn on the strength of the analogy between the challenged conduct and that proscribed in an express liability section, over which differences of opinion will be most pronounced. For example, a misleading report may be reached under section 12(2) of the Securities Act,124 provided the plaintiff has purchased from the defendant. It may also be reached under section 9(a)(4) of the Securities Exchange Act,126 which has a slightly more demanding standard of fault which the plaintiff must establish, although, in contrast to section 12(2), there is no need for privity. It is unclear from which sections the elements to comprise an action under section 10(b) are to be borrowed. The disharmony between section 12(2) and section 9 (a)(4) militates against the policy favoring a construction of section 10(b) in harmony with the express liability sections. The statutory scheme itself implies that some overlap and indeed some statutory disruption is tolerable. The provision for alternative remedies which overlap appears desirable for the protection of investors who may suffer a loss in a variety of circumstances.

Requiring section 10(b) to duplicate the elements of a governing express liability section would also tend to spawn artificial results. Recovery would often depend upon the completely fortuitous presence of an event which triggers the application of the express liability provision. Barnes v. Osofsky126 illustrates the accidental impact inherent in the express liability sections. In 1963, Aileen, Inc., issued 200,000 of its shares to the public in a registered offering. The accompanying prospectus was materially misleading in forecasting sales and profits. The predictions were prepared by individuals who ignored the warning signals of a downturn in Aileen's business. Various class actions were initiated by the purchasers of Aileen's shares, many of whom had purchased their shares on the market. After the withdrawal of the section 10(b) action, only the action under section 11 of the Securities Act127

125. Id. § 78i(4) (1970).
126. 373 F.2d 269 (2d Cir. 1967).
was left. The settlement approved by the district court allowed only purchasers of the shares included within the offering described by the misleading prospectus to participate in the settlement recovery. The Second Circuit approved the result, based on section 11(a)'s provision permitting recovery for a misleading prospectus only for a "person acquiring such security." Judge Friendly believed that the statute's language itself would permit recovery only for shares included within the misleading prospectus. Thus, shares purchased on the market which could not ultimately be traced to the public offering entitled their purchasers to no rights under section 11.

While the construction of section 11 of the Securities Act in Barnes appears entirely sound, it demonstrates the arbitrary results of construing the section 10(b) action in pari materia with the express liability provisions having technical requirements. If section 10(b) under such a construction were applied to the facts in Barnes, the action of the plaintiffs who could trace their purchases directly to the public offering would be governed by the provisions of section 11. The actions of plaintiffs who relied on the very same prospectus but who bought on the open market would be governed by the law that has developed under section 10(b). The two classes of plaintiffs may therefore face different procedural and substantive hurdles, although injured by the same wrongful conduct. Thus, what appears inevitable from Barnes is that too literal an incorporation of the requirements of an express liability section into the implied cause of action under section 10(b) will lead to accidental results bearing little relationship to the broader objective of facilitating informed investment judgments.

Expressio Unius Est Exclusio Alterius

Although the maxim of statutory construction expressio unius est exclusio alterius has been broadly criticized, it recently received new vitality in National Railroad Passenger Corp. v. National Association of Railroad Passengers. The plaintiff sought to enjoin the discontinuance of the railroad passenger service by asserting a cause of action which arose by implication under the Rail Passenger Service Act of 1970. While the act expressly empowered the attorney general to enforce the duties and responsibilities arising from its provisions and

128. Id. at 271-72.
129. See, e.g., 3 L. Loss, supra note 42, at 1731 n.160.
allowed private actions in the case of labor agreements, no express authorization for suits by passengers affected by a discontinuance of service was contained in the act. Rejecting implication for the purpose of filling a gap in the statutory scheme, the Court declared:

A frequently stated principle of statutory construction is that when legislation expressly provides a particular remedy or remedies, courts should not expand the coverage of the statute to subsume other remedies. . . . This principle of statutory construction reflects an ancient maxim—*expressio unius est exclusio alterius*. Since the Act creates a public cause of action for the enforcement of its provisions and a private cause of action only under very limited circumstances, this maxim would clearly compel the conclusion that the remedies created in § 307(a) are the exclusive means to enforce the duties and obligations of the Act.132

To apply the above reasoning to section 10(b) would more easily harmonize its scope with the express liability provisions than to construe section 10(b) to be *in pari materia* with those provisions. Construing section 10(b) to be *in pari materia* may lead to artificial results and pose difficult questions in selecting a referent provision. Under *expressio unius est exclusio alterius*, however, no choice between conflicting express liability provisions need be made. Accidental results are also avoided since exclusion will be dependent upon the conduct regulated rather than the narrow technical requirements appearing within the statute. In view of the breadth of the conduct proscribed generally by the express liability provisions of the Securities Act, the maxim's application will cause significant reduction in the scope of section 10(b). Sections 11 and 12(2) of the Securities Act would eliminate a cause of action for a purchase of a security covered by a misleading prospectus133 as well as for omissions or misstatements made in the personal sale of a security. Sections 9 and 18 of the Securities Exchange Act also could be invoked to foreclose action by a purchaser or seller injured by market manipulation or information filed with the SEC.

On further analysis of the opinions, however, the maxim appears to be merely one of many means employed to ascertain a statute's purpose and to ascertain whether implication would be consistent with its goals.134 This was evident in *National Railroad Passenger's* qualification that "even the most basic general principles of statutory construction must yield to clear contrary evidence of legislative intent."135

132. *Id.* at 458.
best, therefore, the maxim may establish a presumption against implication, falling far short of compelling rejection of implication whenever extensive provision is made for private recourse.

In SEC v. C.M. Joiner Leasing Corp., the Court refused to apply the maxim to exclude from the definition of a security under section 2(1) of the Securities Act the sale of oil leaseholds in subdivided parcels. Even though the act specifically included in the definition of a security the “fractional undivided interest in oil, gas or other mineral rights,” the Court held that the subdivided leaseholds might nevertheless fall within the more general category of “investment contracts” whenever they were in fact a vehicle for investment. The legislative history of the Securities Act clearly indicated that Congress did not intend to regulate all leaseholds and feared unnecessary regulation of many legitimate business activities which were unrelated to investment. Nevertheless, the Court concluded that the more general proscription of investment contracts was enacted as a catch-all to reach atypical investment vehicles which could include other means of offering subdivided interests in oil, gas, or mineral rights.

A clear parallel exists between the question posed in Joiner Leasing and the application of expressio unius to section 10(b). Implicit in the enactment of a catch-all fraud provision is the inability of Congress to foresee and therefore to proscribe expressly all the various devices which may pose a threat to investors or securities markets. The identification by Congress of some areas of concern fails to provide a justification in this instance for the conclusion that other matters are beyond regulation. Furthermore, many of the areas covered by the express liability provisions could have been covered by actions under section 10(b). If the express liability provisions had never been passed, the courts would have shaped the contours of the remedies under section 10(b) in their own manner. The express liability provisions can be and have been viewed as an attempt to modify in important ways the cause of action that otherwise would have been implied. Under this reasoning, the express liability provisions may be mere supplements to the cause of action under section 10(b) instead of vice versa. Implication, therefore, remains consistent with the goals of the acts by providing relief for harms not specifically proscribed as

136. 320 U.S. 344 (1943).
138. 320 U.S. at 350-52.
well as for those harms which are expressly prohibited. Application of the *expressio unius* maxim to further limit the scope of section 10(b) compounds the weaknesses of the inflexible analysis employed in *Ernst & Ernst* whereby the negligence standard for section 10(b) actions was rejected without any consideration of the goals of the federal securities laws.

*Harmonization Through Assessing the Effect of Statutory Disruption*

The policy in *Ernst & Ernst* favoring harmony within the statutory scheme requires that section 10(b) not be expanded so as to "nullify the effectiveness" of the carefully drawn procedural restrictions of the express liability provisions. Before a full assessment can be made of how the implied cause of action under section 10(b) is to be modified to accommodate *Ernst & Ernst*, an important threshold question arises concerning the meaning of harmony. If harmony is to be equated with the requirement that nothing in conflict with the express liability provisions be permitted to arise from the construction and implementation of section 10(b), a poorly conceived definition arises, for no consideration is thereby given to whether the variances between the implied and express causes of action may nevertheless be consistent with the goals of the federal securities laws. *Ernst & Ernst* may have failed to assess properly whether a section 10(b) negligence standard would indeed be disruptive in the sense of nullifying the effectiveness of the express liability provisions, but it does not compel the automatic restriction on the scope of section 10(b) whenever disharmony arises between the implied and the express causes of action. The Court's inquiry into the disharmony posed by a negligence standard under section 10(b) was quite separate from its broader review of the legislative history of the Securities Exchange Act undertaken to discern the probable intent of Congress, and it is extremely doubtful that the Court would have premised its rejection of a negligence standard upon its policy against disharmony without having concluded, albeit erroneously, that the clear intent of Congress was to proscribe only intentional behavior. Earlier, in an analogous situation, the Court in *Blue Chip Stamps v. Manor Drug Stores* acknowledged how unsatisfactory it was to premise its adherence to the purchaser-seller requirement solely upon the statutory disharmony which would arise within the federal securities laws if that requirement were abandoned. The Court in

140. 96 S. Ct. 1375, 1389 (1976).
Blue Chip Stamps, therefore, sought to buttress its position with other considerations.

There is a further reason why the failure of Ernst & Ernst to interrelate its discussion of legislative intent with its policy of harmony within the regulatory scheme should not be interpreted to require that section 10(b)’s scope be restricted to avoid all interstatutory disharmony. The propriety of the advantages of proceeding under section 10(b) rather than the express liability sections was not at issue in Ernst & Ernst. Instead, only the propriety of a negligence standard was litigated. The Court was, therefore, presented with an inadequate opportunity to consider fully how the various conflicts between the express and the implied cause of action should be resolved. Thus, in the context of the full opinion in Ernst & Ernst, intrusion by the implied cause of action under section 10(b) upon the territory of an applicable express liability provision should not be strictly proscribed, provided the variance is consistent with the probable intent of Congress.

As was stated above, the Court in Ernst & Ernst failed to weigh the many factors incident to the choice of proceeding under the implied cause of action rather than the express liability provisions. The essence of the Court’s argument was that the presence of any choice was itself unduly disruptive and therefore a basis for limiting the scope of section 10(b). On thorough exploration, if section 10(b) were construed to cover negligent conduct, the advantages available to a plaintiff proceeding under section 10(b) (with the exception of certain procedural benefits) may prove to be illusory, critical, or lacking of consideration, depending upon the facts of a particular case. In most cases the plaintiff would be better advised to proceed under the applicable express liability section rather than section 10(b). A contrast of the express liability sections in the Securities Act with the requirements of section 10(b) will demonstrate that the fear of statutory disruption in Ernst & Ernst is not as pervasive or compelling as the opinion suggests.

In both sections 11 and 12(2) of the Securities Act, Congress imposed upon the defendants the burden of proving a want of culpability. It was believed that those responsible for the misleading statements probably would be in control of the facts which would establish or negate whether the misstatements or omissions were made with knowledge of their untruth or with lack of due care.142 Because the burden of proof is necessarily important, the express allocation of the burden

of proof to the defendant in sections 11 and 12(2) offers a measurable advantage to the plaintiff. To some extent, the concern that prompted Congress to place the burden upon the defendant in these sections has been reflected in developments under section 10(b). The Second\textsuperscript{143} and Seventh\textsuperscript{144} Circuits have advised that courts should be reluctant to grant a motion to dismiss prior to discovery, believing it otherwise impossible for the plaintiff to amass information sufficient to document a securities violation. Going further, the Ninth Circuit maintains that the plaintiff need not establish the defendant's culpability prior to the conclusion of the defendant's rebuttal testimony, so that any defense motion for a directed verdict made before that time will be denied.\textsuperscript{145} The belief of the Ninth Circuit is that the state of the defendant's mind may only be probed sufficiently through cross-examination. It is arguable that the general advances in discovery procedure since the enactment of the Securities Act have also lessened the concern which prompted Congress to place the burden of proof upon the defendant. None of the above developments, however, go so far as to impose upon the defendant the burden of establishing the want of culpable conduct to the satisfaction of the trier of fact; it must be concluded, therefore, that both sections 11 and 12(2) offer a benefit unavailable under section 10(b). The significance of this advantage will, of course, vary with every case.

Proof of reliance is another area in which sections 11 and 12(2) provide a substantive edge over section 10(b). Although tremendously reduced in significance by the decisions following\textit{Affiliated Ute Citizens v. United States},\textsuperscript{148} reliance is nonetheless a lingering consideration in litigation under section 10(b). It arises either as an affirmative element of the plaintiff's case\textsuperscript{147} or as a defense\textsuperscript{148} in those in-

\begin{itemize}
  \item \textsuperscript{143} Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), \textit{cert. denied}, 395 U.S. 906 (1969).
  \item \textsuperscript{144} \textit{Cf.} Tomera v. Galt, 511 F.2d 504 (7th Cir. 1975).
  \item \textsuperscript{145} White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974).
  \item \textsuperscript{146} 406 U.S. 128 (1972).
  \item \textsuperscript{147} It is perhaps still imposed upon the plaintiff in instances involving a misstatement, although perhaps only for a misstatement committed in a personal transaction. Also, it may be required even for an impersonal market transaction, if the misstatement were not reasonably calculated to influence the investing public. \textit{See generally Landy v. Federal Deposit Ins. Corp.}, 486 F.2d 139 (3d Cir. 1973); \textit{Note, The Reliance Requirement in Private Actions Under SEC Rule 10b-5}, 88 Harv. L. Rev. 584 (1975).
\end{itemize}
stances in which reliance by the plaintiff has been presumed. Under section 12(2), however, the plaintiff need only prove that he was not aware of the untruth of the defendant's representation. The defense that the plaintiff would have acted no differently if apprised of the untruth of the defendant's statement is not available under section 12(2). Furthermore, reliance is no part of an action brought under section 11 for omissions or misstatements appearing in the registration statement, unless the plaintiff's purchase occurred "after the issuer has made generally available . . . an earnings statement covering a period of at least twelve months beginning after the effective date of the registration statement."

In this isolated situation, the plaintiff must prove his reliance upon the omitted or misstated fact, although section 11 provides that this may be established without proving that the plaintiff actually read the registration statement. Given the impracticality of proving reliance upon an omission, the requirement of section 11 in the limited instance just described may be more onerous than that which may be demanded under section 10(b).

In at least one section 10(b) case, however, a district court has indicated that a plaintiff purchasing shares more than one year after issuance of a prospectus containing an omission of a material fact would similarly have to establish his reliance without the benefit of any presumption in his favor.

149. See, e.g., Competitive Ass'n, Inc. v. Laventhal, Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975); Titan Group, Inc. v. Faggen, 513 F.2d 235, 238-39 (2d Cir. 1975); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 239-40 (2d Cir. 1974).

150. 15 U.S.C. § 77k(a) (1970). Like section 12(2), section 11(a) requires that the plaintiff be unaware of the misstatement or omission of a material fact before he can recover.


152. Vogel v. Brown, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94, 831 (S.D.N.Y. 1974). In Vogel, the plaintiff alleged that the defendant had omitted a material fact from a prospectus in connection with the sale of certain convertible debenture bonds. The court held that the prospectus was not misleading, but it also stated that even if the prospectus had been false and misleading the plaintiff was not entitled to relief, as he had not relied on the prospectus. The court noted that the plaintiff had purchased the debentures two years after the issuance of the prospectus.
The presence of reliance as an element of the plaintiff's cause of action under section 10(b) interjects a factor potentially injurious to the plaintiff. The impact of this additional element will necessarily vary with the facts of every case, but it may be assumed that the plaintiff's attorney would prefer that this uncertainty not be present and will accordingly view sections 11 and 12(2) as offering a substantial advantage.

Even the recovery under section 12(2) is more advantageous to the plaintiff than recovery under section 10(b). Under section 10(b), damages are measured by the difference between the price paid and the value of the securities given full disclosure.\textsuperscript{153} This tends to exclude harmful declines in value caused by unexpected factors beyond the defendant's control.\textsuperscript{154} Under section 12(2), while the normal relief is rescission, the recovery of damages is also permitted based upon the difference between the price paid and the current market price. Under section 12(2) the defendant may be responsible for a decline in the security's price caused by factors beyond his control, such as general market declines or natural disasters.\textsuperscript{155} In rare instances, however, the plaintiff under section 10(b) may recover the defendant's profits made through his misconduct, if those are greater than the amount measured by the so-called out-of-pocket rule.\textsuperscript{156} This greater recovery is not authorized under sections 11 or 12(2).

Not only do sections 11 and 12(2) of the Securities Act continue to offer significant substantive advantages in the areas of burdens of proof, reliance, and damages, but after Ernst & Ernst those provisions impose upon the defendant a more rigorous standard of conduct than section 10(b) in that both sections 11 and 12(2) may be based upon negligence.\textsuperscript{157} These factors should permit the distinctions currently

\textsuperscript{153} See Mitchell v. Texas Gulf Sulphur, 446 F.2d 90 (10th Cir. 1971).
\textsuperscript{155} See 3 L. Loss, supra note 42, at 1721 n.122. Professor Loss believes this conclusion is supported by the rescission remedy that is the heart of section 12(2). See also Gerity v. Cable Funding Corp., 372 F. Supp. 679, 683 n.5 (D. Del. 1973). For a further discussion of loss causation, see text accompanying notes 170-83 infra.
\textsuperscript{157} Both sections 11(b)(3) and 12(2) of the Securities Act put the burden on the defendant to show that he was not negligent. 15 U.S.C. §§ 77k(b)(3), 77l(2) (1970).
existing between the elements of section 10(b) and sections 11 and 12(2) to continue without any need to restrict further the scope of section 10(b).

Thus, it is not necessary to restructure the section 10(b) action to eliminate every clear advantage it has over actions under the express liability provisions. One or more isolated advantages in the section 10(b) action will fall short of "nullifying the effectiveness" of the express liability provisions. In making the assessment of whether the effectiveness of these sections is nullified, the elements comprising each cause of action should be viewed as interdependent, just as the provisions of the federal securities laws were viewed as interdependent by the Ernst & Ernst Court in construing the scope of the implied cause of action. Thus the inquiry into the proper breadth of section 10(b) in light of an analogous express liability section transcends the mere examination of whether a single element of the implied cause of action, such as a longer statute of limitations, varies substantially from that applied to an analogous express liability section. The further inquiry should be whether that element contributes to a general subversion of the entire statutory scheme. Prior to Ernst & Ernst this analysis was often precluded by the insubstantial maxim that section 10(b) should be construed to fulfill its broad remedial purpose. A beneficial effect of the Ernst & Ernst Court's policy favoring interstatutory harmonization might be more forthright, incisive analysis of each of the elements comprising the section 10(b) cause of action, which in turn would lead to greater assurance that the scope of the action is consistent with the goals of the act.

There are indications, however, that the Supreme Court would reject the view that the elements of the implied cause of action are not

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Section 11 gives purchasers of a security a cause of action based on registration statements which misstate or omit a material fact. The cause of action can be brought against every person who signed the registration statement, directors of the issuer, the issuer itself, and professionals who were named in the registration statement as assisting in its preparation. The section also provides that any such defendant other than the issuer can escape liability if he can sustain the burden of proof that he had reasonable grounds to believe and did believe that the registration statement was true and complete. Id. § 77k(b)(3).

Section 12, on the other hand, offers purchasers a cause of action against any person who sells or offers to sell a security by means of a misleading prospectus or oral communication. Section 12 gives the defendant an opportunity to escape liability if he can prove that he did not know or could not have known of the misleading statement or omission. Id. § 77l(2).

158. 96 S. Ct. at 1387, 1389.
to be atomized in considering the scope of section 10(b). In *Blue Chip Stamps v. Manor Drug Stores*, the Supreme Court upheld the strict application of the purchaser-seller requirement for all section 10(b) private damage actions. In that case, Blue Chip Stamps had provided trading stamp services to retailers. Ninety percent of its stock was owned by nine retailers, although retailers actually served numbered in the hundreds. As a consequence of a government antitrust action, Blue Chip Stamps was required to reorganize into New Blue Chip. The decree contemplated that the holdings of the controlling shareholders of Old Blue Chip would be reduced by offering a substantial number of shares in New Blue Chip to those retailers who used its stamp service but were not shareholders of the former corporation. These retailers were provided the right under the consent decree to subscribe to an amount of shares in the new corporation proportional with their past usage of the services provided by Old Blue Chip. The offering was made through a prospectus which was alleged to have been materially misleading in projecting an unduly pessimistic picture of the future of New Blue Chip. As a result, the plaintiffs did not exercise their rights to purchase any of the shares.

The Supreme Court in *Blue Chip Stamps* referred to the extensive acceptance of the purchaser-seller requirement by the circuits, as well as to the express liability sections, which (with the sole exception of section 16(b) of the Securities Exchange Act) condition standing to sue upon purchase or sale of a security. But the primary basis

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159. 421 U.S. 723 (1975).
161. See 421 U.S. at 763-64 (Blackmun, J., dissenting) (discussion of the misstatements).
162. 421 U.S. at 731-36.
With the exception of the Seventh Circuit all the circuits have accepted with few modifications the fundamental principal that the plaintiff must be a purchaser or seller of stock to maintain an action for money damage. Bromberg, *supra* note 42, § 4.3 (560)-(569) at 87-88.10; A. Jacobs, *The Impact of Rule 10b-5*, in 1 *Securities Law*, § 38.01(d), at 2-30 to 2-60 (1976). The Seventh Circuit refused to apply the mechanical standard, instead applying a test of whether the plaintiff, in his capacity as an investor, has suffered a significant injury as a direct consequence of the defendant's fraudulent conduct in connection with a security transaction. Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir. 1973), cert. denied, 416 U.S. 960 (1974). Under this standard, standing has been accorded in questionable situations. See, e.g., Karvelas v. Sellas, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,801 (N.D. Ill. 1974).
163. 421 U.S. at 733-34. The court also noted Congress refused to amend section 10(b) in 1957 and again in 1959 to permit nonpurchasers and nonsellers to sue. *Id.* at 732.
for its decision was that without the requirement of an actual purchase or sale by the plaintiff the federal courts would be asked to engage in undue speculation whether the defendant's conduct in fact did cause the plaintiff to incur a financial loss, thus exposing the defendant to far-reaching liability.\textsuperscript{164} To be sure, the purchaser-seller requirement does serve to overcome these concerns. The criticism of the purchaser-seller requirement, however, has been that its application often defeats rather than fulfills the objectives of the federal securities laws.\textsuperscript{165} Ignored by the Court in \textit{Blue Chip Stamps} were the many additional factors which, when considered collectively, would have overcome the very same concerns raised by the Court as justification for its decision. For instance, the scope of the class of potential plaintiffs and, therefore, the magnitude of the defendant's liability in \textit{Blue Chip Stamps} were limited by the terms of the earlier antitrust consent decree, which not only proscribed the class of potential purchasers but also the amount which each such member would be entitled to purchase. In a sense, the consent decree served the same purpose as the requirement of privity. Not only did the plaintiff plead that the misrepresentations appearing in the prospectus were made with the intention of causing the plaintiffs not to purchase, but also the plaintiffs alleged that they in fact relied upon the statements in deciding not to purchase.\textsuperscript{166} The combined showing of privity, reliance, and the intent to cause the plaintiffs not to purchase could easily have been invoked by the Court to quell any uneasiness in permitting a nonpurchaser to recover. In their totality, they overcame each of the considerations of commercial practicality advanced by the Court to justify the purchaser-seller requirement. The threat of unlimited liability was eliminated by the terms of the consent decree which defined the class of potential plaintiffs and established a formula for determining the amount of stock each plaintiff would have purchased. And, contrary to the assumptions invoked by the Court,\textsuperscript{167} proof that the plaintiff would have purchased

\textsuperscript{164} Id. at 739-48. The concurring opinion of Justice Powell does not differ materially in these concerns, but merely adds the additional argument that section 10(b)'s reference to purchase or sale necessarily requires a completed purchase or sale and not merely an attempted one. Id. at 756.


\textsuperscript{166} 95 S. Ct. at 1921.

\textsuperscript{167} 421 U.S. at 746.
but for the defendant's misstatements does not arise solely by the oral declarations of the plaintiff. Proof of the defendant's intent to mislead and the definition of the class were both relevant to this inquiry and clearly constituted independent evidence of plaintiff's injury.

The Supreme Court may therefore refuse to uphold a permissive development under section 10(b) even when its subversive potential is limited by more demanding elements of the implied cause of action or by more attractive elements in the express liability provisions. Even if Blue Chip Stamps does not ultimately have this effect upon the assessment of the disruption caused by developments under section 10(b), certainly the heavy dependence in Ernst & Ernst upon integrity of the legislative scheme nevertheless may require each permissive development under the implied cause of action to be reexamined for their consistency with the requirements of the express liability provisions. Two vulnerable areas are the continued application by the lower courts of a longer limitations period and the manner of establishing plaintiffs' reliance under section 10(b).

Limitation of Actions

The limitation periods applicable to the express liability provisions in both the Securities Act and the Securities Exchange Act require suit to be instituted within one year of discovery of the violation and in no case more than three years after the plaintiff's purchase or sale. As for actions under section 10(b), the lower courts have followed the long standing practice of applying an analogous limitation period of local law. Invariably the result is a limitation period longer than that provided for the express liability sections. The short limitation period for the express liability provisions may therefore be circumvented by bringing the action under section 10(b). Ernst & Ernst invites a thorough reconsideration of whether the disruption caused by attributing a longer limitation period to section 10(b) threatens to nullify the effectiveness of the express liability provisions.


169. See, e.g., Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123 (7th Cir. 1972) (shorter limitation period selected pursuant to belief that section 10(b) imposed liability for negligence in addition to fraud); Douglass v. Glenn E. Hinton Inv., Inc., 440 F.2d 912 (9th Cir. 1971) (court adhered to original limitation even after statute was amended); Vanderboom v. Sexton, 422 F.2d 1233 (8th Cir. 1970) (court selected two-year Blue Sky Law limitation rather than three year limitation under general fraud law); Marth v. Industrial Incomes, Inc. of North America, 290 F. Supp. 755 (S.D.N.Y. 1968).
Closely related to the continued propriety of applying a longer statute of limitations to actions maintained under section 10(b) are the causation requirements of the express liability provisions and the implied cause of action. The express liability provisions tend to have liberal causation rules but short limitation periods. Therefore, if section 10(b) actions are to have long limitation periods, the question arises whether the continuation of liberal causation rules for section 10(b) actions are impermissibly disruptive of the legislative scheme.

Under the federal securities laws, causation may be divided into two distinct inquiries. The first inquiry is whether the challenged conduct prompted the plaintiff to purchase or sell a security. This is called transaction causation and traditionally has been resolved through proof that the plaintiff's trading was in reliance upon the alleged omission or misstatement. The other requirement is loss causation and involves proof that the economic loss suffered by the plaintiff is attributable to the defendant's wrongdoing.\(^\text{170}\)

Under sections 11 and 12(2) of the Securities Act, the plaintiff is generally not required to prove either transaction or loss causation. In section 11, however, a purchaser of a security covered by a defective prospectus issued more than one year prior to the issuer's latest income statement must prove his reliance upon the misleading prospectus. This may be satisfied without proof that the prospectus was actually read by the plaintiff. Section 11 permits the defendant to reduce the damages recoverable by the amount of the decline in the security's price which defendant established was due to factors unrelated to the defect in the prospectus. Loss causation, therefore, arises as an affirmative defense in section 11, but is not available under section 12 (2). Except for the narrow situation in which a broad decline in the market price for all stocks has occurred, the defendant will rarely be able to sustain the burden necessary to reduce his liability under section 11.\(^\text{171}\) Neither section 9 nor section 18 of the Securities Exchange Act imposes any requirement of loss causation. Those sections do require

\(^{170}\) See, e.g., Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 381-82 (2d Cir. 1974).

\(^{171}\) While section 11(e) of the Securities Act permits the defendant to reduce his liability upon proof that the plaintiff's loss was caused by factors unrelated to the misstatement or omission committed by the defendant, the defendant will encounter great difficulty in establishing this defense. See Fox v. Glickman Corp., 253 F. Supp. 1005, 1010 (S.D.N.Y. 1966). In approving a settlement arising out of an action maintained for a variety of omissions and misstatements appearing in a prospectus, the court established a minimum valuation of the plaintiff class shares of $4 per share. The court acknowledged that a higher amount may have been established by the defendant under sec-
a showing that the securities price was somehow affected by the defendant's conduct,\textsuperscript{172} but this is more easily associated with the determination whether the challenged conduct is material and prohibited by the provisions. The plaintiff's recovery under sections 9 and 18 is not limited to the loss directly associated with the defendant's misconduct. Section 18, but not section 9, requires proof of the plaintiff's reliance upon the defendant's omission or misstatement. Nevertheless, section 18's description of the damages which may be recovered reinforces the conclusion that loss causation may not be raised as a defense. The recovery permitted by section 18 is the "damage caused by such reliance." The full diminution in the security's price may therefore be recovered by the purchaser or seller who has relied upon misleading information filed with the SEC. In contrast, section 10(b) limits damages to the difference between the price paid and the value of the security given full disclosure.\textsuperscript{173} This formula tends to eliminate unexpected factors for which the defendant is not responsible.

The relationship between the liberal causation rules under the express liability provisions\textsuperscript{174} and the short limitation period provided for


\textsuperscript{173} See Mitchell v. Texas Gulf Sulphur, 446 F.2d 90 (10th Cir. 1971).

\textsuperscript{174} Professor Loss has stated this conclusion with respect to sections 12(2) of the Securities Act and sections 9(e) and 18 of the Securities Exchange Act. With respect to section 12(2), Professor Loss observes: "It would seem to follow consistently with a rescission measure of damages, that the buyer need not prove causation as a common law deceit." 3 L. Loss, \textit{supra} note 42, at 1721 n.122. He states his conclusions somewhat more cautiously with respect to section 9(e): "[O]nce the plaintiff shows he has bought or sold 'at a price which was affected by' the illegal activity, it is at least arguable that the damages he has 'sustained as a result' of that activity, do not have to be prorated according to the extent to which the price was affected by that activity as distinct from the extent to which it may have been affected by ordinary market movements—a fanciful subject for speculation at best. But even this is by no means certain. And
in those actions may be attributed to the realization by Congress that, as the length of the limitations period is extended without interjecting a more demanding requirement for loss or even transaction causation, the likelihood is increased that the defendant's misleading statement or manipulative conduct will establish him as an insurer of the enterprise's success. The perpetuation of permissive causation requirements for the implied cause of action appearing in the decisions of the lower courts\(^{176}\) might therefore be inconsistent with the objectives of the federal securities laws when suit is maintained under section 10(b) outside the limitations period of the express liability sections.

The legislative reports offer no clear evidence that the intent of Congress in selecting a relatively short limitations period for both the Securities Act and the Securities Exchange Act was in response to the permissive causation requirements contained in their express liability provisions.\(^{176}\) Nevertheless, much of what appears in the legislative history is consistent with the argument that a short limitations period is necessary in view of the unique causation requirements of the express liability provisions. The debates in the Senate were primarily concerned with the desirability of having a twin limitation period—one premised upon discovery of the violation and another dependent upon suit being maintained within a specified period after the occurrence of the violation—rather than a single requirement that suit must be maintained within an arbitrarily selected period of time after the occurrence

except in the cruder cases of manipulation . . . it may be no mean trick to demonstrate . . . that that activity affected the price at which the plaintiff bought or sold." \textit{Id.} at 1748-49. A similar conclusion was reached for section 18. \textit{Id.} at 1752.

175. See text accompanying notes 157-94 infra.

176. When first enacted, the Securities Act provided an extremely long limitation period, requiring suit to be maintained within two years of discovery and barring any action unless filed within ten years of the violation. Securities Act of 1933, Pub. L. No. 73-22, \$ 13, 48 Stat. 84. The limitation period provided in the bills first introduced in the House and the Senate which gave rise to the Securities Exchange Act provided a limitation period shorter than the period Congress had enacted for the Securities Act. Both the House and the Senate versions required suit to be brought within two years of discovery of the violation but contained no limitation demanding suit to be initiated within a specified time after the violation had occurred. S. 2693, 73d Cong., 2d Sess. (1934); H.R. 7852, 73d Cong., 2d Sess. (1934). After hearings, the bills in each house preserved the requirement that suit must in any event have been filed within two years of discovery of the violation. S. 3420, 73d Cong., 2d Sess., \$ 9(e), 18(c) (1934); H.R. 8720, 73d Cong., 2d Sess., \$ 9(d), 17(c) (1934). The House bill emerging from the Committee on Interstate and Foreign Commerce amended the limitations period to require a single limitations period providing that no suit could be maintained more than three years after the violation had occurred. H.R. 9323, 73d Cong., 2d Sess., \$ 8(e), 17(c) (1934). The Senate bill, after debate, was amended to reduce the limitation period to one year after the plaintiff's discovery and established an outer time limit barring any action maintained more than five years after the violation. 78 Cong. Rec. 8202-03 (1934). The widely divergent statute of limitations provisions in the House and Sen-
of the violation. 177 Throughout the debates on this question, there existed a concern that the plaintiff must be diligent in prosecuting his rights under the act. Congress clearly wanted to avoid a limitation provision which would permit investors having a cause of action under the federal securities laws to delay prosecuting their cause of action in order to speculate in further increases in the stock’s price with the knowledge that if the market value of the security should decline they would be able to recoup all their losses because a misstatement or omission had been committed in connection with their purchase or sale. 178 The requirement that suit be maintained within a definite period after discovery was, therefore, drafted in response to this concern. The plaintiff’s ability to speculate in the defendant’s wrongdoing under a long limitations period is directly facilitated by the absence of an affirmative showing of causation. Requiring the plaintiff to prove loss causation in actions maintained under section 10(b) more than three years after the violation would therefore tend to implement the intent of Congress in enacting the acts’ limitation periods for the express liability provisions.

Just as with the requirement that suit be maintained within one year of discovery of the violation, the imposition of a requirement that suit never be maintained more than three years after the violation regardless of when discovery occurred may also have been promulgated out of fear that otherwise the defendant could be held responsible for losses unrelated to his own wrongdoing. Certainly the likelihood of unrelated losses being charged to the defendant increases as the length of the limitation period is increased. 179 In the congressional debates, the only reference to the purpose for requiring suit to be maintained within a stated period of time after the violation appears directed equally to curbing the plaintiff’s ability to speculate in the defendant’s

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177. 78 Cong. Rec. 8197-203 (1934).
178. Id.
179. Dooley, supra note 171, at 801 n.121.
violation, as well as to the pragmatic concern that a maximum time for exposing corporate personnel to liability must be fixed.\textsuperscript{180}

A further justification advanced in the congressional debates for the requirement that suit be maintained within one year of discovery of the violation was that the express liability sections, with the exception of section 9, did not impose upon the plaintiff the burden of proving the defendant’s culpability.\textsuperscript{181} That section 10(b) places this burden upon the plaintiff arguably provides further support for the continuation of a longer limitations period for the implied cause of action. Nevertheless, the application of the short limitations period to section 9 of the Securities Exchange Act, which places the burden of proving the defendant’s mental state upon the plaintiff, diminishes somewhat the support for variant limitation periods being premised solely upon the differing allocations of the burdens of proof between the express liability sections and the implied cause of action.\textsuperscript{182}

The \textit{Ernst \& Ernst} Court’s policy against statutory disruption and its interpretation of congressional intent will permit the continued acceptance of a longer limitation period for the implied cause of action under section 10(b) only if it is consistent with the philosophy underlying the limitation period for the applicable express liability sections. Although the disruptive effect of section 10(b)’s longer limitation period was emphasized in \textit{Ernst \& Ernst},\textsuperscript{183} the Court failed to resolve the problem. The blunt remedy it prescribed for section 10(b)’s circumvention of the shorter limitation period of the express liability sections was the rejection of a negligence standard for the implied cause of action. This response fails to eliminate the continued availability of a longer limitation period for section 10(b)’s application to intentional misbehavior. The unique causation requirements of the express liability sections do, however, offer an acceptable starting point for harmonizing the implied cause of action’s longer limitations period with that of the express liability sections. The allocation of the burden of proof to the defendant in most of the express liability sections is a further consideration in permitting a longer statute of limitations under section 10(b). Consistent with this interpretation of the regulatory scheme, a longer limitations period under section 10(b) should be applied only when accompanied by the imposition of demanding require-

\textsuperscript{180} 78 \textsc{Cong. Rec.} 8199-200 (1934) (remarks of Senator Byrnes).
\textsuperscript{181} \textit{Id.} at 8201 (remarks of Senator Austin).
\textsuperscript{182} The Senate debate proceeded on the erroneous belief that all the express liability sections placed the burden of disproving culpability upon the defendant. \textit{Id.}
\textsuperscript{183} 96 S. Ct. 1375, 1388-89 (1976).
ments for loss and transaction causation. The likelihood of the defendant being held liable for an economic loss for which he is not responsible would thereby be reduced substantially. In this manner, the vitality of the express liability sections is maintained by preserving the recovery they facilitate not only through their allocation of the burden of proof, but also through their elimination of the difficult inquiry into loss and sometimes transaction causation.

The Requirement and Proof of Transaction Causation

The preceding discussion suggests that the plaintiff may properly be required to prove his reliance upon a misleading statement whenever the section 10(b) action is maintained outside the limitation period for the express liability sections. Independent of this narrow question, Ernst & Ernst and its policy favoring harmony within the federal securities law raises substantial doubts about the current role of reliance under section 10(b). For example, section 18 of the Securities Exchange Act mandates an affirmative showing of reliance. Under section 12(2) of the Securities Act, purchasers are barred from recovery if they know of the untruth of the defendant's statements. Conversely, under section 10(b), many lower courts have been abandoning the requirement of reliance and have been permitting recovery merely upon proof of loss causation. Ernst & Ernst invites an examination of whether these liberal causation rules of section 10(b) remain viable. Furthermore, whether courts can continue to establish transaction causation by presuming reliance from a showing of materiality is in doubt. This section will examine both of these developments to determine whether proof of transaction causation should be required under section 10(b) and how it should be established.

After Affiliated Ute Citizens v. United States, reliance has played an ever diminishing role under section 10(b). In Affiliated Ute, the defendants, Gale and Haslam, were employees of a bank which acted both as transfer agent and as custodian for the shares of UDC, an unincorporated association. The shares were distributed among the members of the Ute tribe. Although the bank was requested by UDC to discourage trading by Ute members, Gale and Haslam abused their positions by creating a secondary market for UDC shares and by arranging for the sale of plaintiffs' shares, sometimes to

themselves, at prices substantially below their fair market value. In arranging these sales, the defendants failed to inform the plaintiffs of certain material facts relating to the shares of UDC. The court of appeals denied recovery for some of these sales because there was no evidence that plaintiffs relied upon the defendants’ failure to disclose material facts.\textsuperscript{185} The Supreme Court reversed:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a requisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.\textsuperscript{186}

Responding to the breadth of the above statement by the Supreme Court, the prevailing approach in the lower courts is that proof of the plaintiff’s reliance is subsumed within the plaintiff’s proof of materiality. While most earlier cases have limited this result to omissions,\textsuperscript{187} a similar result has occurred in cases involving misstatements.\textsuperscript{188} Hence, the only proof necessary to establish that the plaintiff’s loss was caused by the defendant’s misstatement or omission of fact is a showing that the plaintiff’s purchase or sale occurred during or after the violation coupled with a showing that the omitted or misstated fact was material. Illustrative of this formulation of causation is Blackie v. Barrack.\textsuperscript{189}

In Blackie, the Ninth Circuit upheld the district court’s determination that a class action could be maintained on behalf of all purchasers of Ampex Corporation’s shares during a twenty-seven month period between the release of an inflated 1970 annual report and the disclosure in 1972 of corporate losses in the amount of $90 million. The defend-

\textsuperscript{185} Reyos v. United States, 431 F.2d 1337, 1348 (10th Cir. 1970).
\textsuperscript{186} 406 U.S. at 153-54.
\textsuperscript{187} See, e.g., Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (3d Cir. 1974).
\textsuperscript{188} See, e.g., Herbst v. International Tel. & Tel. Corp., 495 F.2d 1308 (2d Cir. 1974).
\textsuperscript{189} 524 F.2d 891 (9th Cir. 1975). The case has significance for another reason. The Ninth Circuit held that a district court’s certification of class action is not a “final decision” for purposes of appeal under 28 U.S.C. § 1291 (1970). The court refused to adopt the “reverse death knell” doctrine accepted by the Second Circuit which permits appeal from the district court’s determination that the suit may be maintained as a class action. See Eisen v. Carlisle & Jacqueline, 370 F.2d 119 (2d Cir. 1966), cert. denied, 386 U.S. 1035 (1967).
ant opposed the certification of the class on the ground that common questions did not predominate the litigation, since each member of the class would be required to prove his reliance upon the misleading reports. The Ninth Circuit rejected this argument and held that purchasers of stock in the open market indirectly rely upon published financial reports through their belief that the market price is based upon accurate reporting of corporate information. 190

Proof of reliance is adduced to demonstrate the causal connection between the defendant's wrongdoing and the plaintiff's loss. We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a prima facie case. 191

Eliminated from consideration is whether the plaintiff read or was even aware of the misleading report. In dicta, the Ninth Circuit observed that the causal connection may be overcome by proof that the market price was unaffected, either because the fact misrepresented was not material or because there was insufficient reliance by investors to affect the stock's price; or upon proof that the fact was known to the plaintiff or, if known, would not have changed his investment decision. 192

An even more liberal presumption of causation, however, has been invoked by numerous district courts and may be referred to as the inflated market theory. 193 Under the inflated market theory, the plaintiff's recovery is defeated neither by his knowledge of the falsity of the representation nor by a showing that he would not have consid-

190. 524 F.2d at 907.
191. Id. at 906.
ered the representation important. So long as there is proof that the market price of the security was affected by the misrepresentation, causation is established because the misrepresentation has prevented the plaintiff's purchase at a lower price. Thus, in Wechsler v. Steinberg, 194 the district court refused to dismiss an individual suit for misrepresentation because of the plaintiff's knowledge that the price of the acquired stock was inflated by the defendant's misleading financial reports. The court concluded that the causation would be established upon proof that the plaintiff's losses would have been reduced if the purchase had been consummated at a lower price.

The inflated market theory has much to recommend itself. First, the theory would greatly facilitate the prosecution of class actions by eliminating the burdensome hearings necessitated by reliance defenses. While such a separate proceeding has not prevented the litigation from being conducted as a class action, 195 it continues to raise grave doubts respecting whether common questions do in fact predominate so as to permit certification of class actions:

Use of the bifurcation method, however, does not resolve what appears to be an inherent conflict between proof of the reliance element of 10b-5 action and the "predominance of common issues" requirement of Rule 23(b)(3); it merely delays resolution of the problem until a later date. But this delay in effect prohibits the court from affirmatively finding that the cause is manageable as a class action as required by Rule 23(b)(3)(D). That is, if actual individual reliance in its common law sense need be proved by each class member, the trial of that issue, even at a later stage in the proceedings, would tax the court's (and counsel's) resources to an intolerable extent. Accordingly, the court is constrained to deal with the reliance enigma at the outset in making its determination of whether a class should be certified. 196

Second, the distinction between a rebuttable presumption and a conclusive one may be more apparent than real. The defenses available under a rebuttable presumption may eliminate few plaintiffs in the class and most likely will fail to demonstrate that misstatements or omissions of material facts have not influenced the market price. 197 This is es-

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197. See Blackie v. Barrack, 524 F.2d 891, 906-07 n.22 (9th Cir. 1975); Reliance Requirement, supra note 193, at 590 n.33.
pecially true under the reasoning in *Blackie*, where the reliance upon the market price was held to be an acceptable substitute for direct reliance upon the misleading report itself. To the extent that recovery is over-inclusive, it provides a meaningful deterrent without departing from the compensatory orientation of the implied action. Third, upon proof of market manipulation as a consequence of the misrepresentation there is demonstrable loss by each member of the class who purchased at the inflated price. Finally, the determination of reliance is entirely objective under the market inflation theory, resting upon proof that the reasonable investor would have considered the misstated or omitted fact important. In appropriate cases, the defense that the fact was not material, or that there was insufficient reliance by investors to have influenced the stock’s price, may be shown by expert testimony.

The authority relied upon by the proponents of the inflated market theory and other liberal presumptions of reliance in section 10 (b) actions is *Mills v. Electric Auto-Lite Co.* and *Chris-Craft Industries v. Piper Aircraft Corp.* The holdings on causation in these cases, however, are inapposite to causation questions presented by open market purchases, thereby making analogy to either case inappropriate to determine causation rules for section 10(b) actions.

In *Mills*, an action was maintained under section 14(a) of the Securities Exchange Act seeking damages for losses caused by shareholder approval of a merger. Plaintiffs claimed that the proxy statement of management contained an omission of a material fact. The first Supreme Court decision to consider the role of reliance in securities litigation, *Mills* held that a causal relationship between the alleged omission and the approval of the merger may be presumed from a showing of materiality. The approval of the merger in *Mills* by the shareholders’

198. Because the plaintiff had incurred some financial loss, the recovery by a nonrellying plaintiff under the inflated market theory is distinguishable from *Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R.*, 417 U.S. 703 (1974). In *Bangor Punta* standing to sue was denied to a plaintiff who suffered no financial loss as a result of a violation of section 10(b). *Id.* at 717.

199. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).


vote was required by state law, and each shareholder was forced to under go the merger’s effects, even though he may have voted against the merger or was fully aware of the misrepresentation in the proxy materials. Thus, the personal reliance of the plaintiff was irrelevant in causing his loss and therefore was held not to be a basis for excluding him from participating in the recovery under section 14(a). Reliance by a majority of the shareholders approving the merger was relevant, however. Thus, the Mills Court limited rebuttal of the presumption of causation to a showing that the number of shareholders who found or would have found the omitted or misstated facts immaterial were sufficient to assure approval of the merger.

A similar analysis is applicable to injuries which may attend a fraudulent tender offer in violation of section 14(e) of the Securities Exchange Act. In Chris-Craft Industries v. Piper Aircraft Corp., a defeated tender offeror sued its opponent with whom it was competing for the control of Piper Aircraft Corporation, alleging that the defendant’s misleading tender offer had prevented the plaintiff from acquiring control of Piper. The district court required proof that the stockholders of Piper relied upon the defendant’s misleading tender offer in arriving at their decisions to reject the plaintiff’s offer and to accept the defendant’s offer. The Second Circuit reversed this holding and stated that reliance by numerous investors could be presumed upon establishment of the materiality of the misrepresentation. As with the proxy solicitation in Mills, the plaintiff’s reliance or knowledge was irrelevant in assessing whether its loss was caused by the defendant’s violation of section 14(e). Whether the plaintiff would incur a loss was completely dependent upon the action of others in reliance upon the defendant’s misstatement or omission of material fact.

The investment decisions protected by section 10(b) are easily distinguished from much of the conduct proscribed by sections 14(a) and 14(e). Included within the class of investors protected by sections 14(a) and 14(e) are those who cannot protect themselves from the consequences of the defendant’s misrepresentations, even though the investor was fully informed. In other words, their individual reliance is irrelevant. For example, the defeated tender offeror in Chris-Craft or the shareholder requesting relief on behalf of the corporation for

206. 480 F.2d 341 (2d Cir. 1973).
208. 480 F.2d at 373-74.
a defective proxy solicitation in *Mills* each suffered an alleged economic loss, although fully informed of the falsity of the defendant's representations. The collective decision of other investors who were not aware of the falsity of the representations assured the loss of each nonrelying plaintiff. Therefore, whenever the decision is a collective one, only collective reliance is relevant. Examination of reliance of individual investors in such a situation is only relevant to document the immateriality of the misrepresentations or, given their materiality, the fact that the group would not have changed its decision if it had knowledge of the misrepresentations. Thus, the inflated market theory, in which the proof of causation in open market transactions under section 10(b) is patterned after the inquiry of *Mills* and *Chris-Craft* into causation, has accordingly viewed the plaintiff's nonreliance as only relevant in the larger inquiry whether the defendant's representation has artificially stimulated the security's price.

Under section 10(b), however, each investor's decision to purchase or sell is independent of that of other investors. Although section 10(b) has occasionally been applied to tender offers and proxy solicitations, in which the analogy to the simplified causation requirements of *Mills* and *Chris-Craft* would be proper, the antifraud provision is more generally applied to individual market transactions. In such simple buy-sell transactions, the individual plaintiff, if aware of the defendant's misconduct, has the power to avoid a loss by withdrawing himself from the proposed purchase or sale. Because of this freedom of choice, unavailable to plaintiffs in tender offers or proxy solicitations, courts should reject the inflated market theory and should exclude from recovery investors who proceeded to invest despite their knowledge of the manipulation or misrepresentations, as well as those investors who would not have altered their decision had they known. The argument that they have nevertheless been causally injured by a purchase or sale at an inflated price is not persuasive. The recoveries permissible under section 10(b) should be no broader than the protections intended to be offered by section 10(b). For those securities transactions which are volitional because the plaintiff's purchase or sale is not compelled by the collective decision of others, the scope of the antifraud provision is properly limited to assuring the flow of material information to investors so that an informed investment decision may be made by the individual investor. Once the investor has been informed of the full facts and possesses the freedom to forego a security transaction, there appears little justification to extend the protections of section 10(b) to compensate for matters unrelated to the decision to purchase.
or sell. An analogy to *Mills* and *Chris-Craft* is proper, however, in section 10(b) actions involving nonvolitional transactions in which full disclosure does not itself prevent the plaintiff's loss. For such nonvolitional purchases and sales, transaction causation has less importance and proof of the plaintiff's nonreliance should not merit dismissal.

The language of section 10(b) is inconsistent with the inflated market theory. Section 10(b)'s requirement that the manipulation or deception occur or be used "in connection with the purchase or sale of any security" invites proof that the defendant's violation prompted the plaintiff's purchase or sale. This position is supported by much of the Supreme Court's discussion in *Blue Chip Stamps v. Manor Drug Stores*, in which the Court followed the *Birnbaum* rule that only actual purchasers or sellers in connection with the fraud have standing under the implied right of action. The Supreme Court recognized as a consequent disadvantage of the *Birnbaum* rule that it would frequently operate to prevent recovery for losses causally connected with a violation of section 10(b). The Court, however, believed the countervailing advantages of the *Birnbaum* rule overcame the disadvantages it posed.

The Court was of the belief that adherence to the *Birnbaum* rule would afford a workable device to deter nuisance suits and dilatory litigation practices. The Court's explanation of how these purposes would be served strongly suggests that transaction causation must be established in all actions maintained under section 10(b), as the Court believed that the purchaser-seller requirement of *Birnbaum* achieved this purpose at least at a threshold level.

But it [the *Birnbaum* rule] also separates in a readily demonstrable manner the group of plaintiffs who actually purchased or actually sold, and whose version of the facts is therefore more likely to be believed by the trier of fact, from the vastly larger world of potential plaintiffs who might successfully allege a claim but could seldom succeed in proving it.

Thus, the actual purchase or sale confirms the allegation that the defendant's misrepresentation induced the plaintiff's trading. It may be

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212. *421* U.S. at 738-39, 754-55. *See also* *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136, 145 (9th Cir. 1973) (Hufstedler, J., dissenting).

213. *421* U.S. at 743.
argued that the requirement of proof of transaction causation implicit in the Court's opinion would have been directed solely to the proof required of a nonpurchasing or nonselling plaintiff, but would have no application to plaintiffs who satisfy Birnbaum. The Court's references are not so limited. Nowhere in the opinion did the Court assume that the elements of proof would be different for nonpurchasers or nonsellers from those applicable to actual purchasers or sellers.\textsuperscript{214} Coupled with its recognition that an economic loss may occur irrespective of a purchase or sale by the plaintiff, the Court appears to view the purchaser-seller requirement as a means of establishing transaction causation. The presence of the purchase or sale by the plaintiff serves as objective verification of the plaintiff's allegation that the transaction was induced by the defendant's misrepresentation. Therefore, a dispensation of the requirement that the plaintiff prove transaction causation to recover in a section 10(b) action would appear to be inconsistent with the implications underlying Blue Chip Stamps.

But even if it is agreed that transaction causation is to be maintained as a predicate to recover under section 10(b), it is far from clear how this element is to be established. Certainly no issue in securities litigation raises as much skepticism as the uncorroborated assertion of reliance. The following excerpt from Blue Chip Stamps, although directed toward the results which would occur in the absence of a Birnbaum rule, is equally applicable to actual purchasers or sellers:

Plaintiff's entire testimony could be dependent upon uncorroborated oral evidence of many of the crucial elements of his claim, and still be sufficient to go to the jury. The jury would not even have the benefit of weighing the plaintiff's version against the defendant's version, since the elements to which the plaintiff would testify would be in many cases totally unknown and unknowable to the defendant. The very real risk in permitting those in respondent's position to sue under Rule 10b-5 is that the door will be open to recovery of substantial damages on the part of one who offers only his own testimony to prove that he ever consulted a prospectus of the issuer, that he paid any attention to it or that the representations contained in it damaged him.\textsuperscript{215}

Responsive to the concern expressed above is the argument that the materiality of an item or event to the reasonable investor, like evidence of an actual purchase or sale, serves to corroborate the plaintiff's assertion of reliance. Material information has been defined as information

\textsuperscript{214} Id.
\textsuperscript{215} Id. at 746.
that a reasonable investor would consider important (but not necessarily decisive) in making an investment decision. 216

The Court's recognition that the bare fulfillment of the *Birnbaum* rule does not itself assure causation makes the corroborative impact of a finding of materiality a far more important factor than proof of the plaintiff's purchase or sale. Nevertheless, the corroborative value of a threshold showing of materiality is far from clear in view of the results of several studies of investor behavior. These studies suggest that a showing of materiality is not a reliable method of predicting what course of conduct investors would actually take.

Although some generalizations may be deduced from the empirical studies of materiality concerning information believed important by investors, each study has revealed that investors maintain disparate viewpoints when called upon to reach determinations of whether an event or fact would be considered important in making an investment decision. 217 The disparity of opinion among investors increases as they are required to assess in the context of a specific decision the relative significance of information already characterized by them to be material. 218

Therefore, if materiality is to serve the additional purpose of predicting reliance, arguably the determination of materiality should not become a function of whether the reasonable investor would consider disclosure of the fact important, but whether disclosure would have had a decisive impact on the investor's decision. The Supreme Court, however, has rejected the notion that materiality should encompass only information which will alter investor behavior.

In *TSC Industries, Inc. v. Northway, Inc.*, 219 the Supreme Court clarified its dicta in *Mills* defining materiality for section 14(a) of the Securities Exchange Act:

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An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote... It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. 220

In another portion of its opinion, the Court reaffirmed its holding in Mills that the demonstration of materiality obviates the need for the plaintiff to prove further the causal relationship between the fraudulent conduct and injury. 221

The test of materiality set forth in Northway, Inc. is not significantly different from that presently applied under section 10(b). 222 Since the validity of this standard as an indicator of investor reliance may be questionable, it fails to complement fully the concerns for corroboration articulated in Blue Chip Stamps. It would be far better to recognize the basic distinctions in causation between actions under section 14(a) and section 10(b), namely that the individual questions of reliance are not as critical under the former, due to their unique factual settings, whereas the independent character of the investment decisions

220. Id. at 2133 (emphasis added). See also Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384-85 (1970), where the Court rejected the argument that causation required in addition to proof of materiality that "the defect actually had a decisive effect on the voting."

221. Id. at 2130-31.

222. The standard of materiality applied by most of the circuits under section 10(b) is that embodied in Restatement (Second) of Torts § 538(2)(a) (1965), namely whether a reasonable man would attach importance to the fact not disclosed in determining his choice of action in the transaction in question. See, e.g., Robinson v. Cupples Container Co., 513 F.2d 1274, 1277 (9th Cir. 1974); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 603-04 (5th Cir. 1974); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965). The First, Third, Fourth, Sixth, and Tenth Circuits have also adopted the standard. Only the Seventh Circuit adhered to a more liberal standard of whether the reasonable investor might have considered the fact important. See Hidel v. International Diversified Inv., 520 F.2d 329, 333 (7th Cir. 1975). This liberal interpretation was held consistent with the standard for materiality applied under section 14(a). See Northway, Inc. v. TSC Indus., Inc., 512 F.2d 324 (7th Cir. 1975), rev'd, 96 S. Ct. 2126 (1976). The Supreme Court, in its reversal of the Seventh Circuit's more liberal standard of materiality, clearly intimated the Court's definition would also be applied to section 10(b). See TSC Indus., Inc. v. Northway, Inc., 96 S. Ct. 2126 n.9 (1976). A further reason for concluding that the Supreme Court's verbal formulation of a materiality standard for section 14(a) in TSC Industries will apply as well to section 10(b) is that no variance in the standard for materiality is merited on the basis of the use of the information. Discussion Memorandum, An Analysis of Issues Related to Criteria for Determining Materiality, 111 (F.A.S.B. 1975).
protected by section 10(b) heightens the importance of the individual question of reliance. The willingness of courts to presume causation under section 14(a) from a showing of materiality should not automatically lead them to the same conclusion in actions under section 10(b). A far more realistic approach under section 10(b) is to recognize that the strength of the inference of reliance to be drawn from proof of materiality will necessarily vary with each case, depending upon the magnitude of the event or fact. In accordance with this view, materiality should become merely one of many circumstantial facts from which the trier of fact may conclude that the plaintiff did rely upon the misstatement or omission. As such, it would be inappropriate to prejudge this inference by concluding that the strength of the inference is sufficient to support a presumption of reliance.

This interpretation is consistent with the Court’s disposition of reliance in Affiliated Ute. An important qualification in the Supreme Court’s subsumption of reliance within materiality was that it believed this treatment of reliance was applicable “under the circumstances of this case.”223 The Court’s analysis preceding its formulation of causation gives meaning to this qualifying language. The Court carefully distinguished the duties of a defendant described in the first and third subparagraphs of Rule 10b-5, which reach devices, schemes, or artifices to defraud, from the material omissions and misstatements covered in the second subparagraph.224 The thrust of the Court’s argument appears to be that if the defendant’s conduct rose to the level of fraud, such as inducing the plaintiffs to dispose of their shares below their fair value, liability may be premised without any further showing of causation other than the failure to disclose the fraudulent scheme. In this way, the defendant’s wrongful intention serves to corroborate the presence of transaction causation. On the other hand, if the defendant did not intend to induce the plaintiff’s purchase or sale, but merely engaged in a knowing misstatement or omission, proof of reliance may arguably be required, since the conduct fails to rise to the level to constitute the fraud presented in Affiliated Ute. In addition, Affiliated Ute can be viewed as no more than a case in which evidence on the record was found to support a finding of reliance. The clear fiduciary relationship which existed between the unsophisticated plaintiffs and the defendants,225 in which the defendants were the plain-

224. Id.
225. See id. at 145.
tiff’s sole contact with the outside investors, itself supports a strong inference that they were relying upon the defendants to inform them of any fact important in their decision. Also it was reasonable to assume that if the plaintiffs had known a higher price was available for their shares, they would not have sold as they did for a lower price. Therefore, many more considerations were at work in Affiliated Ute than the mechanical consideration of whether a material omission had occurred. A far more flexible approach to the materiality-causation consideration which arises under section 10(b) would be to follow the approach adopted by a minority of the Circuits and view Affiliated Ute’s unique factual setting as establishing proof of reliance rather than the automatic presumption of reliance from proof of materiality. It is appropriate to recognize that inferences of reliance varying in strength arise from many factors, including the materiality of the misstatement or omission, the defendant’s intent, and the existence of a fiduciary relationship. This approach to reliance will not only fulfill the concern expressed in Blue Chip Stamps against over inclusive recoveries, but also will avoid further conflicts with the express liability provisions which were disfavored by the Court in Ernst & Ernst.

Conclusion

Perhaps the only conclusion which can safely be drawn from the Supreme Court’s resolution of Ernst & Ernst is that a negligence standard in a section 10(b) action for damages has been rejected without qualification. The absence of any consideration of policy in the opinion should foreclose equitable relief for mere negligence as well. Even these conclusions are blurred by the Court’s apparent willingness to include recklessness within its requirement of scienter for the lower courts have already demonstrated a propensity to disagree whether con-


227. The First Circuit has held that a trial court finding of materiality and that a relationship of trust and confidence existed between the plaintiff and the defendant constituted an implicit finding of reliance. Janigan v. Taylor, 344 F.2d 781, 785-86 (1st Cir. 1965). See also Fridrich v. Bradford, [Current Binder] CCH Fed. Sec. L. REP. ¶ 95,723 (4th Cir. 1976) (rejecting argument that Affiliated Ute greatly simplified the plaintiff’s proof of causation in case of nondisclosure); Landy v. Federal Deposit Ins. Corp., 486 F.2d 139, 168 (3d Cir. 1973) (presumption of reliance should not apply when reports containing omission were not publicly distributed); Thomas v. Duralite Co., 386 F. Supp. 698 (D.N.J. 1974), modified, 524 F.2d 577 (3d Cir. 1975) (fact was so material that it must have been a decisive factor in the plaintiff’s decision to sell).
duct is merely negligent or reckless behavior. The more uncertain ramification of *Ernst & Ernst* is the impact the Court's approach will have in further refining the scope of section 10(b). To be sure, the Court's policy of interstatutory harmony and its interpretation of congressional intent were flawed in many ways which detract from the value of *Ernst & Ernst* as a thoughtful guidepost for the future consideration of other areas of concern under section 10(b). Nevertheless, the Court's fresh and unqualified concern that the elements of section 10(b) not disrupt the statutory scheme, as well as the great concern that section 10(b)'s scope must be consistent with the probable intent of Congress, should cause a reconsideration of a variety of permissive developments that have occurred under section 10(b). Indeed each of the elements comprising the implied cause of action are in need of reexamination in view of the new perspectives advanced in *Blue Chip Stamps* and *Ernst & Ernst*. For those who have found the expansion of section 10(b) too hasty and often ponderous due to the dearth of consideration given to each new development, *Ernst & Ernst* not only offers substantial impetus for the lower courts to consider more fully the developments which have occurred in the implied cause of action but also should cause the lower courts to be more skeptical before making any future departures from the contours of the express liability provisions. Even though such a reevaluation may not lead to a wholesale restriction on the scope of the implied cause of action, the adjustments which do occur, when coupled with a more complete analysis and justification for the disharmonies which arise between the express and the implied causes of action, should provide the best assurance that further sweeping restrictions will not later be imposed by the Supreme Court upon the flexible application of section 10(b). In this way, *Ernst & Ernst*, although reducing the protections offered by the antifraud provision through its rejection of a negligence standard, may ultimately result in strengthening the implied cause of action's application to other levels of wrongdoing through the impetus it provides for the lower courts to clarify and rationalize its scope and application.

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