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Culpability in Implied Private Actions Under § 17(a): Is Scienter Required After Aaron v. SEC?

Alexander H. Gillespie

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RECENT DEVELOPMENTS IN CORPORATE AND SECURITIES LAW

Culpability in Implied Private Actions Under § 17(a): Is Sciente...
gent scienter requirement by focusing on “the plain meaning of section 10(b),” which clearly evinces an intent to censure only “knowing or inten-
tional misconduct.”

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

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

7. 446 U.S. at 690-91.
8. See, e.g., Herman & MacLean v. Huddleston, 459 U.S. 375, 378 n.2 (1983) (the Court reserved decision whether § 17(a) affords a private remedy).
9. See, e.g., Cleary v. Perfectune, Inc., 700 F.2d 774, 779-80 (1st Cir. 1983) (requiring scienter on the assumption that § 17(a) private action exists).
10. See, e.g., Kirshner v. United States, 603 F.2d 234, 241 (2d Cir. 1978), cert. denied, 442 U.S. 909 (1979) (language of § 17(a) broad enough to encompass private course of action).
11. See, e.g., Newman v. Prior, 518 F.2d 97, 99 (4th Cir. 1975) (Fourth Circuit "committed" to implied § 17(a) private action); Johns Hopkins Univ. v. Hutton, 488 F.2d 912, 914 (4th Cir. 1973) (evidence supplied elements required of private § 17(a) action).
13. See, e.g., Lincoln National Bank v. Herber, 604 F.2d 1038, 1039-40 & 1040 n.2 (7th Cir. 1979) (§ 17(a) prohibits fraud in offer or sale of securities); Daniel v. International Bhd. of Teamsters, 561 F.2d 1223, 1244-45 & n.44 (7th Cir. 1977) (fraudulent sale actionable under § 17(a)), rev'd on other grounds, 439 U.S. 551 (1979); Surowitz v. Hilton Hotels Corp., 342 F.2d 696, 603-04 (7th Cir. 1965) (§ 17(a)'s plain language supports finding implied private action), rev'd on other grounds, 383 U.S. 363 (1966). A three-judge panel, however, recently declared that the existence of a private cause of action under § 17(a) is an open question. Teamsters Local 282 Pension Trust Fund v. Angelos, 762 F.2d 522, 530-31 (7th Cir. 1985). As a result, one district court within the Seventh Circuit held that no implied cause of action exists under § 17(a). Beck v. Cantor, Fitzgerald & Co., Inc., 621 F. Supp. 1547, 1558-60 (N.D. Ill. 1985).
14. See, e.g., Stephenson v. Calpine Conifers II, Ltd., 652 F.2d 808, 815 (9th Cir. 1981) (cannot deny § 17(a) private action after § 10(b) private action established).
15. See, e.g., Landry v. All American Assurance Co., 688 F.2d 381, 387-91 (5th Cir. 1982) (plaintiff did not meet test for implied actions enunciated in Cort v. Ash, 422 U.S. 66 (1979)).
16. See, e.g., Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 155 (8th Cir. 1977) (purchaser's private remedy must be found in § 12(2), not § 17(a)), cert. denied, 434 U.S. 1086 (1978); Greater Iowa Corp. v. McLendon, 378 F.2d 783, 788-90 (8th Cir. 1967) (private civil liability under § 17(a) circumvented by § 12(2)'s express remedy).
vate cause of action under section 17(a), the Court must decide between two conflicting standards of culpability. The Court could impose a negligence standard for private actions under sections 17(a) and (a)(3) consistent with the Aaron standard in administrative enforcement proceedings. Alternatively, the Court could require proof of scienter in all section 17(a) private actions, consistent with the scienter requirement imposed on private actions under section 10(b) and rule 10b-5 of the 1934 Act. Because rule 10b-5 encompasses most activity actionable under section 17(a), a scienter requirement would not add to the alternatives already available to aggrieved purchasers. As a practical matter, therefore, requiring scienter is tantamount to disallowing private actions under section 17(a).

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

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

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

25. 401 F.2d 833, 864 (2d Cir. 1968) (Friendly, J., concurring).
26. *See infra* notes 29-31 and accompanying text.
28. 446 U.S. at 695. *Hochfelder* held that because the language and history of § 10(b) were “dispositive of the appropriate standard of liability, there was no occasion to examine additional considerations of ‘policy’ . . . .” 425 U.S. at 214 n.33. *But cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) (consideration of policy considerations in § 10b and rule 10b-5 action “proper” when it is clear that Congress could not have foreseen “the present state of the law with respect to Rule 10b-5”).
29. 401 F.2d at 866-68. Section 11 delineates a cause of action for misstatements or omissions in a registration statement, but affords registrants a “due diligence” exception for many experts. 15 U.S.C. § 77k(b)-(c) (1982). Section 12(2) renders offerors and sellers liable for incorrect or misleading prospectuses unless the offeror or seller proves “he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.” 15 U.S.C. § 77l(a) (1982).
30. 425 U.S. at 211, *citing* 401 F.2d at 867-68 (Friendly, J., concurring).
32. *Id.* at 206. *See also* Herman & MacLean v. Huddleston, 459 U.S. 375, 380-87 (1983) (avail-
This same logic applies to private actions under section 17(a), but with even greater force. Although the language of section 10(b) may indicate a stronger scienter standard, section 17(a) and sections 11 and 12(2) are provisions of the 1933 Act. Only the most spurious legal reasoning would predicate *implied* private actions under section 17(a) on a negligence standard when the practical effect is to nullify sections 11 and 12(2), *express* remedies of the *same* Act. As Judge Friendly observed, there is unanimity among the commentators, including some who were in a peculiarly good position to know, that . . . § 17 . . . was intended only to afford a basis for injunctive relief and, on a proper showing, for criminal liability, and was never believed to supplement the actions for damages provided by §§ 11 and 12(2). When the House Committee Report listed the sections that "define the civil liabilities imposed by the Act" it pointed only to §§ 11 and 12(2) and stated that "[t]o impose a greater responsibility [than that provided by §11 and 12(2)] *** would unnecessarily restrain the conscientious administration of honest business with no compensating advantage to the public."  

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

Judge Friendly noted that vexatious litigation creates two potentially negative consequences. First, Judge Friendly stressed that corporations facing potential liability for negligent disclosures would be prone to err
on the side of nondisclosure, contrary to the express intent of both the 1933 and 1934 Acts. Second, because innocent investors ultimately bear the burden of negligent disclosures, vexatious litigation could have a substantial "chilling" effect on venture capital formation.

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

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38. 401 F.2d at 866-67 (imposing a negligence standard for civil damages actions under rule 10b-5(2) and § 17(a) would cause corporations to remain silent).
39. Judge Friendly recognized that "commendable and growing recognition . . . of the importance of informing security holders and the public generally with respect to important business and financial developments." Id. at 867 (citation omitted).
40. Judge Friendly added that "the risk that a slip of the pen or failure properly to amass or weight the facts—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers. . . ." Id. See also Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 747 (1975) (fearing strike suits in pursuit of "retrospectively golden opportunities").
41. See supra note 35 and accompanying text.