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Obscuring the Standard for Aiding and Abetting Liability

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The Securities Exchange Act of 1934 (the 1934 Act) contemplates a broad scheme to compel disclosure and prevent fraud in connection with the purchase and sale of securities. The principal antifraud provision of the 1934 Act is section 10(b), which makes it unlawful "[t]o 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." Section 10(b) is not self-enforcing, but under section 21(d) of the 1934 Act, the Securities Exchange Commission (SEC) is authorized to enlist the aid of the district courts to enjoin conduct in violation of section 10(b). Furthermore, although Congress did not expressly grant private parties a right of action under section 10(b), a private right of action to recover damages sustained as a result of a violation of the prohibitions of section 10(b) and rule 10b-5 has

* 605 F.2d 612 (2d Cir.), cert. granted, 100 S.Ct. 227 (1979). Before Anderson, Feinberg and Timbers, J.J.; opinion per Timbers, J.


2 Id. § 78j(b).

3 Id. Section 10(b) of the 1934 Act provides:
   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.

4 Id. § 78u(d). Section 21 allows the Commission to bring suit in federal court to enjoin "any person [who] is engaged or is about to engage in acts or practices constituting a violation of any provision of [the securities laws]." Id. Section 21(d) also authorizes the SEC to "transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this chapter or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter." Id.
long been recognized.\(^5\)

In 1976, in *Ernst & Ernst v. Hochfelder*,\(^6\) the Supreme Court held that, in a private damage action under section 10(b) and rule 10b-5, liability may not be imposed in the absence of a showing that the defendant acted with scienter.\(^7\) The Court declined, however, to address the question of the requisite state of mind for the granting of relief in SEC enforcement actions.\(^8\)

Several circuits have held that the SEC need not show scienter in order to obtain relief in enforcement actions;\(^9\) other courts have held that scienter is an essential element.\(^10\) The Second Circuit consistently has held that the SEC may enjoin violations of section 10(b) by showing only that the defendant acted negligently.\(^11\)

\(^5\) A private right of action under § 10(b) was recognized initially in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946), and has been accepted by the Supreme Court. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).


\(^7\) *Id.* at 193. Following the common law definition of scienter, the United States Supreme Court in *Ernst & Ernst v. Hochfelder* defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 193 n.12. The traditional common law concept of scienter, however, is a requisite element of the torts of deceit and misrepresentation. In discussing scienter, Dean Prosser noted that liability for deceit will be imposed on a defendant who intends to deceive or who knows that his statement is false or who lacks sufficient basis to know that his statement is true. W. PROSSER, LAW OF TORTS § 105, at 685-86 (4th ed. 1971). In defining the requisite knowledge, the "courts have stopped short of the situation where the defendant honestly believes that he knows and [believes] that his statement is true, but is negligent in not obtaining accurate information." *Id.* at 696. With respect to the tort of misrepresentation, scienter has been defined as an "intent to deceive, to mislead, [or] to convey a false impression." *Id.* § 107, at 700. The requisite intent which underlies culpability has been found where the "speaker believes his statement to be false [or when a] representation is made without any belief as to its truth, or with reckless disregard" as to its truth or falsity. *Id.* at 701.

\(^8\) Justice Powell stated that "[s]ince this case concerns an action for damages we also need not consider the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5." 425 U.S. at 194 n.12.


The defendant's state of mind also has been a critical factor in determining the liability of an aider and abettor. The approaches taken by the various circuits have been more uniform in this area, in that they have refused to impose liability for aiding and abetting another's wrongful conduct when it is demonstrated that the defendant did not have knowledge of the wrong and was merely negligent.\(^{12}\)

The question of the defendant's state of mind becomes additionally complex when the court is confronted with an injunctive enforcement proceeding in an aiding and abetting context. In \textit{SEC v. Aaron},\(^{13}\) the Second Circuit reaffirmed its prior holdings that scienter is not a necessary element in SEC enforcement actions, notwithstanding the fact that the court imposed liability on the defendant ultimately for aiding and abetting. The court did not address either the traditional elements of aiding and abetting liability\(^{14}\) or the rationale for extending the negligence standard to aiding and abetting situations. By so extending the negligence standard to aiding and abetting liability in enforce-

\(^{12}\) See text accompanying notes 118-50 infra.

\(^{13}\) 605 F.2d 612 (2d Cir.), cert. granted, 100 S.Ct. 227 (1979).

\(^{14}\) Id. at 616-17.
ment actions without discussing the fundamental elements of such liability, the Aaron opinion generates further uncertainty in an already chaotic area of securities law. 15

Peter Aaron was a long-term employee of his father's brokerage firm, E. L. Aaron & Company (Aaron & Co.). 16 Although he was not designated a corporate officer, he performed many supervisory duties as liaison between departments and overseer of the firm's salesforce and registered representatives.

In 1974, Aaron & Co. expanded its operations by opening a new branch office, to be managed by Norman Schreiber with the assistance of Donald Jacobson, two registered representatives employed by the brokerage firm. From the time the branch office opened until September 1975, Schreiber and Jacobson worked to create a market for the common stock of Lawn-A-Mat Chemical & Equipment Corporation (LAM). Specifically, they solicited orders from LAM's stockholders and franchise dealers for the purchase of additional LAM shares. In the course of these solicitations, they represented to the prospective purchasers that LAM was planning to develop and manufacture new-style equipment, and predicted substantial increases in the price of LAM's stock. There was no basis for these representations because LAM had experienced significant losses during this period. 17 Although LAM's officers and counsel informed Schreiber and Jacobson that LAM had no such plans, the registered representatives continued to make these statements.

Peter Aaron had knowledge of these false representations from two sources. He was informed directly by LAM's counsel that Schreiber's and Jacobson's statements were false and that the two men had been so advised. In addition, because part of his duties at Aaron & Co., included maintaining LAM's due diligence file, "he had ample independent reason to know" 18 that LAM had no intention of manufacturing a new line of equipment.

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15 See text accompanying notes 107-12 infra.


18 605 F.2d at 615.
In connection with its underwriting arrangement with LAM, Aaron & Co. solicited stock sales by the president and vice-president of LAM. Because LAM's president and vice-president were controlling persons of the company, their shares could not be sold unless the shares either were registered pursuant to the Securities Act of 1933 (the 1933 Act), or exempt from the registration requirements of that Act. In an effort to avoid registration and to meet the requirements necessary for an exemption, Aaron & Co. employed an intermediary brokerage firm to effectuate the sale.

Since Aaron & Co. wanted to acquire the LAM shares for its own account, it could not solicit customers' orders to buy LAM stock without violating the requirements of rule 144. Accordingly, Aaron attempted to qualify for the exemption by arranging for another brokerage firm, Weller & Co., to purchase the LAM shares from the president and vice-president of LAM and then resell the shares to Aaron & Co. Thus, Aaron & Co. hoped that Weller & Co. would act as the control persons' agent in the sale of their shares, thereby allowing Aaron & Co. to sell the shares without registration.

In 1976, in an effort to halt these disreputable practices, the SEC commenced an enforcement action against Peter Aaron and

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19 The definition of the term "control person" must be viewed in terms of section 2(11) of the 1933 Act, 15 U.S.C. § 77b(11) (1976), which defines the term "issuer" as "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." The Aaron court's finding that both LAM's president and vice-president were controlling persons was predicated upon the fact that both individuals were officers and directors of the corporation. 605 F.2d at 615.

20 Section 5(a) of the 1933 Act, 15 U.S.C. § 77e(a) (1976), prohibits the sale of unregistered securities unless either the securities themselves or the transaction is exempt from the registration requirements. See §§ 3 and 4 of the 1933 Act, id. §§ 77c, 77d.

Section 4(4), id. § 77d(4), sets forth the exemption relevant in Aaron. It provides that "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market" are exempt from registration, although solicitation of such orders is not exempt. Id.

The SEC has promulgated rule 144(f), 17 C.F.R. § 230.144(f) (1979), as a guide to those who seek to execute transactions exempt under § 4(4), 15 U.S.C. § 77d(4) (1976). Rule 144(f) provides that the broker executing the sale of securities "shall not...solicit or arrange for the solicitation of [customers'] orders to buy the securities in anticipation of or in connection with such transaction." 17 C.F.R. § 230.144(f).

21 [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,683. The court, however, determined that the transaction was a sham and therefore outside the protection of the § 4(4) exemption. Id. at 91,685-86.
Aaron & Co. in the United States District Court for the Southern District of New York. The complaint charged Aaron with, \textit{inter alia},\textsuperscript{22} aiding and abetting violations of section 10(b) of the 1934 Act\textsuperscript{23} and SEC rule 10b-5,\textsuperscript{24} and sought permanent injunctive relief pursuant to section 21(d) of the 1934 Act.\textsuperscript{25}

The district court determined that Aaron's managerial role in the company subjected him to liability under the securities law.\textsuperscript{26} Moreover, the court found that Aaron "intentionally failed to terminate the false and misleading statements made by Schreiber and Jacobson, knowing them to be fraudulent."\textsuperscript{27} Thus, according to the court, Aaron had acted with scienter.\textsuperscript{28} However, the district court concluded that in this circuit the SEC need not establish scienter in order to enjoin Aaron from

\textsuperscript{22} Aaron was also charged with violating and aiding and abetting violations of § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976), and the registration provisions of the 1933 Act, §§ 5(a), 15 U.S.C. § 77e(a) (1976), and 5(c), 15 U.S.C. § 77e(c) (1976). See [1977-78 Transfer Binder] \textit{FED. SEC. L. REP.} (CCH) at 91,680-81.

\textsuperscript{23} [1977-78 Transfer Binder] \textit{FED. SEC. L. REP.} (CCH) at 91,680.

\textsuperscript{24} Id. at 91,681. 17 C.F.R. § 240.10b-5 (1978). Rule 10b-5, promulgated under section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976), states in relevant part:

\begin{quote}
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.
\end{quote}

\textsuperscript{25} 15 U.S.C. § 78u(d) (1976), \textit{quoted in relevant part in note 4 supra.}

\textsuperscript{26} The district court found, notwithstanding Aaron's lack of an official title at Aaron & Co., that Aaron's "active participation in the management of the firm" made him responsible for the fraudulent conduct of the firm's employees. [1977-78 Transfer Binder] \textit{FED. SEC. L. REP.} (CCH) at 91,684.

In deciding that the absence of a corporate title is not a factor to be considered in determining liability, the district court relied on Gross v. SEC, 418 F.2d 103 (2d Cir. 1969). In Gross, a vice-president of a brokerage firm who participated in the hiring, training and supervision of sales employees was held liable under § 10(b) of the 1934 Act and § 17(a) of the 1933 Act for aiding and abetting the actions of the firm's employees. 418 F.2d at 107. In finding Gross liable as an aider and abettor, the court focused on the defendant's "participation in the management of the firm," not on his status as a corporate officer. \textit{Id.} The Aaron court employed similar reasoning.

\textsuperscript{27} [1977-78 Transfer Binder] \textit{FED. SEC. L. REP.} (CCH) at 91,685.

\textsuperscript{28} \textit{Id.} In this connection, Judge Gagliardi noted that Aaron's knowledge of the falsity of the statements and his willful failure to terminate them sufficed to establish his scienter. For a discussion of scienter, see note 7 \textit{supra.}
engaging in security transactions.\textsuperscript{29}

On appeal to the United States Court of Appeals for the Second Circuit, Aaron claimed that the district court erred in imposing liability on him for the acts of others and in holding that negligence alone would suffice as a basis for a permanent injunction. The Second Circuit affirmed the district court in all respects.\textsuperscript{30} Significantly, although the district court noted that Aaron’s conduct may have established his scienter under the securities laws,\textsuperscript{31} the Second Circuit refused to review this finding,\textsuperscript{32} but instead, took the opportunity to reassert its rule that negligence is sufficient to support the granting of injunctive relief in SEC enforcement actions under section 10(b).\textsuperscript{33} Moreover, this reaffirmation was announced at a time when the United States Supreme Court’s decision in \textit{Ernst & Ernst v. Hochfelder}\textsuperscript{34} had generated confusion in the federal courts in the area.

The question whether proof of scienter is necessary to establish liability under section 10(b) of the 1934 Act had been a source of controversy in the federal securities law long before \textit{Hochfelder}.\textsuperscript{35} Prior to \textit{Hochfelder} the various circuit courts ap-
plied two divergent standards with respect to the requisite mental state of the defendant in SEC enforcement actions for injunctive relief. The majority view was that negligence was sufficient to constitute a violation of section 10(b) and rule 10b-5 in an injunction action. Courts subscribing to this view relied on the approach taken by the Supreme Court in SEC v. Capital Gains Research Bureau, Inc. and the Second Circuit's decision in SEC v. Texas Gulf Sulphur Co.

In Capital Gains, the SEC brought a preliminary injunction action against registered investment advisers for violations of section 206(2) of the Investment Advisers Act of 1940. The defendants had failed to make full and adequate disclosure to their clients, and thereby violated section 206(2), which statutorily prohibits any practice that "operates as a fraud or deceit upon any client or prospective client." Both the district and circuit

qured); Shemtob v. Shearson, Hammill and Co., 448 F.2d 442, 445 (2d Cir. 1971) (allegation of scienter, intent to defraud or reckless disregard for the truth required); Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1290-91 (2d Cir. 1969) (mere negligence insufficient), cert. denied, 397 U.S. 913 (1970); Heit v. Weitzen, 402 F.2d 909, 913-14 (2d Cir. 1968) (actual knowledge of the fraud satisfies the scienter requirement), cert. denied, 395 U.S. 903 (1969). However, Hochfelder ended this controversy by holding that an allegation of negligence is insufficient to support liability under § 10(b) and rule 10b-5. 425 U.S. at 210.


15 U.S.C. § 80b-6(2) (1976). Section 206(2) states:

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

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

Id. Compare the language of § 206(2) with that of rule 10b-5 and § 17(a). See note 24 supra for full text of rule 10b-5. See note 63 infra for full text of § 17(a).


courts, construing the statute's language, reasoned that the words "fraud" and "deceit" required a showing of intent to prove a violation. The Supreme Court, granting certiorari because of the statute's importance to the investing public and financial community, reversed the decision of the lower courts.43

In determining the necessary standard of liability, the Court focused on the legislative history and purpose of the Investment Advisers Act of 1940. The Court reasoned that, because the Act was designed to protect investors, "[i]t would defeat the manifest purpose of the [Act]" to require "proof of intent to injure and actual injury to clients."44 The Court resolved the apparent conflict between the requirement of intent for common law fraud45 and its holding that negligence was sufficient by distinguishing between private damage suits and actions seeking injunctive relief.46 Private damage suits vindicate individual rights under the securities laws insofar as individual plaintiffs seek monetary relief.47 By contrast, SEC injunctive actions are

44 375 U.S. at 185.
45 Id. at 192.
47 375 U.S. at 193-95. The Court noted that the content of common law fraud has varied "with the nature of the relief sought, the relationship between the parties, and the merchandise in issue." Id. at 193. Specifically, the Court relied upon the different interpretation given to "fraud" in equity than that given at law in concluding that intent to deceive is not a necessary element in an injunctive proceeding. Id. (quoting H. HANSBURY, MODERN EQUITY 643 (8th ed. 1962) and W. DEFUNIAK, HANDBOOK OF MODERN EQUITY 235 (2d ed. 1965)). Moreover, the Court supported its finding by distinguishing between the two types of actions. The Court found that private damage actions are usually suits seeking monetary relief involving parties to "arm's-length transactions" concerning "land and ordinary chattels," while injunction actions are proceedings in which equitable relief is sought against a fiduciary for a breach of his affirmative duty to give "full and fair disclosure of all material facts" in transactions involving the sale of advice and securities. 375 U.S. at 194. See also SEC v. Blatt, 583 F.2d 1325, 1333 (5th Cir. 1978); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1090 (2d Cir. 1972); Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1290-91 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring), cert. denied sub. nom. Coates v. SEC, 394 U.S. 976 (1969); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 547 (2d Cir. 1967); SEC v. Wills, 472 F. Supp. 1250, 1270 (D.D.C. 1978); SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226, 1243 n.4 (S.D.N.Y. 1976), aff'd on different grounds, 565 F.2d 8 (2d Cir. 1977); SEC v. Lum's Inc., 355 F. Supp. 1046, 1057-58 (S.D.N.Y. 1973).
48 375 U.S. at 193. See, e.g., SEC v. Blatt, 583 F.2d 1325, 1333 (5th Cir. 1978); Abra-
brought for the purpose of protecting the investing public against harm.\textsuperscript{48} The essential nature of the injunctive suit is equitable.\textsuperscript{49} Because injunction actions are "mild prophylactic[s]," a negligent violation warrants a court-ordered injunction against the violator.\textsuperscript{50} Thus, the Court concluded, "Congress intended the Investment Advisers Act of 1940 to be construed like other securities [antifraud] legislation . . . , not technically and restrictively, but flexibly to effectuate its remedial purposes."\textsuperscript{51}

In \textit{SEC v. Texas Gulf Sulphur Co.},\textsuperscript{52} the Second Circuit applied the policy considerations enunciated by the Supreme Court in \textit{Capital Gains}, and determined that in SEC proceedings for injunctive relief under section 10(b) and rule 10b-5 in-

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\textsuperscript{48} 375 U.S. at 193.
\textsuperscript{50} 375 U.S. at 192-93.
\textsuperscript{52} 375 U.S. at 192-93.
\textsuperscript{54} 401 F.2d 833 (2d Cir. 1968), cert. denied sub nom. Coates v. SEC, 394 U.S. 976 (1969).
tent is not a necessary element. In Texas Gulf Sulphur, the SEC, pursuant to its authority under section 21(d) of the 1934 Act, sought to enjoin various defendants from violating section 10(b) and rule 10b-5. The court reasoned that since Congress designed section 10(b) "to prevent inequitable and unfair practices and to insure fairness in securities transactions generally," the remedial purposes of the statute would be frustrated if proof of specific intent to defraud were necessary to establish a cause of action. The Second Circuit also reasoned that since injunctive suits were brought for the protection of the investing public, a modification of the scienter standard was justified. According to the court, Congress did not intend "to deny [the SEC's injunctive] power whose use in appropriate cases can be of such great public benefit and do so little harm to legitimate activity." Finally, the court concluded that in an injunctive action a negligence standard would permit the SEC to achieve the desirable end of "uniformity of enforcement" of the securities laws.

In contrast to the Capital Gains and Texas Gulf Sulphur

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53 Id. at 854-55 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963)).
55 In Texas Gulf Sulphur, the Commission brought an injunction action under § 10(b) and rule 10b-5 against Texas Gulf Sulphur Company (TGS) and several of its officers and directors, charging that the defendants had either personally or through agents purchased TGS stock on the basis of inside information, while such information remained undisclosed to the public. 401 F.2d at 839-40. On this issue the court held that anyone in possession of material inside information has a duty to disclose this information to the public before he can trade in or recommend the securities for purchase. Id. at 848.
56 Id. at 847-48.
57 Id. at 854-55. The Second Circuit also recognized the distinction enunciated in Capital Gains contrasting private actions with SEC injunction suits, and stated that the differences between the two types of actions warranted different standards of liability. Id. at 868 (Friendly, J., concurring). See text accompanying notes 44-50 and note 46 supra.
58 401 F.2d at 854-55.
59 Id. at 868 (Friendly, J., concurring).
60 Id. at 855. See also SEC v. Management Dynamics, Inc., 515 F.2d 801, 809 (2d Cir. 1975); SEC v. Dolnick, 501 F.2d 1279, 1284 (7th Cir. 1974); SEC v. Spectrum Ltd., 489 F.2d 535, 541 (2d Cir. 1973); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1032, 1096 (2d Cir. 1972); SEC v. Geyer Minerals Corp., 452 F.2d 876, 880 (10th Cir. 1971); Hanley v. SEC, 415 F.2d 589, 596 (2d Cir. 1969); SEC v. Lum's, Inc., 365 F. Supp. 1046, 1057-58 (S.D.N.Y. 1973). It should be noted that the articulation of a scienter standard would have resulted in uniform enforcement of the securities laws.
approach, a minority of circuits have adopted a standard of intentional culpability in SEC injunctive suits.\footnote{See, e.g., SEC v. Coffey, 493 F.2d 1304, 1314 (6th Cir. 1974) (fraud or deceit requires a superior knowledge of one party over another), cert. denied, 420 U.S. 908 (1975); SEC v. Glass Marine Indus., Inc., 208 F. Supp. 727, 740 (D. Del. 1962) ("intent is essential to a scheme to defraud"). After the Supreme Court's holding in Hochfelder the Fifth Circuit and several district courts in the Fourth, Seventh, Tenth, and District of Columbia Circuits joined the minority. See cases cited in note 84 infra.} SEC v. Coffey,\footnote{493 F.2d 1304 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975).} a Sixth Circuit case, is typical of those cases holding that a showing of intent is required. In Coffey, the SEC sought to enjoin the board chairman (John King) and the financial vice-president (William Coffey) from misrepresenting the financial condition of the corporation in violation of section 17(a) of the 1933 Act\footnote{15 U.S.C. § 77q(a) (1976). Section 17(a) provides that:

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

Id. In SEC v. Coven, 581 F.2d 1020 (2d Cir. 1978), cert. denied, 440 U.S. 950 (1979), the Second Circuit, employing the analysis of the Supreme Court in Hochfelder, concluded that neither the language of § 17(a) nor its legislative history require that liability be predicated on a showing of scienter in SEC injunctive proceedings. Id. at 1026-27. The court noted that the language of subsection (2) of § 17(a) does not predicate liability on fraudulent intent and that the phrase in subsection (3), "operates as a fraud," emphasizes the "effect of potentially misleading conduct on the public, not...the culpability of the person responsible." Id. at 1026 (emphasis in original). Moreover, in support of its conclusion that negligence suffices in § 17(a) enforcement actions, the court relied on Justice Douglas's statement that § 17 makes unlawful "even innocent acts to obtain money or property by means of untrue statements of material facts or omissions to state material facts." Id. at 1027 (quoting Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171, 181 (1933)).

for liability under section 10(b), the court stated that the SEC must prove that the defendant had knowledge of the undisclosed facts about the corporation and the materiality of the omitted information.65 Eschewing the policy considerations relied on by the Second Circuit in Texas Gulf Sulphur, the Sixth Circuit based its holding primarily on the language of the statute because section 10(b) prohibits "fraudulent or deceptive scheme[s] or practice[s]."66 The court looked to the common law standard of fraud which requires proof of the defendant's intent to defraud before liability may be imposed,67 and concluded that scienter is a necessary element in securities fraud as well, regardless of the nature of the proceeding.68

In Ernst & Ernst v. Hochfelder,69 the Supreme Court entered the controversy created by the dichotomy in the circuit courts with respect to the mental state required to support the imposition of liability under section 10(b) and rule 10b-5, but addressed the issue only in the context of a private damage action. Hochfelder held that in a private damage action under those provisions, the plaintiff cannot recover unless he establishes that the defendant acted with scienter.70 The Court declined, however, to address the question of the state of mind standard to be applied in SEC enforcement actions.71 Thus, while Hochfelder did not cause the controversy, its silence on the question of the mental state required in enforcement actions exacerbated an already intense debate.72 Hochfelder did, how-

65 Id. at 1314.
66 Id. at 1311.
67 Id. at 1313. See note 45 supra.
68 Id. Although the Coffey court did not state specifically that scienter is required, the decision is rife with discussion of knowledge. Thus, the scienter requirement is implicit in the court's holding.
70 Id. at 193. See notes 6-7 and accompanying text supra.
71 See note 8 supra.
ever, have the effect of setting the course lower courts are to follow in construing the securities laws, particularly section 10(b).

In analyzing section 10(b) the Supreme Court in *Hochfelder* focused on the language of the section, the legislative intent, and the overall enforcement scheme of the securities laws. First, the Court found that the use of the words “manipulative or deceptive” in conjunction with “device or contrivance” limit the section’s application to conduct that is knowing or intentional. The Court then considered the legislative history of the 1934 Act. While the congressional reports did not disclose an explicit expression of Congress’ intent, neither did the bills that gave rise to section 10(b) indicate that the section was intended to prohibit conduct that did not rise to the level of scienter. In addition, a spokesman for the drafters described section 10(b) as a “catch-all clause to prevent manipulative devices.” The Court seized on the appearance of the word “manipulative” in this context to support its conclusion that scienter is a requisite element.

Finally, the Court examined the overall enforcement scheme

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*in Light of Hochfelder, 52 Notre Dame Law. 925 (1977); Note, Recklessness Under Section 10(b): Weathering the Hochfelder Storm, 8 Rut.-Cam. L. J. 325 (1977).*

73 425 U.S. at 214. See text accompanying notes 74-85 infra.

74 Id. at 197-201.

75 Id. at 206-11. Although the Supreme Court recognized that it must focus primarily on the language of § 10(b) in determining the congressional intent with respect to the standard of liability, it nevertheless turned to the legislative history of the 1934 Act for further support of its holding that the language of that section specifically prohibits intentional wrongdoing. Id. at 200-01. The Court found that portions of the legislative history of the 1934 Act revealed that Congress intended to impose liability under § 10(b) only “where the defendant has not acted in good faith.” Id. at 206.

76 Id. at 206-11. Recognizing that it had stated in *SEC v. National Secs., Inc.*, 393 U.S. 453, 466 (1969), that “the interdependence of the various sections in the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen,” the Hochfelder Court addressed the SEC’s contention that, in contrast to other sections of the securities laws, § 10(b) is not “explicitly restricted to willful, knowing, or purposeful conduct.” 425 U.S. at 206-07.

77 425 U.S. at 197. See note 3 supra for the relevant text of § 10(b). See notes 91-92 and accompanying text infra for a discussion of the Aaron court’s use of this part of the Hochfelder opinion.

78 Id. at 201-02.

79 Id. at 202 (citing Hearings on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934) (statement of Thomas G. Corcoran)).

80 Id. at 203.
of the 1934 Act and the interdependence of various sections of that Act. According to the Court, other sections, particularly those that provide for civil remedies, require either conduct beyond negligence or "significant procedural restrictions not applicable to § 10(b)." The Court reasoned therefrom that a negligence standard for section 10(b) would serve to undercut the requirements imposed by Congress on other civil liability sections. Thus, the Court determined that scienter is a necessary element of liability in private damage actions under section 10(b).

Because Hochfelder declined to extend its mandate to SEC injunctive suits, the circuit courts were free to continue the pre-Hochfelder debate. The decision did, however, preclude mere

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81 Id. at 209. See, e.g., § 11(b)(3) of the 1933 Act, 15 U.S.C. § 77k(b)(3) (1976) (exempting from liability any person other than the issuer with regard to portions of the registration statement prepared by such person if he can show that he had a "reasonable ground to believe and did believe" that the statements made were true and "that there was no omission to state a material fact"); § 12(2) of the 1933 Act, id. § 77l(2) (avoiding seller's liability for untrue statements or the omission of necessary statements by proving that "he did not know" or "could not have known" of the untruth or omission); § 15 of the 1933 Act, id. § 77o (affording a controlling person, who otherwise may be held liable with and to the same extent as the controlled person, the means to escape liability by establishing that he "had no knowledge of or reasonable ground to believe in the existence of facts" upon which the liability of the controlled person is predicated); §§ 9(a), (e) of the 1934 Act, id. §§ 78k(a), (e) (requiring knowing or willful conduct as a precondition for civil liability); § 18(a) of the 1934 Act, id. § 78r(a) (imposing liability on any person who makes false or misleading statements in any report filed with SEC, but providing the person an escape from liability if he proves "he acted in good faith or had no knowledge" that the statement made was false); § 20(a) of the 1934 Act, id. § 78t(a) (imposing civil liability on a controlling person to the same extent that the controlled person is liable for violations of the Act, but exculpating the controlling person if he acted in good faith and did not induce the violation).

82 425 U.S. at 210.

83 Id. at 214.

discussion of policy, and mandated scrutiny of the statute instead.\textsuperscript{85}

When faced with the issue in \textit{Aaron}, the Second Circuit reasoned that the "compelling distinctions between private damage actions and government injunction actions"\textsuperscript{86} allowed the court to avoid a wholesale application of the \textit{Hochfelder} analysis. Rellying on the public policy objectives of investor protection, the court decided that the need for effective protection for the investing public outweighed the potential danger that a broader standard of liability would pose to the defendants.\textsuperscript{87} Accordingly, the Second Circuit determined that, despite the Supreme Court's pronouncements in \textit{Hochfelder}, negligence is the appropriate standard of liability in SEC enforcement actions under section 10(b) and rule 10b-5.\textsuperscript{88}

In discussing the policy considerations underlying the securities laws,\textsuperscript{89} the Second Circuit implicitly recognized that it

\textsuperscript{85} In addressing the scienter issue the Court specifically noted that "[t]he starting point in every case involving construction of a statute is the language itself." 425 U.S. at 197 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 at 756 (1975) (Powell, J., concurring)). The Court also found that since the language and history of § 10(b) was dispositive with respect to the standard of liability, there was no need to examine policy considerations. \textit{Id.} at 214 n.33.

\textsuperscript{86} 605 F.2d at 620. The Second Circuit specifically noted that prior to \textit{Hochfelder}, it "had construed the language of § 10(b) to require scienter in the context of private damage actions," but had "uniformly . . . held that the language and history of the section [did] not require a showing of scienter in an injunction enforcement action." \textit{Id.} at 620-21. \textit{See} text accompanying notes 35-36 supra.

\textsuperscript{87} 605 F.2d at 621. The court supported this position by citing SEC v. Spectrum, Ltd., 489 F.2d 535, 541-42 (2d Cir. 1973). In \textit{Spectrum}, the SEC sought to enjoin an attorney who prepared an opinion letter that provided the basis for a sale of unregistered securities by his client. The Second Circuit found that, since the defendant knew his opinion letter could be used to sell the unregistered securities, he would be held liable as an aider and abettor. \textit{Id.} at 541-42. In applying the negligence standard of culpability, the court stated that "in a proceeding by the SEC seeking prophylactic relief, [the court] would be undermining this salutary mechanism by an overly fine appraisal of conduct which contributes to its circumvention." \textit{Id.} at 541 n.12. However, the \textit{Spectrum} court limited its application of the negligence standard to the specific facts of the case. The court stated that "the standard of culpability . . . appropriate for the author of an opinion letter in an action for injunctive relief . . . should not . . . apply to more peripheral participants in an illicit scheme." \textit{Id.} at 542.

\textsuperscript{88} 605 F.2d at 619.

\textsuperscript{89} It should be noted that "a major congressional policy behind the securities laws in general, and the antifraud provisions in particular, is the protection of investors who rely on the completeness and accuracy of information made available to them." Chris-Craft
could no longer predicate the validity of a negligence standard solely upon the Supreme Court's holding in *Capital Gains* and the policy objectives expressed in that case. Therefore, in addition to emphasizing policy, the *Aaron* court supported its holding with an extended analysis of statutory language and legislative history which paralleled, at least in form, the approach taken by the Supreme Court in *Hochfelder.* As the Supreme Court did in *Hochfelder*, the Second Circuit considered first the language of section 10(b) itself. The panel noted that, although the language of the statute applied to suits brought by the SEC as well as to actions instituted by private parties, that language had been construed differently depending on the nature of the action and the character of the plaintiff. Therefore, the language of section 10(b), without more, did not compel adherence to the result reached in *Hochfelder* in all contexts.

Because the language itself failed to provide a clear directive regarding the proper construction of the statute, the *Aaron*
court consulted legislative history for further guidance. Noting that the Supreme Court found the legislative history of section 10(b) “bereft of any explicit explanation of Congress’ intent,” the Aaron panel concentrated on the legislative history of section 21(d) of the 1934 Act which authorizes the SEC to seek injunctive relief against any person who allegedly has violated the securities laws. The discussion of section 21(d) in the Senate Report accompanying the Securities Act Amendments of 1975 served as the object of the Aaron court’s focus. In review-

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92 605 F.2d at 621.
93 425 U.S. at 201. The Hochfelder Court decided that since the language of § 10(b) was “sufficiently clear,” it was essentially unnecessary to look at the legislative history of the 1934 Act, but it did so to determine only “whether there [was] support for the meaning attributed to § 10(b) by the Commission.” Id. The approach taken by the Supreme Court is consistent with the general view of the use of legislative history in determining congressional intent. See United States v. Oregon, 366 U.S. 643, 648 (1961); Packard Motor Car Co. v. NLRB, 330 U.S. 485, 492 (1947); Railroad Comm’n of Wis. v. Chicago B. & Q. R.R., 257 U.S. 563, 589 (1922). Specifically, legislative history will not be “given effect to override a clear and unambiguous meaning conveyed by the language of the statute.” C. SANDS, 2A STATUTES & CONSTRUCTION § 48.14 (4th ed. 1973). However, the Supreme Court in United States v. American Trucking Ass’ns, 310 U.S. 534, 543-44 (1940), while recognizing that the words of a statute are the most “persuasive evidence” in ascertaining congressional intent, stated that when the statutory language is ambiguous, the Court will look beyond the plain meaning of the words. “When aid to construction of the meaning of words, as used in the statute, is available, there certainly can be no ‘rule of law’ which forbids its use, however clear the words may appear on ‘superficial examination.’ ” Id. (footnotes omitted). See also Train v. Colorado Pub. Interest Research Group, Inc., 426 U.S. 1, 10 (1976); Cass v. United States, 417 U.S. 72, 78-79 (1974); Harrison v. Northern Trust Co., 317 U.S. 476, 479 (1943). See generally Murphy, Old Maxims Never Die: The “Plain-Meaning Rule” and Statutory Interpretation in the “Modern” Federal Courts, 75 COLUM. L. REV. 1299 (1975).

95 605 F.2d at 622.
97 Pub. L. No. 94-29, 89 Stat. 154 (codified at 15 U.S.C. § 78u(d) (1976)). The 1975 Amendment of § 21 of the 1934 Act exempted enforcement actions brought by the SEC from consolidation with private damage actions. Generally, private parties would file actions involving questions similar to those of the Commission’s action, and then attempt to latch onto the government action. As a result of the consolidation, the Commission encountered substantial delays, placing an unnecessary burden on the injured investor. Thus, in a successful attempt to eliminate this disruptive burden, the Commission recommended legislation to exempt its enforcement actions from the operation of these judicial procedures, arguing that such an exemption would provide expeditious enforcement of the securities laws, a vital element in the protection of security investors. S. Rep. No. 75, 94th Cong., 1st Sess. 73-77 (1975), reprinted in [1975] U.S. CODE CONG. & AD.
Aiding and Abetting Liability

ing the nature of SEC enforcement actions, the Senate Report noted the distinction between such actions and private damage suits: a private damage action may require determination of issues "such as scienter, causation and extent of damages," but these elements are not necessarily required in a Commission injunctive action. The Aaron court found this expression sufficiently clear to serve as the basis for its conclusion that Congress intended to "exempt SEC injunction actions from the scienter requirement." It should be noted, however, that while the language of the Senate Report indicates that proof of scienter is not a prerequisite for the granting of an injunction against a violator, section 21(d) only authorizes the suit to be brought; it does not purport to articulate what constitutes a violation. Moreover, the Senate Report predated Hochfelder, and therefore contains no reference to the Supreme Court's analysis of section 10(b) violations. Thus, the Report is of limited value as support for a negligence standard.

After reviewing the statutory language and legislative history of section 10(b), the Second Circuit observed that the use of a negligence standard for enforcement suits under section 10(b) would not eliminate as enforcement vehicles "comparable provisions" of the securities laws. The court noted that other sections permitting injunctive suits for similar violations do not explicitly require scienter. Reasoning that the conflict between various sections, raised in Hochfelder, did not exist in Aaron, the court determined that recognizing a negligence standard under section 10(b) would not circumvent any other securities laws.

According to the court's reasoning, the difference between

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News 179, 251-56.
99 605 F.2d at 622.
100 See note 4 supra.
101 See note 109 and accompanying text infra.
102 605 F.2d at 623. When the court spoke of "comparable provisions", it was referring to § 11 of the 1933 Act, 15 U.S.C. § 77k(b)(3) (1976), § 12(2) of the 1933 Act, id. § 77l(2), and § 15 of the 1933 Act, id. § 77o (1976). For a discussion of these sections see note 81 and accompanying text supra.
103 605 F.2d at 622 n.14.
104 See notes 81-83 and accompanying text supra.
105 605 F.2d at 623.
private damage actions and government enforcement actions permitted it to avoid the *Hochfelder* result, although not its rationale. The court’s analysis, however, demonstrates that examination of the language, legislative history and overall enforcement scheme disclosed nothing to proscribe the application of a negligence standard. The court tipped the balance in favor of negligence by considering policy, a factor which the *Hochfelder* Court refused to consider.106

While the Second Circuit expressly accepted the district court’s “adequate findings of fact,”107 it declined to consider whether Aaron’s conduct did indeed rise to the level of scienter.108 This equivocal aspect of the opinion leaves unclear the precise view of Aaron’s conduct adopted by the circuit court. It does highlight, however, that the court’s announcement of negligence as a sufficient predicate for SEC injunctive suits was unnecessary.109

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106 See note 85 and text accompanying notes 86-90 supra.

In deciding that policy considerations should govern in an enforcement action, the *Aaron* court relied on SEC v. *Coven*, 581 F.2d 1020 (2d Cir. 1978), cert. denied, 440 U.S. 950 (1979). The defendant in *Coven*, a securities lawyer, was retained for the purpose of effectuating a public offering of certain securities. In accordance with his agreement, the defendant hired two firms to underwrite the proposed issue. The basis of the action arose when the underwriters failed to comply with the terms of the offering and began to manipulate the price of the stock in customers’ transactions. See id. at 1022. Subsequently, the SEC instituted an injunction action charging the defendant with violating § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976), quoted in note 63 supra. See 581 F.2d at 1021.

In applying negligence as the standard of culpability under § 17(a), the *Coven* court focused on the underlying policy considerations of SEC enforcement actions as enunciated by the Supreme Court in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). See 581 F.2d at 1027-28.

107 605 F.2d at 614.

108 Id. at 619.

The opinion is vulnerable to criticism on another ground, as well. The SEC's complaint charged, and the district court found, that Aaron had violated and aided and abetted violations of the securities laws. The Second Circuit specifically held that because of his "participation in the management of the firm and his supervisory responsibilities . . . Aaron [had] aided and abetted the violations by the firm's salesmen." The circuit court's opinion, however, failed to apply an aiding and abetting analysis to the facts. Thus, in simultaneously announcing a negligence

1973). Some of the other factors that are relevant in determining whether an injunction should issue include:

the fact that defendant has been found liable for illegal conduct; the degree of scienter involved; whether the infraction is an "isolated occurrence"; whether defendant continues to maintain that his past conduct was blameless; and whether, because of his professional occupation, the defendant might be in a position where future violations could be anticipated.

SEC v. Commonwealth Chem. Secs., Inc., 574 F.2d 90, 100 (2d Cir. 1978) (quoting SEC v. Management Dynamics, Inc. [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,229, at 98,214 (S.D.N.Y. 1975)). The ultimate question is "whether the defendant's past conduct indicates—under all the circumstances . . .—that there is a reasonable likelihood of further violations in the future." L. Loss, III SECURITIES REGULATION 1976 (2d ed. 1961). As was noted by Justice Rehnquist at oral argument in Aaron v. SEC, the Commission would be hard pressed to make a demonstration that the defendant is likely to violate the law again when the defendant is merely negligent. 48 U.S.L.W. 3564 (Mar. 4, 1980). Although the Commission may be authorized to seek an injunction based upon negligent conduct, the grant of such an injunction requires a greater showing of culpability. This apparent conflict further undermines the appropriateness of not only a negligence standard but also the Aaron court's reliance on § 21(d) to support that standard.

110 [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,685. The district court found that Aaron was aware that the firm's registered representatives were making false and misleading statements in connection with the market-making activities for the LAM stock. Id. at 91,684. Additionally, the district court found that since Aaron functioned in a managerial capacity, his failure to terminate the false and misleading statements was sufficient to establish his scienter and make him liable as an aider and abettor under § 10(b). Id. at 91,685.

111 605 F.2d at 617. See also note 26 supra.

112 Aiding and abetting liability has been recognized in securities fraud cases since SEC v. Timetrust Inc., 28 F. Supp. 34, 43 (N.D. Cal. 1939). The origins of aiding and abetting liability are found in both tort and criminal law concepts.

Many courts have relied on the tort law principles governing aider and abettor liability to impose liability in the securities fraud context. The Restatement of Torts provides:

For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he (a) does a tortious act in concert with the other or pursuant to a common design with him, or (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately con-
standard and imposing aiding and abetting liability on Aaron, the court provided an opportunity for an unwarranted departure from prior case law in this area.

Traditionally, the imposition of liability for aiding and abetting is dependent on the satisfaction of three elements of the cause of action.113 It must be shown first, that some other party—the principal wrongdoer—has committed an independent wrong;114 second, that the alleged aider and abettor has knowledge of the independent wrong;115 and third, that the alleged aider and abettor has substantially assisted the independent wrong.116 Although these elements derive from principles of tort

sidered, constitutes a breach of duty to the third person. 

Similarly, the criminal law imposes liability on one who assists the wrongful conduct of another. 18 U.S.C. § 2(a) (1976) provides: "[w]hoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal." See Pettit v. American Stock Exch., 217 F. Supp. 21, 28 (S.D.N.Y. 1963); SEC v. Timetrust Inc., 28 F. Supp. 34, 43 (N.D. Cal. 1939). The Supreme Court in Nye and Nissen v. United States, 336 U.S. 613 (1949), stated that "[i]n order to aid and abet another to commit a crime it is necessary that a defendant 'in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, [and] that he seek by his action to make it succeed.'" Id. at 619 (quoting United States v. Peoni, 100 F.2d 401, 402 (2d Cir. 1939)).


and criminal liability, they have been applied as well to violations of the securities laws.\textsuperscript{117}

In aiding and abetting cases, courts have recognized that knowledge of the wrongful act and awareness of the party's role in the accomplishment of the wrong are crucial to liability.\textsuperscript{118} The courts' articulation of these elements, however, may vary by requiring either knowledge of the fraud or knowing substantial assistance, or both.\textsuperscript{119} For example, in \textit{SEC v. Coffey},\textsuperscript{120} the conduct of the primary wrongdoers consisted of alleged misrepresentations and omissions of material facts concerning the financial condition of an Ohio corporation. As a result of their alleged wrongdoing, the state of Ohio purchased certain notes from their corporation and suffered financial loss. Defendant Coffey's participation consisted of discussing the terms of the Ohio transaction with a member of the "money-finder" firm that arranged the purchase of the notes.\textsuperscript{121} The Sixth Circuit held that liability for aiding and abetting could be imposed on Coffey if the SEC could establish that he was aware that an "actionable fraud was being perpetrated on the State of Ohio."\textsuperscript{122} A logical interpretation of the court's statement compels the conclusion that the court deemed it appropriate to impose aiding and abetting liability upon a showing of knowledge of the wrong coupled with substantial assistance.\textsuperscript{123}

In contrast to, although not inconsistent with, the \textit{Coffey} holding, the Fifth Circuit, in \textit{Woodward v. Metro Bank}\textsuperscript{124} em-

\begin{itemize}
\item \textsuperscript{117} See note 113 supra.
\item \textsuperscript{118} See notes 115-16 supra. See text accompanying notes 120-50 infra.
\item \textsuperscript{119} See note 143 and text accompanying notes 120-32 infra.
\item \textsuperscript{120} 493 F.2d 1304 (6th Cir. 1974), cert. denied, 420 U.S. 903 (1975).
\item \textsuperscript{121} See id. at 1308.
\item \textsuperscript{122} Id. at 1319.
\item \textsuperscript{123} In addressing the aiding and abetting issue, the \textit{Coffey} court set forth a three-tier analysis. In order to impose secondary liability there must first be an independent securities law violation committed by a party other than the aider and abettor. \textit{Id.} at 1316. In this regard, the court found the element satisfied by the omission of material facts by the "money-finder" in his dealings with the Ohio officials. The court then focused on whether Coffey was aware of his role in the fraudulent scheme. Here the circuit court directed the district court's attention to the circumstances surrounding Coffey's discussion of the terms of the Ohio transaction with the "money-finder." \textit{Id.} It should be noted that the court considered the knowledge requirement to be the crucial element in establishing aiding and abetting liability, for it proceeded to require that the aider-abettor knowingly render substantial assistance to the principal wrongdoer. \textit{Id.} at 1316-17.
\item \textsuperscript{124} 522 F.2d 84 (5th Cir. 1975).
\end{itemize}
phasized the defendant's knowing substantial assistance. In *Woodward*, the defendant bank allegedly aided and abetted a securities fraud perpetrated by one of its customers (E.T. Starnes). Starnes had induced the plaintiff to execute security agreements and pledge collateral in support of a loan from the bank to him personally and his corporation. At the time of the transaction, however, the bank failed to disclose to the plaintiff facts regarding the corporation which might have indicated its financial instability. In determining the defendant's liability, the court found that the ordinary nature of the business transaction and the absence of any direct duty to the plaintiff on the part of the bank precluded the imposition of liability.

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126 Id. at 95-97. The court stated that “[a] remote party must not only be aware of his role, but he should also know when and to what degree he is furthering the fraud.” Id. at 95.

In deciding that the aider and abettor must be found to have rendered the assistance knowingly, the *Woodward* court cited to *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974). In *Landy*, the court found that the existence of an independent wrong, knowledge of that wrong and substantial assistance in the wrong were all necessary elements in establishing aiding and abetting liability. Id. at 162-63. Examination of these elements by the *Woodward* court revealed that since the substantial assistance aspect of aiding and abetting liability demonstrates that it is the participation in the fraudulent scheme which is at issue, the key to liability must lie in the aider and abettor's knowledge of his role in the overall scheme. 522 F.2d at 95-96. The *Woodward* court noted that “[o]ne could [potentially] know of the existence of a ‘wrong’ without being aware of his role in the scheme.” Id. at 95. Thus, the *Woodward* panel found that the absence of the “knowing” substantial assistance element of the *Landy* test created room for overinclusiveness. Id. It was the apparent need to safeguard against the imposition of liability for totally innocent conduct that compelled the *Woodward* court to establish restraints on aiding and abetting liability. Id. at 97.

The comments to § 876 of the Second Restatement of Torts set forth several criteria to be used in determining whether the participation by the defendant is substantial enough to find that an individual is liable for the misconduct of another. The factors to be considered are: (1) the nature of the act encouraged; (2) the amount of assistance rendered by the defendant; (3) the presence or absence of the defendant at the time of the tort; (4) the defendant's relation to the other person; and (5) the state of mind of the defendant. *RESTATEMENT (SECOND) OF TORTS* § 876, comment to clause (b) (1979). The “state of mind” criterion suggests that “substantial assistance” implies knowledge of the independent wrong.

Moreover, as illustrated in *Nye and Nissen v. United States*, 336 U.S. 613, 619 (1949), the Supreme Court's application of aiding and abetting liability in the criminal area harmonizes with the Restatement’s state of mind criterion. See note 112 supra.

128 See id. at 88.

129 See id. at 88-89. The court noted that the defendant bank was not aware of its customer's “dismal” financial situation. Id. at 88 n.10.
on the bank. The court reasoned that since the imposition of aiding and abetting liability is contingent upon a finding of participation, that participation should be knowing.

Here, there was insufficient evidence to support a conclusion that the bank's assistance was rendered knowingly.

Although the Woodward court apparently eliminated the requirement of knowledge of the independent wrong, it is clear that knowing substantial assistance necessarily requires that the

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129 Id. at 98-99. The Woodward court emphasized that the defendant's behavior was consistent with the duties imposed by state law and that the bank's loan transactions with the primary wrongdoer were confidential. Therefore, there was no duty on the part of the bank to disclose such information to the plaintiff. Id. at 99.

The origin of aiding and abetting liability for mere silence and inaction can be found in Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 681-82 (N.D. Ind. 1966), aff'd, 417 F.2d 147 (7th Cir. 1969), cert. denied, 397 U.S. 959 (1970). See Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 740 (10th Cir. 1974); Green v. Jonhop, Inc., 358 F. Supp. 413, 419 (D. Or. 1973). It appears, though, that liability for silence and inaction arises only "when there is a duty of disclosure owed to the plaintiff." Stern v. American Bankshares Corp., 429 F. Supp. 818, 825 (E.D. Wis. 1977). See, e.g., Steedman v. SEC, 603 F.2d 1126, 1141 (5th Cir. 1979); Edwards & Hanly v. Wells Fargo Secs. Clearance Corp., 602 F.2d 478, 494-95 (2d Cir. 1979); SEC v. Coffey, 493 F.2d 1304, 1317 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975); Lany v. FDIC, 468 F.2d 139, 161-62 (3d Cir. 1973), cert. denied, 468 U.S. 960 (1974); Lanza v. Drexel & Co., 479 F.2d 1277, 1259, 1303-04, 1309 (2d Cir. 1973); Strong v. France, 474 F.2d 747, 752 (9th Cir. 1973); Wessel v. Buhler, 437 F.2d 279, 283 (9th Cir. 1971); SEC v. National Bankers Life Ins. Co., 324 F. Supp. 189, 195 (N.D. Tex.), aff'd, 448 F.2d 652 (5th Cir. 1971). See generally A. Bromberg, supra note 113 § 8.5, at § 533; Ruder, supra note 113, at 643-44. The alleged aider and abettor must be shown to have possessed "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 . . . [a] breach of a duty of disclosure." Hochfelder v. Midwest Stock Exch., 503 F.2d 364, 374 (7th Cir.), cert. denied, 419 U.S. 875 (1974). Thus, it appears that the courts effectively have limited aiding and abetting liability for mere silence or inaction to situations where the alleged aider and abettor has knowledge of the fraud or can be deemed to have such knowledge and has failed to disclose the primary wrong in breach of his duty to make disclosure.

130 522 F.2d at 95.

131 Id. at 99-100. In applying the final requirement for aiding and abetting liability, the court focused on the nature of the assistance rendered and the duty owed by the alleged aider and abettor. The court noted that where there is some type of affirmative assistance in conjunction with silence or inaction, the "degree of knowledge required [to impose aiding and abetting liability depends] on how ordinary the assisting activity is in the business involved." Id. at 97 (footnote omitted). Thus, if the alleged aider and abettor can show that his actions were consistent with normal business practices, he may be held liable only upon proof of a specific intent to violate the securities laws. However, the knowledge necessary for aiding and abetting liability may be inferred if the activity engaged in is of an unusual nature. Id. Accord, A. Bromberg, supra note 113, § 8.5, at § 582.
actor have knowledge of the independent wrong. Conversely, an actor who has knowledge of the independent wrong may be deemed, by inference, to have acted knowingly in rendering substantial assistance to the primary wrongdoer. As a result, the two statements in Coffey and Woodward indicate differences merely in emphasis rather than in substance.

In addition to the formalistic variations with respect to which element demands a showing of knowledge, there remains a question as to what level of knowledge is sufficient for the imposition of aiding and abetting liability. Some courts have indicated a willingness to impose aiding and abetting liability on the basis of a showing of less than actual knowledge. The Woodward court, in its discussion of the defendant's general awareness of his role in the improper scheme, stated that knowledge

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132 See notes 129-31 and accompanying text supra.

133 See, e.g., Edwards & Hanly v. Wells Fargo Secs. Clearance Corp., 602 F.2d 478, 485 (2d Cir. 1979) ("something closer to an actual intent to aid in a fraud, at least in the absence of some special relationship with the plaintiff that is fiduciary in nature" is required); Monsen v. Consolidated Dressed Beef Co., Inc., 579 F.2d 793, 799 (3d Cir.) (actual knowledge is required, but "knowledge may be less strict where the alleged aider and abettor derives benefits from the wrongdoing") (citations omitted), cert. denied, 439 U.S. 930 (1978); Hirsch v. duPont, 553 F.2d 760, 769 (2d Cir. 1977) ("knowledge of the fraud, and not merely the undisclosed material facts, is indispensable"); Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 780 (3d Cir. 1976) ("where the alleged aider and abettor derives benefits from wrongdoing . . . the proof offered must establish conscious involvement in impropriety or constructive notice of intended impropriety") (citation omitted); Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975) ("liability for aiding and abetting may be found on less than actual knowledge of the illegal activity [but] how much or how little knowledge [varies] with the facts of each case"); Woodward v. Metro Bank, 522 F.2d 84, 96 (5th Cir. 1975) ("[k]nowledge may be shown by circumstantial evidence, or by reckless conduct, but the proof must demonstrate actual awareness of the party's role in the fraudulent scheme"); Hochfelder v. Midwest Stock Exch., 503 F.2d 364, 374 (7th Cir.) ("the party charged with aiding and abetting [must have actual] knowledge of or, but for a breach of duty of inquiry, should have [known of] the fraud"), cert. denied, 419 U.S. 930 (1974); SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974) (a "general awareness [on the part of the aider-abettor] that his role was part of an overall activity that is improper" satisfies the knowledge requirement), cert. denied, 420 U.S. 908 (1975); Landy v. FDIC, 486 F.2d 139, 163 (3d Cir. 1973) (an allegation that "the brokerage firms knew from the volume of trading, the improper manner in which the account was handled . . . and from personal and direct knowledge of the affairs of the bank, that [the] accounts were part of a device and scheme to defraud" may not be "sufficient to fulfill the knowledge requirement"), cert. denied, 416 U.S. 960 (1974); Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147, 150 (7th Cir. 1969) (the defendants "knew . . . that Dobich . . . had made a number of misrepresentations"), cert. denied, 397 U.S. 989 (1970); SEC v. National Bankers Life Ins., Co., 324 F. Supp. 189, 195 (N.D. Tex.) ("knowledge may be actual or constructive"), aff'd, 448 F.2d 652 (6th Cir. 1971). See Ruder, supra note 113, at 638.
AIDING AND ABETTING LIABILITY

may be shown by reckless conduct.\textsuperscript{134} Similarly, the Northern District of Texas, in \textit{SEC v. National Bankers Life Ins. Co.,}\textsuperscript{135} a case involving stock manipulation, announced that knowledge of the fraudulent act may be either actual or constructive.\textsuperscript{136}

The apparent flexibility with which the courts have dealt with the question of the requisite level of knowledge for aiding and abetting liability may, however, be misleading. While the \textit{Woodward} court indicated willingness to accept reckless conduct, it demanded in addition a showing of the defendant's "actual awareness of [its] role in the fraudulent scheme."\textsuperscript{137} This equivocation is paralleled by the \textit{National Bankers} court's requirement that the defendants have a "general awareness that any acts . . . committed were necessary to the furtherance of [the] improper [scheme]."\textsuperscript{138} Although the court noted that constructive knowledge would suffice,\textsuperscript{139} the quoted statement is inconsistent with constructive knowledge.\textsuperscript{140}

While there is a lack of unanimity regarding which of the latter two elements of the cause of action for aiding and abetting gives rise to the requirement that the defendant have


Reckless conduct has been defined as "an act of an unreasonable character in disregard of a risk known to [the actor] or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow." W. \textit{Prosser}, \textit{supra} note 7, § 34, at 185. For cases following this definition in the securities law context, see \textit{Rolf v. Blyth}, Eastman Dillon & Co., Inc., 570 F.2d 38, 44-45 (2d Cir.), \textit{cert. denied}, 439 U.S. 1039 (1978); \textit{Saunders v. John Nuveen & Co., Inc.}, 554 F.2d 790, 793 (7th Cir. 1977); \textit{Lanza v. Drexel & Co.}, 479 F.2d 1277, 1306 n.98 (2d Cir. 1973). \textit{See also} \textit{Ruder, Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases}, 63 \textit{Nw. U. L. Rev.} 423, 436 (1968).

\textsuperscript{135} 324 F. Supp. 189 (N.D. Tex.), \textit{aff'd}, 448 F.2d 682 (6th Cir. 1971).


Constructive knowledge has been defined as "what a person should know as opposed to what he does know," and as "knowledge of facts stimulating inquiry and . . . failure to perform a duty of acquiring information." A. \textit{Bromberg}, \textit{supra} note 113, § 8.4, at § 531 (citation omitted).

\textsuperscript{137} 522 F.2d at 96.

\textsuperscript{138} 324 F. Supp. at 197 (emphasis added).

\textsuperscript{139} \textit{Id.} at 195.

\textsuperscript{140} \textit{See} note 136 \textit{supra}. 
knowledge,\textsuperscript{141} and a lack of certainty with respect to what minimal level of knowledge is required,\textsuperscript{142} there is no question that some knowledge on the part of the defendant must be shown before liability for aiding and abetting may be imposed.\textsuperscript{143} The knowledge requirement serves a useful purpose by ensuring that an innocent party who "unwittingly facilitate[s] the wrongful acts of another" will not be liable for the consequences of that wrong.\textsuperscript{144}

The knowledge requirement is particularly important in the securities field. For example, in the absence of such a requirement, a broker who merely executes a sell order for a customer would be held liable for the resulting damage if the transaction were fraudulently induced by the purchaser. In addition to offending ordinary notions of fairness, the imposition of liability in such circumstances upon anyone who sells securities would impose an undue, as well as an unreasonable, burden of investigation, which, in turn, would pose a threat to the continued viability of the securities industry.

\textsuperscript{141} See text accompanying notes\textsuperscript{119-32 supra.}

\textsuperscript{142} See note 133 supra.


In *Rolf v. Blyth, Eastman, Dillon & Co.*, a case decided the term preceding *Aaron*, the Second Circuit appeared to have extended the existing limits of aiding and abetting liability while keeping intact the policy behind the knowledge requirement. The *Rolf* court imposed aiding and abetting liability on a fiduciary whose reckless conduct substantially assisted the fraud perpetrated on the plaintiff by his investment advisor. Although there was no showing that the defendant had actual knowledge of the fraud, the court found the defendant liable, essentially charging him with the knowledge he would have gained had he not breached his fiduciary duty by recklessly failing to investigate. While this analysis does not mesh with prior aiding and abetting cases, arguably it is not totally inconsistent with those cases because the predicate for liability in *Rolf* was the defendant's culpable conduct which rose to the level of scienter.

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146 Id. at 46 n.15. The *Rolf* court found that reckless behavior as opposed to knowing conduct may be sufficient to impose liability for aiding and abetting while recognizing the strong policy against imposing liability for "wholly faultless conduct." Id. (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 198 (1976)). Because *Hochfelder* held that § 10(b) could not be extended to illicit activities where the defendant had acted in good faith, the Second Circuit reasoned that the adoption of a recklessness standard would not frustrate the policy of avoiding overinclusiveness, since reckless conduct could not be interpreted as coming within the ambit of good faith. Id. See text accompanying note 148 infra.

147 Id. at 48.

148 Id. at 47. In addressing the knowledge requirement for establishing aiding and abetting liability, the *Rolf* court stated that where the alleged aider and abettor owes a fiduciary duty to the defrauded party, proof of reckless conduct will satisfy the scienter requirement. Id. at 44, 47. In light of the traditional interpretation given to reckless conduct, see note 134 supra, the *Rolf* court's adoption of a recklessness standard for aiding and abetting liability appears to eliminate any requirement that the aider and abettor have knowledge of the wrong or that he be aware of his participation in the fraudulent scheme. For an analysis of the opinion in *Rolf*, see Comment, Reckless Conduct: The Securities Fraud Aider and Abettor as a Concurrent Tortfeasor, 45 BROOKLYN L. REV. 1391 (1979).

Since Aaron rejects the requirement of scienter in an enforcement action to enjoin an aider and abettor, it cannot be harmonized through the same rationale.

The difficulty with the Aaron opinion lies in the conflict between its finding of fact and its conclusion of law. The court reaffirmed that in the Second Circuit negligence is sufficient to sustain an SEC enforcement action to enjoin a defendant from violating rule 10b-5. At the same time, the court held that Aaron had aided and abetted violations of the rule. Although negligence may indeed be the appropriate standard in this context with respect to a primary wrongdoer, negligence is clearly insufficient to support a finding of aiding and abetting a rule 10b-5 violation. Because it is apparent from the facts that Aaron’s state of mind with respect to his conduct exceeded negligence, it is unlikely that the Second Circuit’s finding of aiding and abetting was grounded in mere negligence. Therefore, the court’s determination is consistent with traditional aiding and abetting analysis. A danger, however, exists in the court’s failure to discuss the requirement of knowledge at all, for this void may provide authority for future courts to extend unreasonably the reach of aiding and abetting liability.

Joseph A. DeGirolamo

Editor’s Note:

On June 2, 1980, the Supreme Court reversed the Second Circuit’s decision in Aaron. Justice Stewart, writing for the majority, stated that “the rationale of Hochfelder ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought.” The Court firmly re-

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150 570 F.2d at 46-48.
151 See text accompanying notes 107-08 supra.
152 605 F.2d at 619.
153 Id. at 617.
154 See Lowenschuss v. Kane, 520 F.2d 255, 268 n.10 (2d Cir. 1975) (“some allegation of facts implying knowledge or reckless disregard is necessary [for the imposition of aiding and abetting liability]; a mere negligence standard cannot be used”).
155 See note 110 supra.
156 Aaron v. SEC, 100 S. Ct. 1945 (1980).
157 Id. at 1952.
jected the Commission's reliance on SEC v. Capital Gains as the controlling precedent by contrasting Capital Gains with Hochfelder on the basis of legislative history and the effect of the language of the particular statutory provision involved.

In addition, the majority found that the language of section 17(a) requires a finding of scienter under section 17(a)(1), but not under section 17(a)(2) or section 17(a)(3). In so doing, the Court emphasized the unambiguous language of section 17(a), and found further justification for its decision by noting that there is no "very clear expression of congressional intent in the legislative history" such as would "justify the conclusion that the statute does not mean what it so plainly seems to say."

Justices Marshall, Brennan and Blackmun dissented from the majority's section 10(b) holding. The dissent adopted the policy oriented approach of the Second Circuit majority and contended that the Court's "wooden analysis" of Hochfelder "unnecessarily undercuts the Commission's authority to police the marketplace."

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159 100 S. Ct. at 1954.
160 Id. at 1956.
161 Id.
162 Id. at 1959.