

1-1-1988

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Recommended Citation

Thomas C. Daniels, *The Existence, Necessity, Recognition, and Contradiction of an Implied Right of Action Under Section 17(a) of the 1933 Securities Act*, 28 SANTA CLARA L. REV. 43 (1988).

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THE EXISTENCE, NECESSITY, RECOGNITION, AND CONTRADICTION OF AN IMPLIED RIGHT OF ACTION UNDER SECTION 17(a) OF THE 1933 SECURITIES ACT

Thomas C. Daniels*

Although the implied private right of action is a common law principle,¹ federal securities legislation is one of the most fruitful sources of the implied right of action.² Courts have recognized that violations of federal securities statutes often give rise to the right of private parties to seek remedy.³ However, they have struggled to define the precise analysis to apply in determining whether an implied private right exists.

The Supreme Court has recognized an implied private right of action for unlawful fraud but not for all conduct proscribed by the federal securities laws.⁴ This article focuses on the recognition of an implied right of action under section 17(a) of the Securities Act of 1933 (the 1933 Act).⁵ The article begins by discussing the United States Supreme Court's development of implied rights of action.⁶ It

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1. *Couch v. Steel*, 118 Eng. Rep. 1193 (Q.B. 1854).

2. Note, *Implying Civil Remedies from Federal Regulatory Statutes*, 77 HARV. L. REV. 285, 286 (1963).

3. *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967).

4. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.2 (1983) (reserving decision on private right of action for violation of section 17(a) of the 1933 Act); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) (allowing a private right of action under section 215 of the Investment Advisor Act but not under section 206 anti-fraud provisions of the Act); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) (rejecting private right of action based on misstatements in reports filed with Commission under section 17(a) of the 1934 Act); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977) (refusing to recognize private rights of action for violation of section 14(a) of the 1934 Act); *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975) (denying right of action under Securities Investor Protection Act).

5. Securities Act of 1933, ch. 38, 48 Stat. 74 (current version at 15 U.S.C. § 77a (1982)).

6. See *infra* notes 14-17 and accompanying text.

outlines the statutory remedies available under the 1933 Act⁷ and the Securities Exchange Act of 1934 (the 1934 Act).⁸ Then it relates these statutory remedies to implied private rights of action under section 17(a) of the 1933 Act.⁹ The article discusses possible conflicts between implied rights of action under section 17(a) and express statutory rights of actions.¹⁰ It then concludes by suggesting possible solutions to these conflicts.¹¹

I. THE SUPREME COURT'S APPROACH TO RECOGNITION OF IMPLIED PRIVATE RIGHTS OF ACTION

In a series of decisions during the mid-1970's the Supreme Court began modifying the standard for implying private rights of action.¹² Previously, the Court had established that it would require two showings before finding an implied right of action: (1) a statute created in favor of a class; and (2) injury to a member of that class.¹³ This standard followed from the common law principle enunciated in *Couch v. Steel*.¹⁴ The United States Supreme Court enunciated this principle in 1946, when it provided private parties with a general right to recover for injury caused by conduct that was unlawful under federal statutes.¹⁵

In 1964, the Supreme Court recognized an implied private right of action under the federal securities laws. In *J.I. Case Co. v. Borak*,¹⁶ a case involving false and misleading proxy statements in violation of section 14(a) of the 1934 Act,¹⁷ the Court recognized an implied private right of action, stating "the power to enforce implies the power to make effective the right of recovery afforded by the [1934] Act."¹⁸ In granting a cause of action to private parties, the

7. See *infra* notes 67-102, 106-26 and accompanying text.

8. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (current version at 15 U.S.C. § 78a (1982)).

9. See *infra* notes 148-209 and accompanying text.

10. See *infra* notes 210-44 and accompanying text.

11. See *infra* notes 245-50 and accompanying text.

12. Comment, *Implied Private Rights Of Actions; The Court Search for Limitations In a Confused Area of the Law*, 13 CUMB. L. REV. 569, 577 (1983).

13. *Id.*

14. 118 Eng. Rep. 1193, 1196 (Q.B. 1854).

15. *Bell v. Hood*, 327 U.S. 678, 684 (1946) (violation of Safety Appliance Act recognized private right of action).

16. 377 U.S. 426 (1964).

17. Section 14(a) of the 1934 Act states in pertinent part: "It shall be unlawful for any person . . . in contravention of such rules and regulations . . . to solicit any proxy . . . of any security registered pursuant to section 12 of this title." 15 U.S.C. § 78n(a) (1975).

18. 377 U.S. at 433 (quoting *Deckart v. Independence Shares Corp.*, 311 U.S. 282, 288 (1940)).

Court focused on the fact that the chief purpose of the 1934 Act is to protect investors such as the plaintiff.¹⁹ The Court believed that by granting remedy to the very persons the Act was designed to protect, the private right of action would help effectuate this purpose. Therefore, the Court found it "clear" that private parties have a right under section 17 to bring suit for violation of section 14(a) of the 1934 Act.²⁰ This decision comports with the common law principle and the Supreme Court's affirmation in *Couch v. Steel*.²¹

However, in what one writer has described as a hope to "retard the proliferation of lawsuits,"²² the Supreme Court set out to delineate a four-prong test for determining whether a private cause of action may be implied from a statute. In *Cort v. Ash*,²³ the parties sought a private right of action for injuries arising from the defendant's violation of a criminal statute prohibiting corporations from making political contributions.²⁴ The Court established four requirements for finding a private right of action: (1) the plaintiff must be one of the class for whose *especial* benefit the statute was enacted; (2) the Legislature's intent, either explicit or implicit, is to create or deny a remedy; (3) the private right is consistent with the underlying purposes of the legislation; and (4) the private right of action is not one traditionally relegated to state law, in an area of state concern, so that it would be inappropriate to infer a right of action based solely on federal laws.²⁵ Although the *Cort* test is very similar to the one found in *Borak*,²⁶ it is narrower in that the relevant statute must not only favor the plaintiff generally, but the statute must have been created to benefit the plaintiff specifically.²⁷

Two years later, in *Piper v. Chris-Craft Industries, Inc.*,²⁸ the Supreme Court adopted the *Cort* test in the federal securities context. There, the Supreme Court decided the purpose of the statute was to get important information to investors.²⁹ Unlike the purpose announced by the Court in *Borak*, the purpose enunciated here was

19. J.I. Case Co. v. Borak, 377 U.S. 426, 433 (1964).

20. *Id.*

21. Comment, *supra* note 12, at 577.

22. Comment, *supra* note 12, at 577.

23. 422 U.S. 66 (1975).

24. *Id.* at 78.

25. *Id.* (the especial class seems to narrow the protected class somewhat more than *Borak*).

26. *Id.* at 79.

27. *Id.* at 82.

28. 430 U.S. 1 (1977) (involving a violation of section 14(a) of the 1934 Act).

29. *Piper*, 430 U.S. at 30-31.

not to protect a narrow class of people.³⁰ After stating the *Cort* factors were relevant but not dispositive,³¹ the Court concluded awarding damages under the statute would only remotely effectuate the legislative purpose of protecting stockholders.³² Based on this failure to satisfy the first prong of the *Cort* test, the Court refused to grant a private right of action under section 14(e) of the 1934 Act.³³

In 1979, the Court considered implied rights of action in at least five different contexts. In *Touche Ross Co. v. Redington*,³⁴ the plaintiff attempted to assert a right of action under section 17(a) of the 1934 Act against the accountants of a bankrupt brokerage service for misstatements in credit financial reports. Upon examining the 1934 Act, the Court found the legislative history made no mention of implied private rights of action³⁵ and refused to recognize plaintiff's claims due to a failure to satisfy the second prong of the *Cort* test.³⁶ Also in *Touche*, the Court reaffirmed that violations of statutes do not automatically entitle a private party to an action under the statute.³⁷

In *Transamerica Mortgage Advisors, Inc. v. Lewis*,³⁸ the United States Supreme Court examined private rights of action under the Investment Advisors Act (Act). Although the Court recognized the existence of a private right of action under section 215 of the Act, it declined to find an implied remedy under the anti-fraud provisions of section 206. The Court stated that although both section 213 and 206 were "intended to benefit the clients of the investment advisor,"³⁹ thereby fulfilling the first prong of the *Cort* test, the critical question was whether Congress intended to create a private remedy.⁴⁰ When the Court found the legislative history silent with respect to private rights of action,⁴¹ it looked to the language and structure of the statute to determine whether such an intent to provide private remedies was implied. The Court found that section 206 did not create any civil liabilities.⁴² Moreover, the Court urged that

30. *Id.* at 35.

31. *Id.* at 37.

32. *Id.* at 42.

33. *Id.*

34. 442 U.S. 560, 562 (1979).

35. *Id.* at 571.

36. *Id.* at 560.

37. *Id.* at 568; *Cannon v. University of Chicago*, 441 U.S. 677, 688 (1979).

38. 444 U.S. 11 (1979).

39. *Id.* at 17.

40. *Id.* at 18.

41. *Id.*

42. *Id.* at 19.

courts must be wary of finding implied remedies when a statute already provides a particular remedy expressly.⁴³

Although the Securities and Exchange Commission (SEC) argued in an *amicus curiae* brief that the Court should not stop its analysis when it fails to find a legislative intent to allow private rights of action, the Court refused to consider the remaining elements of the *Cort* test without first finding the second prong satisfied.⁴⁴ In an attempt to establish legislative intent, then, the SEC argued that the 1970 Congressional amendments to the Act condoned an implied private right of action. However, the Court replied that "subsequent legislation can disclose little or nothing of the intent of Congress in enacting earlier laws."⁴⁵ *Transamerica* is not the last time the SEC attempted to infer legislative intent from subsequent amendments of the federal securities laws.

Although the Court in *Touche* did not overrule *Borak*,⁴⁶ the opinion did signify a shift towards a more restrictive approach to the recognition of implied private rights of action.⁴⁷ Despite this move towards a stricter standard, the court subsequently liberalized its approach to evaluating congressional intent. In *Merrill Lynch, Pierce, Fenner and Smith v. Curran*,⁴⁸ the Court, after finding the Commodity Futures Trading Commission Act of 1974 silent on the subject of private remedies,⁴⁹ for the first time accepted the SEC's argument regarding the inference of Congressional intent from subsequent amendments to statutes. The Court in *Merrill Lynch* recognized that in certain circumstances the failure of Congress to provide express rights of action in legislation or later amendments is not necessarily inconsistent with an intent to make private remedies available to those the legislation was designed to benefit.⁵⁰ The Court conceded that if federal courts had uniformly⁵¹ recognized an implied private right of action prior to the enactment of an amendment and the amendment expressed Congressional intent to preserve pre-existing remedies, then the Court may infer a right to private remedy from the statute's "contemporary legal context."⁵² In *Merrill*

43. *Id.*

44. *Transamerica*, 444 U.S. at 20.

45. *Id.* at 23 n.13.

46. *Touche*, 442 U.S. at 578.

47. *Id.*

48. 456 U.S. 353 (1982).

49. *Id.* at 367.

50. *Id.* at 374.

51. *Id.* at 379.

52. *Id.* at 381.

Lynch, the Court's broad inquiry into Congress' perception of the Futures Trading Commission Act vis-a-vis judicial interpretations allowed the Court to recognize a right to private remedies that was not expressly provided by a 1974 amendment to the act.⁵³

One year later in *Herman and MacLean v. Huddleston*,⁵⁴ the Court returned to the *Merrill Lynch* analysis. The plaintiff in *Herman* brought suit under section 10(b) and Rule 10b-5 of the 1934 Act against accountants who had allegedly misrepresented the financial condition of a bankrupt issuer.⁵⁵ The plaintiff also alleged violations of sections 11 and 17(a) of the 1933 Act.⁵⁶ In recognizing an implied right of action under section 10(b), the court noted that federal circuit courts had unanimously recognized implied private rights of action under the section. The Court reasoned that Congress' decision to leave section 10(b) intact through otherwise comprehensive revisions of the 1934 Act in 1975 suggests Congress ratified judicially-recognized 10(b) actions brought by private plaintiffs.⁵⁷ *Herman* illustrates the Court's decided acceptance of the argument earlier advanced by the SEC in *Merill Lynch* that Congressional silence may be interpreted as an acceptance of judicially-created rights of action.

Herman also signals the Court's refutation of the exclusivity of express remedies under the securities laws in that it allowed the plaintiff to recover under section 10(b) of the 1934 Act notwithstanding a contemporaneous actionable claim under section 11 of the 1933 Act.⁵⁸ The Court refers to the 1933 and 1934 acts as "interrelated components of the federal regulatory scheme governing transactions in securities."⁵⁹ The Court reasoned that a denial of recovery under section 10(b) of the 1934 Act for conduct prohibited by section 11 of the 1933 Act would conflict with the basic purpose of the act: to provide greater protection to purchasers of securities.⁶⁰

II. THE STATUTORY SCHEME OF THE 1933 AND 1934 ACTS

As discussed above, the United States Supreme Court has em-

53. *Id.* at 378.

54. 459 U.S. 375 (1983).

55. The issuer, Texas International Speedway, made a public offering of \$4,398,900 in securities to the public. *Id.* at 377.

56. The plaintiff abandoned the § 17(a) claim, thereby enabling the Court to postpone deciding whether § 17(a) affords a private remedy. *Id.* at 378 n.2.

57. *Id.* at 385-86.

58. *Id.* at 387.

59. *Id.* at 380.

60. *Id.* at 383.

phasized that discerning legislative intent is the Court's primary task under the *Cort* test. In the most clear instance, when Congress intends to provide private remedy, it does so expressly.⁶¹ In deciding whether to recognize an implied private right of action, courts must first look to the remedies expressly provided by the statutes.

The 1934 Act expressly provides private rights of action under sections 9(e),⁶² 16(b),⁶³ and 18(a).⁶⁴ The Court has often been reluctant to recognize implied private rights of action for conduct already governed by these provisions. But, as the Court observes in *Herman*, express remedies are not exclusive under the securities laws.⁶⁵ For instance, although misleading statements are expressly actionable under section 18(a), the Court has allowed an implied private right of action for injury caused by misstatements under section 10(b) and Rule 10b-5.⁶⁶ The Court has sanctioned this overlap of remedies, stating that it is "neither unusual nor unfortunate"⁶⁷ because express remedies under section 9(e), section 16(b), and section 18(a) were not intended to cover all activities the 1934 Act was designed to prevent. The Court therefore allows a "catch-all" private right of action for wrongful conduct not otherwise addressed by the other provisions

61. *Touche*, 442 U.S. at 572.

62. Section 9(c) provides in relevant part: "Any person who willfully participates in any act or transaction in violation of subsection (a), (b) or (c) of this section, shall be liable to any person who shall purchase or sell any security at a price which was affected by such acts or transaction. . . ." 15 U.S.C. § 78i(e) (1976).

63. Section 16(b) states:

For the purpose of preventing the unfair use of information which may have been obtained by such . . . owner . . . by reason of his relationship to the issuer, any profit realized by him from any purchase or sale, or any sale and purchase, of equity security of such issuer within any period of less than six months . . . shall inure to and be recoverable by the issuer.

15 U.S.C. § 78p(b) (1975).

64. Section 18(a) reads:

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. . . .

Id.

65. 459 U.S. at 383.

66. *Id.* at 387.

67. *Id.* at 383.

of the Act.

Lower courts had recognized a private right of action under section 10(b) for thirty-five years before the Supreme Court explicitly recognized such a right in *Herman*.⁶⁸ However, until the Supreme Court's clarification in *Ernst and Ernst v. Hochfelder*,⁶⁹ courts had not agreed whether section 10(b) or Rule 10b-5 actions required a showing of scienter.⁷⁰ In *Ernst*, plaintiff alleged a section 10(b) violation based on an accounting firm's negligent failure to investigate the practices of First Security Company of Chicago. There, the Court refused to recognize a cause of action for negligent conduct.⁷¹ Upon examining the language and legislative history of the statute, the Court concluded that the Legislature's use of the words "manipulative device" and "contrivance" did not indicate an intent to create liability for mere negligence.⁷² Also, the legislative history suggested a showing of scienter was required in regulating manipulative practices, supporting a requirement of scienter in section 10(b) rights of action.⁷³ Therefore, according to *Ernst*, allegations of mere failure to exercise reasonable care are not actionable under section 10(b) or Rule 10b-5.⁷⁴

According to *Ernst* then, actions under section 10(b) or Rule 10b-5⁷⁵ of the 1934 Act require a showing of scienter in the purchase or sale of securities by means of interstate commerce, the mails, or national securities exchanges. In addition, a right of action based on subsection (1) requires that the party prove a device, scheme, or artifice to defraud. Under subsection (2), a party must prove a misrepresentation or omission of a fact. Also under subsection (2) an action based on misrepresentations of a material fact requires a party to show they relied on the misrepresentation to their detriment. However, reliance is not required with respect to omissions. Finally, under subsection (3), a party must prove defendant participated in an act, practice, or course of business which operated

68. *Id.* at 380.

69. 425 U.S. 185 (1976).

70. *Id.* at 196-97 (defined as a mental state requiring an actual intent to manipulate, defraud, or deceive).

71. *Id.* at 198.

72. *Id.* at 203; *see also* S. 2693, 73d Cong., 2d Sess. (1934); H.R. 7852, 73d Cong., 2d Sess. (1934).

73. *Ernst & Ernst v. Hochfelder*, 424 U.S. 185, 184 (1976).

74. *Id.* at 200 (because the allegation of negligence would not support a § 10(b) right of action, the court was not required to decide if a private right of action existed).

75. Rule 10b-5 was enacted in 1942 under the authority granted by the Commission by § 10b. It is important to note the similarity between Rule 10b-5 and § 17(a) of the 1933 Act. *Gunter v. Hutchinson*, 433 F. Supp. 42 (N.D. Ga. 1977).

or would operate as a fraud.⁷⁶

Although courts have traditionally equated scienter with actual intent, since *Ernst* courts have held that recklessness is sufficient to fulfill the scienter requirement.⁷⁷ Therefore, a plaintiff may establish scienter by showing "knowing misconduct" or "severe recklessness" amounting to an extreme departure from the standard of ordinary care.⁷⁸ Under section 10(b) or Rule 10b-5, the manipulative or deceptive conduct must be in connection with a purchase or sale of a security.⁷⁹ In *Blue Chip Stamps v. Manor Drug Stores*,⁸⁰ for instance, the Court denied recovery under section 10(b) when the defendant had neither purchased nor sold any securities. In that ruling, the Court relied on a decision by the Second Circuit Court of Appeals in *Birnbaum v. Newport Steel Corp.*⁸¹ requiring an actual purchase or sale before finding liability. The 1934 Act, then, protects corporations as well as individuals who purchase or sell a security.⁸²

Since the express remedies of the 1934 Act were not designed to remedy a broad category of fraudulent conduct, an implied right of action under section 10(b) and Rule 10b-5 rectifies this problem by enabling a private party to sustain a right of action for a wider range of fraudulent conduct.

Express remedies under the 1933 Act begin with section 11,⁸³

76. 17 C.F.R. § 240.10b-5 (1985).

77. *See, e.g.,* McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979).

78. SEC v. Carriba Air, Inc., 681 F.2d 1318, 1324 (11th Cir. 1982).

79. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752, *reh'g denied*, 423 U.S. 884 (1975).

80. 421 U.S. 723, *reh'g denied*, 423 U.S. 884 (1975).

81. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

82. *Superintendent of Ins. of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) (a corporation is protected from deceptive practices of its officers, even though the corporation itself was involved in the sale of the securities).

83. Section 11 states:

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statement therein not misleading, any person acquiring such security may, . . . sue— (1) every person who signed the registration statement; (2) every person who was a director (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted; (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner; (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to

which allows a private action for misstatements of material facts in registration statements.⁸⁴ The statute, however, permits recovery only against a narrow class of persons connected with an offering.⁸⁵ Section 12(1) of the 1933 Act⁸⁶ expressly creates a private right of action for violations of section 5 of the 1933 Act.⁸⁷ The private right of action under section 12(1) was enacted by Congress to provide a remedy for violations of the provisions of the Act that require the registration of securities.⁸⁸ Liability under section 12(1) applies to any person who offers or sells a security in violation of the registration requirements enunciated in section 5.

Section 12(2) grants private actions for misstatements or omissions of material fact.⁸⁹ One court has described section 12(2) as the "anti-fraud section" of the 1933 Act.⁹⁰ However, section 12(2) contains several limitations to recovery. The statute contains a "due diligence" defense for offerors or sellers of a security who can show that they "did not know and, in the exercise of reasonable care, could not have known of such untruth or omission."⁹¹ Furthermore, some courts have required privity and permitted recovery only from immediate offerors or sellers.⁹² Although section 15 of the 1933 Act modifies the requirement of privity by including "control persons"⁹³ as

have been prepared or certified by him; (5) every underwriter with respect to such security.

15 U.S.C. § 77k(a) (1976).

84. *Herman*, 459 U.S. at 382.

85. *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786 (2d Cir. 1951).

86. Section 12 reads:

(1) Any person who offers or sells a security in violation of section 5, or-(2) offers or sells a security . . . by use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him. . . .

15 U.S.C. § 77l(2) (1976).

87. Section 5 requires registration of a security before the security may be sold to the public. 15 U.S.C. § 77e (1975).

88. *Id.*

89. *See supra* note 86.

90. *Russell v. Travel Concepts Corp.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,230, at 98,217 (M.D. Tenn. June 19, 1975).

91. 15 U.S.C. § 77l(2) (1976).

92. *Jackson Tool & Die, Inc. v. Smith*, 309 F.2d 88 (5th Cir. 1964).

93. The statute defines "control person" as: "Every person who, by or through stock ownership . . . or otherwise . . . controls any person liable under section 77k or 77l . . . shall

potential defendants under section 12(2), some courts strictly construed the privity requirement and found a participant liable only if his or her acts were both a necessary and substantial factor in the securities transactions.⁹⁴

Section 17(a)⁹⁵ of the 1933 Act permits private actions against offerors and sellers of securities.⁹⁶ The scienter requirement was resolved in *Aaron v. SEC*,⁹⁷ where the SEC instituted an action for violations of section 17(a) against a managerial employee of a registered broker-dealer who had been disseminating false and misleading information concerning a company's financial status.⁹⁸ Although the parties to the action proposed a uniform requirement of culpability for the three subsections of section 17(a),⁹⁹ the Court rejected this analysis in favor of an interpretation more consistent with the statutory language and the Congressional intent of the statute.¹⁰⁰ The Court examined the subsections of section 17(a) separately. Under subsection (1), the Court concluded that since the terms "device," "scheme," and "artifice" connote knowing or intentional conduct, a showing of scienter was needed.¹⁰¹ The Court noted that this analysis was supported by Congressional history, which revealed that Congress excluded the words "willfully" and "with intent to defraud" from the statute as redundant and unnecessary given the nor-

also be liable. . . ." 15 U.S.C. § 77o (1976).

94. *Koehler v. Pulvers*, 614 F. Supp. 829, 845 (S.D. Cal. 1985).

95. Section 17 provides:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly;

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

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Id.

96. 15 U.S.C. § 77q (1976); *see also* *Aaron v. SEC*, 446 U.S. 680, 687 (1980); *United States v. Naftalin*, 441 U.S. 768 (1979); *Fund of Funds, Ltd. v. Arthur Anderson & Co.*, 545 F. Supp. 1314, 1353 (S.D.N.Y. 1982); *Barnes v. Peat, Marwick, Mitchell & Co.*, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,511, at 92,483 (N.Y. Sup. Ct. May 26, 1972).

97. 446 U.S. 680 (1980).

98. The E.L. Aaron & Co. maintained due diligence files. These files helped to establish the falsity of the representations about the company. *Id.*

99. *Id.* at 697.

100. *Id.*

101. *Id.* at 696.

mal meaning of the language of the subsection.¹⁰²

Subsections (2) and (3) of section 17(a) were analyzed separately. The Court's analysis of subsection (2) revealed a complete absence of any indication of a scienter requirement.¹⁰³ With respect to subsection (3), the Court focused on the words "operates or would operate as a fraud or deceit."¹⁰⁴ The Court concluded that the subsection addressed conduct that may have been merely negligent but which operated as a fraud on the investing public. Therefore, the Court declined to require scienter under subsection (3).¹⁰⁵

According to the Court's interpretation above, then, section 17(a) would read as follows: Under subsection (1), plaintiff must show scienter or that defendant engaged in a device, scheme, or artifice with an intent to defraud; under subsection (2), plaintiff must show that defendant procured money or property by a negligent misstatement or omission of a material fact; and under subsection (3), plaintiff must show that defendant engaged in any transaction which negligently operated as a fraud upon the purchaser.¹⁰⁶

Because the Supreme Court considers congressionally-enacted express remedies as deterring the creation of implied private rights of action, it is important to consider the similarities between section 17(a) and the other remedies available to potential plaintiffs. A comparison of section 12(2) and section 17(a)(2) reveals a strong similarity between the sections, notwithstanding the fact that section 12(a) offers a "due diligence" defense. Due to this similarity, courts consider remedies under section 17(a)(2) as counterparts to express remedies under section 12(a).¹⁰⁷ According to the Supreme Court, section 17(a)(2)'s similarity to an express remedy strongly negates any inference of an implied private right of action.¹⁰⁸

A like comparison between express and implied rights of action may be drawn between section 17(a) of the 1933 Act and section 10(b) and Rule 10b-5 of the 1934 Act. The difference between section 17(a) and Rule 10b-5 is comparatively small. Rule 10b-5 prohibits conduct in the purchase or sale of securities, whereas section

102. *Id.* at 699.

103. *Id.* at 696. The clear language revealed no intent to require scienter under subsection (2). See 3 L. LOSS, *SECURITIES REGULATIONS* 1142 (2d ed. 1961).

104. *Aaron*, 446 U.S. at 697 (quoting 15 U.S.C. § 77q(a)(3) (1982)).

105. *Id.* at 702.

106. 15 U.S.C. § 77q(a) (1982).

107. See *Dyer v. Eastern Trust and Banking Co.*, 336 F. Supp. 890 (N.D.M.E. 1971).

108. *Tucker v. Schwandt*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,402, at 95,374 (D. Kan. Feb. 8, 1974) (the specific remedy of § 12(2) precludes an implied private right of action under § 17(a)).

17(a) prohibits conduct in the offer or sale. Therefore, rule 10b-5 seems to give broader protection against fraudulent conduct. Despite this difference, many lower courts have allowed a section 17(a) action to stand once a plaintiff has stated a cause of action under section 10(b).¹⁰⁹ Since section 10(b) and Rule 10b-5 effectively provide all the necessary protection, a section 17(a) right of action is unnecessary. Therefore, under this analysis, the Court's recognition of an implied right of action under section 17(a) would be redundant.

III. APPLICATION OF THE SUPREME COURT'S ANALYSIS TO SECTION 17(a)

The first step in recognizing an implied right of action is to fulfill the first prong of the *Cort* test. The plaintiff must be "one of the class for whose *especial* benefit the statute was created."¹¹⁰ Some courts have held that section 17(a) was enacted to censure fraudulent practices generally and not to benefit a particular class of individuals.¹¹¹ But those same courts have recognized that an argument could be made that section 17(a)(3) identifies purchasers as a "special class" for which the statute was enacted to protect.¹¹² In fact, the Supreme Court has held that section 17(a) was in fact needed to protect investors¹¹³ from fraudulent conduct,¹¹⁴ thereby creating "a federal right" in plaintiff's favor.¹¹⁵

Under the second prong of the *Cort* test, courts must determine whether there is "any indication of legislative intent, explicit or implicit, either to create such a remedy or deny one."¹¹⁶ One court, in an apparent attempt to sidestep an examination of the legislative intent, dismissed such an analysis as virtually impossible absent careful interviews with each Congressman who voted on the matter.¹¹⁷ However, legislative intent may be discerned from floor debates con-

109. *Blumberg v. Berland*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,389, at 92,361 (N.D. Ga. Dec. 9, 1981), *aff'd*, 678 F.2d 1068 (11th Cir. 1982).

110. *Cort*, 422 U.S. at 78 (quoting *Texas & Pac. R. Co. v. Rigsby*, 241 U.S. 33, 39 (1916)).

111. *Brabham v. Patenta*, 614 F. Supp. 568, 569 (D.C. Ore. 1984).

112. *Landry v. All Am. Assurance Co.*, 688 F.2d 381, 389 n.32 (5th Cir. 1982).

113. *Naftalin*, 441 U.S. at 775; *see also* 77 CONG. REC. 2983 (1933) (statements of Mr. Fletcher).

114. *McLendon*, 378 F.2d at 790.

115. *In re Fortune Systems Sec. Litig.*, 604 F. Supp. 150, 155 (N.D. Cal. 1984) (quoting H.R. Rep. No. 85 73rd Cong., 1st Sess. (1933)) *reprinted in* 1 Fed Bar Ass'n Law Comm., Fed. Sec. Laws Legislative History 1933-1982 at 146-47.

116. *Cort*, 422 U.S. at 78.

117. *Blumberg*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,389, at 92,362 (N.D. Ga. Dec. 9, 1981), *aff'd*, 678 F.2d 1068 (11th Cir. 1982).

cerning the enactment of the bills, from comments of the principal parties involved in the enactment of the laws, and from the legislation itself. For instance, Senator Fletcher, a major proponent of the 1933 Act, explained that the purpose of the Act was to protect the investor from "further exploitation of the public by the sale of unsound, fraudulent and worthless securities through misrepresentation. . . ." ¹¹⁸ He also stated that the legislation was enacted to rectify the inequality of bargaining power between professional securities firms and the average investor ¹¹⁹ and to close existing loopholes in the law punishing fraud and creating civil liability against issuers. ¹²⁰ The legislators attempted to satisfy these purposes by requiring full and fair disclosure with respect to securities sold to the public. ¹²¹

However, when the Joint Conference Committee returned the 1933 Act to the Senate and the House, the bill distinctly labeled section 11 and section 12 as sections creating civil liability, ¹²² while deeming section 17 as prohibiting fraud. Some courts have interpreted this distinction between section 17 and sections 11 and 12 as negating an intent to create a private right of action under section 17(a). ¹²³ This conclusion is supported by James M. Landis, Commissioner of the Federal Trade Commission, who explained in a communication to Senator Fletcher that section 17(a) creates only criminal liability. Senator Fletcher agreed with Commissioner Landis that enforcement was left to injunction, stop order, and criminal prosecution, and not to private parties. ¹²⁴ The statements of Senator Fletcher and Commissioner Landis were reaffirmed by Mr. Lausch in 1954. In an attempt to rectify jurisdictional inconsistency in section 12(2) of the 1933 Act, Mr. Lausch stated that section 17(a) was the basis for "injunctive and criminal action." ¹²⁵

Although the majority of courts that have examined the legislative history of the Act refuse to recognize an implied private right of

118. 77 CONG. REC. 2983 (1933).

119. Note, *The Scope of the Judicially Implied Right of Action Under Rule 10b-5: Shores v. Sklar*, B.Y.U. L. REV. 180, 187 (1982) (quoting L. LOSS, *supra* note 103, at 1435).

120. 77 CONG. REC. 2,983 (1933).

121. *Id.* at 3,879.

122. Section 11 was entitled "Civil Liabilities on account of False Registration Statements" and section 12 was entitled "Civil Liabilities arising in connection with Prospectus and Communication." 77 CONG. REC. 3,882-83 (1933).

123. *Citizen's State Bank v. Continental Assurance Co.*, 598 F. Supp. 1111, 1115 (W.D. Wis. 1984); *Landry*, 688 F.2d at 389.

124. 78 CONG. REC. 8,711-12 (1934).

125. 103 CONG. REC. 11,632 (1957).

action, courts have failed to consider the legislation as it read before it was submitted to the joint conference committee. An earlier draft of Senate Bill 75 combined liability from misstatements of material facts and false or deceptive representation within one section of the proposed legislation.¹²⁶ This is important because the majority of courts that deny a private right of action do so because section 11 and section 12 are labeled as the exclusive provisions for civil liability. However, when the bill was presented to the joint conference committee, sections 11 and 12 contained prohibitions against the type of fraudulent conduct that is now left to criminal sanction under section 17(a). But, this argument is not conclusive as to the existence of an implied private right of action under section 17(a), for the committee may have purposely removed the "false and deceptive" language from sections 11 and 12 as being fully covered under the criminal provision of section 17.

The Court's 1983 decision in *Herman*,¹²⁷ however, should reopen discussions of legislative intent. As discussed above, the Court in *Herman* recognized Congressional silence as ratification of judicially-created private rights of action. The Court described the 1975 amendments to the federal securities laws as the "most substantial and significant" revision of the federal statutes.¹²⁸ The 1975 Congressional Amendments Senate Report characterized the securities laws as interrelated acts designed to allow both the SEC and private plaintiffs the opportunity to rectify inequality in the area of securities. Implying the securities laws were enacted to allow both criminal and civil actions.¹²⁹

Although courts recognized private rights of action prior to the 1975 amendment, there has been no overwhelming consensus regarding private rights of action under section 17(a). Furthermore, there has been considerable disagreement over the analysis used in determining whether to recognize private actions. Most recently, federal circuit and district courts have uniformly refused to allow private rights of action under section 17(a).

On at least two occasions, the Supreme Court has declined to

126. 77 CONG. REC. 2,998 (1933). Another argument in favor of a private right of action under 17(a) was the clearly recognized principle of implying private rights of action for violations of statutes in the 1930's. Comment, *Implied Rights of Actions: The Court's Search of Limitations in a Confused Area of the Law*, 13 CUMB. L. REV. 569, 569 (1983).

127. 459 U.S. 375 (1983).

128. *Id.* at 384.

129. S. REP. NO. 75, 94th Cong., 1st Sess. 2, reprinted in 1975 U.S. CODE CONG. & ADMIN. NEWS, 179, 255.

decide whether an implied private right of action exists under section 17(a) of the 1933 Act.¹³⁰ However, lower courts have advanced a variety of theories to support the existence of an implied right of action. In some earlier decisions, courts merely assumed that implied private rights of actions were intended, and therefore available, under the federal securities acts.¹³¹ The majority of courts that have used this theory and recognized a private right of action under section 17(a) of the 1933 Act placed significant emphasis on the similarity between section 17(a) and Rule 10b-5 of the 1934 Act,¹³² often finding a defendant's conduct as violative of both statutes and allowing section 17(a) actions to ride the "coattails" of Rule 10b-5.

The second theory of recovery is an expansion of the "coattail theory," based on a statement made in *SEC v. Texas Gulf Sulphur, Inc.*¹³³ After finding an implied right of action under Rule 10b-5, Judge Friendly in his concurrence states: "once it had been established, however, that an aggrieved buyer has a private action under section 10(b), there [was] little practical point denying the existence of such action."¹³⁴ Relying upon Judge Friendly's statements, courts have recognized an implied right of action under section 17(a) as a completely independent right of action.¹³⁵

Another basis for an implied right of action was enunciated in *Fischman v. Raytheon Manufacturing Co.*¹³⁶ There, the court found that a right of action based on section 17, with proper allegations of fraud, could be maintained as long as it was coupled with an action under section 11 of the 1933 Act.¹³⁷ Therefore, some courts allow private actions under section 17(a) when brought with other actions expressly provided by the 1933 Act.

The last theory of recovery again compares section 17(a) with Rule 10b-5. In a rather strange attempt to find an implied private

130. *Herman*, 459 U.S. at 378 n.2; *International Bd. of Teamsters v. Daniel*, 439 U.S. 551, 557 n.9 (1979).

131. *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949); *see also Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946) (implied rights of action based on tort principles explicitly held inapplicable to federal securities laws).

132. *Banowitz v. State Exch. Bank*, 600 F. Supp. 1466 (N.D. Ill. 1985).

133. 401 F.2d 833 (2d Cir. 1968).

134. *Id.* at 867 (Friendly, J., concurring). *Savino v. E.F. Hutton & Co.*, 507 F. Supp. 1225, 1231 n.4 (S.D.N.Y. 1981) (alleging of violation of section 17(a) and Rule 120b-5 based upon misrepresentation of material facts); *Salgado v. Piedmont Capital Corp.* 534 F. Supp. 938, 940 (D.P.R. 1981) (basing an allegation on oral misrepresentation in sale of security actionable under both § 17(a) and Rule 10b-5).

135. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 867 (2d Cir. 1968).

136. 188 F.2d 783 (2d Cir. 1951).

137. *Id.* at 787 n.2.

right of action, the Southern District Court of New York sustained an implied right of action under section 17(a)(1) but not under section 17(a)(2) or section 17(a)(3).¹³⁸ The court's reason for dissecting section 17(a)(1) rested on the fact that section 17(a)(1) requires scienter, whereas the remaining two subsections do not.

Courts that have denied private remedy under section 17(a) have likewise relied on a variety of theories. The courts' major argument against recognizing an implied cause of action is that such recognition permits parties to circumvent procedural restraints such as statute of limitations that attach only to express remedies and open the "flood gates" to securities litigation.¹³⁹ Courts have also based their denial of private actions on comments made by Judge Friendly in *Texas Gulf* indicating his doubt as to Congress' intent to create an implied private right of action under section 17(a).¹⁴⁰

Recently, courts that have adopted *Cort's* four-prong test have also declined to recognize a private right of action under section 17(a). In *Clearly v. Perfecture, Inc.*,¹⁴¹ the court refused to recognize a private right of action due to the parties failure to satisfy the second prong of the test by showing legislative intent to allow private remedy. Furthermore, courts have applied what appears to be the Supreme Court's stricter standard of analysis.¹⁴² Moreover, a few courts have interpreted the Supreme Court's denial of actions for violations of the anti-fraud provision of the Investment Advisory Act of 1940¹⁴³ as indication that a similar denial of private actions under section 17(a)'s anti-fraud provision of the 1933 Act would be appropriate.¹⁴⁴ Other courts have questioned the soundness of allowing a private right of action under section 17(a)(1) exclusively, stating that such recognition would strain legislative draftsmanship to the limit. They reason that Congress hardly could have intended to permit private rights of action under one but not all subsections of section 17(a).¹⁴⁵

138. *Dannenber v. Dorison*, 603 F. Supp. 1238 (S.D.N.Y. 1985).

139. This argument is totally unsupported on a floodgates theory. Since the Court has recognized an implied right of action under Rule 10b-5, the increase of federal securities litigation in the federal district courts has only increased by 7.8% while all federal litigation has increased by 8.1%. Proceedings of the Judicial Conference of the United States, 133 (1984).

140. *Keys v. Wolfe*, 540 F. Supp. 1054 (N.D. Tex. 1982), *rev'd*, 709 F.2d 413 (5th Cir. 1983).

141. 700 F.2d 744 (1st Cir. 1983).

142. *Brabham*, 614 F. Supp. 568 (D. Or. 1984).

143. *Keys*, 540 F. Supp. at 1059.

144. *Id.* See also *Transamerica*, 444 U.S. at 20.

145. *Keys*, 540 F. Supp. at 1058-59.

The third prong of the *Cort* test requires courts to find that private actions under section 17(a) "[are] consistent with the underlying purpose of the legislative scheme."¹⁴⁶ Courts that have considered this prong of the test have concluded private actions under section 17(a) would "undermine Congress' careful statutory scheme" and unduly distort the civil remedy framework of section 11 and section 12 of the 1933 Act.¹⁴⁷ As previously discussed, the 1933 Act¹⁴⁸ has a broad pattern of expressly remedying unpermitted conduct. Noncompliance with section 5, for instance, results in an express remedy under section 12(a). Therefore, the recognition of a private right of action may not be consistent with the underlying legislative scheme.

Because courts that have followed *Cort's* four-prong test have consistently failed to find the first three prongs satisfied, analysis of the fourth prong is virtually non-existent.

Although the SEC position is not controlling, it is interesting to observe a change of attitude concerning an implied private right of action under section 17(a). The SEC felt that a violation of section 17(a) was to be remedied by injunction or criminal sanctions.¹⁴⁹ However, in 1953, the SEC seemed to suggest an implied private right of action existed under section 17(a). In an *amicus curiae* brief filed in *Blackwell v. Bert*,¹⁵⁰ the SEC attempted to argue that if section 12(2) of the 1933 Act required the use of the mails in making a fraudulent misrepresentation, then plaintiff's right of action could be maintained under section 17(a).¹⁵¹ Although the SEC presented an alternative argument in favor of an implied right of action in *Blackwell*, the SEC has favored an implied right of action under section 17(a) of the 1933 Act. Recently, the SEC has encouraged private enforcement of the provisions of the federal securities laws as a necessary supplement to the Commissioner's enforcement proceedings.¹⁵² Again in *Transamerica*, the SEC attempted to persuade the Court that due to the tremendous unexpected expansion in the fraud

146. *Citizens State Bank*, 598 F. Supp. at 1114 (quoting *Bassler v. Central Nat'l Bank of Chicago*, 715 F.2d 308, 310 (7th Cir. 1983)).

147. *Hudson v. Capital Management Int'l, Inc.*, 565 F. Supp. 615, 626 (N.D. Cal. 1983).

148. *Russell*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,230, at 98,218 (M.D. Tenn., June 19, 1975).

149. *Gunter*, 433 F. Supp. at 47.

150. 203 F.2d 690 (5th Cir. 1953).

151. *Amicus Curiae* Brief of Securities and Exchange Commission at 75, *Blackwell v. Bert*, 203 F.2d 690 (5th Cir. 1953).

152. *Borak*, 377 U.S. at 433.

of securities, private enforcement would help supplement the SEC's limited enforcement capabilities.¹⁵³

IV. IMPACT OF CREATING A SECTION 17(A) IMPLIED RIGHT OF ACTION

If courts recognize an implied right of action under section 17(a) of the 1933 Act, courts will have to determine the applicable statute of limitations, the burden of proof, and the impact of this action upon the procedural safeguards of section 11 and section 12 of the 1933 Act.

A. *Statute of Limitations*

Because the Act only provides a statute of limitations for actions brought under section 11 and section 12,¹⁵⁴ a court must determine statute of limitations to apply to actions under section 17(a). When Congress does not expressly provide a statute of limitations, federal policy requires the adoption of "the local law of limitations"¹⁵⁵ applicable to an analogous right of action under state law.¹⁵⁶ In a section 17(a) implied right of action, the court must compare the forum state's fraud statute with the state's "blue sky" statutes. If the state's blue sky statute has a statute of limitations, the court must select the statute most closely related to a section 17(a) right of action. When the analogous state blue sky law has a prescribed statute of limitations, the majority of courts have applied the state blue sky statute.¹⁵⁷

Although the time period for the statute of limitations is borrowed from the state, the tolling rule of the federal courts is applicable.¹⁵⁸ Therefore, the period of limitations does not begin to run un-

153. *Transamerica*, 444 U.S. at 35 (White J., dissenting).

154. No action shall be maintained to enforce any liability created under section 11 or section 12(2) unless brought within one year after discovery of the untrue statement . . . or after discovery should have been made by the exercise of reasonable diligence or if the action is to enforce a liability created under section 12(1) unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability created under section 11 or section 12(2) more than three years after the security was . . . offered . . . or under section 12(2) more than three years after the sale.

15 U.S.C. § 77m (1975).

155. *Newman v. Prior*, 518 F.2d 97, 99 (4th Cir. 1975).

156. *Salgado v. Piedmont Capital Corp.*, 534 F. Supp. 938, 945 (D.P.R. 1981). *Goodman v. Moyer*, 523 F. Supp. 35, 37 (E.D. Pa. 1981).

157. *Wachovia Bank & Trust Co. v. National Student Marketing Corp.*, 650 F.2d 342, 346 (D.D.C. 1980), *cert. denied*, 452 U.S. 954 (1981).

158. *Ohio v. Peterson, Lowry, Rall, Barber & Ross*, 651 F.2d 687 (10th Cir.), *cert.*

til discovery of the violations.¹⁵⁹ The Sixth Circuit applies a reasonable person standard requiring an investor to exercise reasonable care in discovering the alleged violation.¹⁶⁰

B. *Burden of Proof*

In determining the appropriate burden of proof, two elements are relevant. The court must consider (1) the type of case involved, and (2) the severity of possible sanctions.¹⁶¹ The Supreme Court in dicta has suggested a "clear and convincing" proof standard.¹⁶² However, in *SEC v. C.M. Jones Leasing Corp.*,¹⁶³ the Court required a "preponderance of the evidence" burden of proof in civil actions but the stricter "beyond a reasonable doubt" standard in criminal proceedings.¹⁶⁴ Some courts require the common law fraud standard of "clear and convincing evidence" in actions under the anti-fraud provisions of the federal securities laws.¹⁶⁵ But, in administrative proceedings, the SEC will grant injunctive relief upon a showing by a preponderance of the evidence that the defendant has violated the federal securities laws.¹⁶⁶

In *Herman*,¹⁶⁷ the Court held that the common law standard of "clear and convincing evidence" does not apply to actions brought for violations of the federal securities laws. The Court reasoned that although a standard of "clear and convincing evidence" may be appropriate when "important individual interests or rights are at stake,"¹⁶⁸ the purpose of the securities laws is to protect investors. Therefore, the Court determined the "preponderance of the evidence" standard, allowed an equitable allocation of the risk between both parties.¹⁶⁹ Furthermore, a "preponderance of the evidence" standard as adopted for actions under section 10(b) would be applicable to section 17(a) rights of action, thereby reaffirming the standard of proof required in SEC proceedings.

denied, 454 U.S. 895 (1981).

159. *Dyer*, 336 F. Supp. at 901.

160. *Herm v. Stafford*, 663 F.2d 669, 682 (6th Cir. 1981).

161. *Colling Sec. Corp. v. SEC*, 562 F.2d 820, 824 (D.C. Cir.), *reh'g denied*, (D.C. Cir. 1977).

162. *Woodely v. Immigration & Naturalization Serv.*, 385 U.S. 276, 285 n.18 (1976).

163. 320 U.S. 344 (1943).

164. *Id.* at 355.

165. *Collins*, 562 F.2d at 824.

166. *SEC v. First Fin. Group*, 645 F.2d 429, 435 (5th Cir. Unit A, May 1981).

167. 459 U.S. at 375.

168. *Id.* at 381.

169. *See Steadman v. SEC*, 450 U.S. 91 (1981).

C. Circumvention of 1933 Express Civil Remedies

The recognition of implied rights of action under section 17(a) creates the possibility for circumvention of express legislative provisions. After *Aaron*,¹⁷⁰ an implied private action under section 17(a)(2) or section 17(a)(3) for negligent misrepresentation of a material fact may seriously undermine the legislative design of the 1933 and 1934 acts.¹⁷¹

A plaintiff instituting a right of action under section 17(a)(2) may be able to completely negate the procedural safeguards of section 12(2).¹⁷² Most particularly, the explicit one year statute of limitations as prescribed in section 13 of the 1933 Act would be inapplicable, thereby requiring courts to adopt the statute of limitation that apply to analogous state actions.¹⁷³ Another major problem with a section 17(a) right of action based on negligent conduct is the plaintiff's ability to deny a defendant the "due diligence defense" previously allowed in section 12(2) actions.¹⁷⁴

However, did Congress intend to enact the 1933 Act as a form of investor insurance?¹⁷⁵ One writer suggests the express remedies of the 1933 Act provides a remedy for every substantive protection conferred without implying private rights of action under section 17(a).¹⁷⁶ By allowing an implied private right of action under section 17(a)'s broad language, a plaintiff may maintain suits against a larger class of defendants which were not intended to be subjected to liability under the 1933 Act.¹⁷⁷

However, in *United States v. Naftalin*,¹⁷⁸ the Court rejected in part and concurred in part with this analysis. The Court agreed that the 1933 Act was "primarily concerned with the regulation of new offerings."¹⁷⁹ But the anti-fraud provisions in section 17(a) were "intended to cover any fraudulent scheme in an offering of securi-

170. 446 U.S. 680 (1980).

171. *Gunter*, 433 F. Supp. 42 (N.D. Ga. 1977).

172. *Kirkland v. E.F. Hutton & Co.*, 564 F. Supp. 427, 438 (E.D. Mich. 1983).

173. *Id.* at 438.

174. A defendant is liable only if he "shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." 15 U.S.C. § 77k(b) (1975).

175. *Contra Note, The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143, 1160 (1982).

176. See L. LOSS, *supra* note 103, at 1785.

177. See L. LOSS, *supra* note 103, at 1785.

178. 441 U.S. 768 (1979).

179. *Id.* at 777-78.

ties."¹⁸⁰ Therefore, the Court held section 17(a) of the 1933 Act was intended to provide a remedy for fraud in an initial distribution or in ordinary market trading.¹⁸¹ In *Naftalin*, the Court expanded the number of potential defendants to include persons engaged in distribution and market trading, thereby recognizing common law rights of action for fraud, deception and misrepresentation in the sale of outstanding securities.¹⁸²

D. Possible Solutions

The possible solutions lay at two extremes. One solution is to allow a private right of action for negligent conduct under all subsections of section 17(a) regardless of the availability of a remedy under section 17(a)(2) and section 17(a)(3). The other extreme is to deny an implied right of action under all subsections of section 17(a). The courts have offered a variety of intermediate suggestions.

Some courts have attempted to avoid the implication of *Aaron* by requiring only a showing of negligence under section 17(a)(2) and section 17(a)(3) in the context of SEC proceedings,¹⁸³ and requiring a different standard of conduct in private suits.¹⁸⁴ However, restricting *Aaron* to the precise factual situation presented was not suggested by the Court. Different requirements in SEC proceedings and private rights of action may lead to inconsistent results, a situation courts may be unwilling to adopt.¹⁸⁵

Because *Aaron* requires showing scienter under section 17(a)(1), one possible solution is to allow a private right of action only under subsection (1). However, as previously discussed, this would require that Congress intended to allow private rights of action under only one subsection of the provision of the 1933 Act, while barring private rights of action under other subsections.¹⁸⁶

Another possible solution is the judicial enactment of procedural safeguards similar to those that presently apply to the express remedies of the 1933 Act. This would mean a right of action based on section 17(a) must comply with both the statute of limitations as set out in section 13 and the "due diligence defense." However, since the

180. *Id.* at 778.

181. *Id.*

182. *Id.*

183. *Pharo v. Smith*, 621 F.2d 656 (5th Cir. 1980); *In re Disonics Sec. Litig.*, 599 F. Supp. 447 (N.D. Cal. 1984).

184. *Kramas v. Sec. Gas & Oil*, 672 F.2d 766 (9th Cir. 1982).

185. *Landry*, 688 F.2d at 387.

186. *See* L. Loss, *supra* note 103, at 1786.

majority of courts are unwilling to "judicially legislate" in such a manner, this solution is unacceptable.

Although not a clear solution, the American Law Institute has drafted a code section combining the elements of a cause of action under section 10(b) and Rule 10b-5 of the 1934 Act with the elements of a right of action under section 17(a).¹⁸⁷ Although this Federal Securities Code does not create an express remedy, the American Law Institute does adopt the *Cort* four-prong test for the recognition of implied private rights of action.¹⁸⁸ The code combines all the anti-fraud provisions into one substantive provision, but does not create a right of action for fraudulent conduct similar to that prohibited by section 17(a).

V. CONCLUSION

Since the United States Supreme Court's initial recognition of an implied right of action under the federal securities laws, the Court has continuously attempted to define a procedure to guide the lower courts in recognizing implied rights of action. The courts have considered the second prong of the *Cort v. Ash*¹⁸⁹ four-prong test as paramount and thereby requires a showing of legislative intent to imply a private right of action.¹⁹⁰ In an apparent recognition of a lack of legislative intent and possible conflict with the express remedies, the courts have been reluctant to create a private right of action under section 17(a).

However, based on *stare decisis*, some courts have refused to overrule implied rights of action presently recognized, thus creating conflicts among the circuits. These conflicts have resulted in what one court describes as "an area of securities laws which is, at best, unsettled."¹⁹¹

Although the Supreme Court could settle these conflicts, it has reserved addressing the existence of an implied right of action under section 17(a). Therefore, courts are left to apply existing standards and decide whether to recognize implied rights of action without the

187. "It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with: (1) a sale or purchase of a security, an offer to sell or buy a security, or an inducement not to buy or sell a security. . . ." ALI Fed. Sec. Code § 1602(a) (1978).

188. *Id.* § 1772(a).

189. 422 U.S. 66, 78 (1975).

190. *Transamerica*, 444 U.S. at 23-24 (quoting *Touche*, 442 U.S. at 575-76).

191. *Roskos v. Shearson/American Express, Inc.*, 589 F. Supp. 627, 629 (E.D. Wis. 1984).

guidance of the Supreme Court. Meanwhile, investors are "consuming a great deal of court time and litigation expense and effort" litigating this issue.¹⁹²

Unfortunately, a definitive answer to the existence of an implied right of action under section 17(a) is not possible until the Supreme Court addresses the issue. Until then, the parties to securities litigation must overcome obstacles and present the strengths of their respective positions when they assert an implied right of action under section 17(a).

192. *Masri v. Wakefield*, 602 F. Supp. 404, 406 (D. Colo. 1983).