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Standing

Merle Y. Waldman

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CASENOTES

STANDING—STATES LACK STANDING AS *Parens Patriae* TO CHALLENGE ARBITRARY AND CAPRICIOUS ACTS OF FEDERAL OFFICIALS. *Pennsylvania v. Kleppe*, 533 F.2d 668 (D.C. Cir. 1976)

*Parens patriae*¹ is a seldom used theory of standing which allows a state government to bring suit on behalf of its citizens. States may always sue to protect their own proprietary interests, but *parens patriae* standing enables them to represent their citizens' interests as well. While these actions may be brought against private entities² and other states,³ states have traditionally been denied *parens patriae* standing in actions against the federal government.⁴ Although there have been significant attempts to narrow this broad federal exemption,⁵ the United States Court of Appeals for the District of Columbia, in *Pennsylvania v. Kleppe*,⁶ recently held that the federal government continues to enjoy immunity from state *parens patriae* actions.

1. Translated literally: "parent of his country." BLACK'S LAW DICTIONARY 1269 (rev. 4th ed. 1968).

2. See, e.g., *Georgia v. Pennsylvania R.R.*, 324 U.S. 439 (1945) (antitrust rate-fixing violations); *Georgia v. Tennessee Copper Co.*, 206 U.S. 230 (1907) (discharge of fumes across state lines).

3. See, e.g., *North Dakota v. Minnesota*, 263 U.S. 365 (1923) (diversion of waters); *Pennsylvania v. West Virginia*, 262 U.S. 553 (1923) (state statute restricting exports); *Kansas v. Colorado*, 206 U.S. 46 (1907) (diversion of waters); *Missouri v. Illinois*, 180 U.S. 208 (1901) (discharge of sewage into river).

4. In *Massachusetts v. Mellon*, 262 U.S. 447 (1923), the Supreme Court held that a state lacks *parens patriae* standing to challenge the constitutionality of a federal statute because the federal, not the state, government is best able to represent the citizens as *parens patriae*. *Id.* at 486. Subsequent lower court decisions have held that a state lacks *parens patriae* standing to challenge the actions of federal officials as well as the constitutionality of federal statutes. In *Minnesota ex rel. Lord v. Benson*, 274 F.2d 764 (D.C. Cir. 1960), Minnesota brought suit as *parens patriae* to challenge a milk marketing order by the United States Department of Agriculture. The court held that the action was barred by *Mellon*. See also *Public Util. Comm'n v. United States*, 356 F.2d 236 (9th Cir.), *cert. denied*, 385 U.S. 816 (1966); *Idaho ex rel. Robson v. First Security Bank*, 315 F. Supp. 274 (D. Idaho 1970); *Wisconsin v. Zimmerman*, 205 F. Supp. 673 (W.D. Wis. 1962).

5. The Court of Appeals for the Ninth Circuit has allowed a state regulatory commission *parens patriae* standing to challenge the administration of a federal statute. See *Washington Util. & Transp. Comm'n v. FCC*, 513 F.2d 1142 (9th Cir. 1975).

6. 533 F.2d 668 (D.C. Cir. 1976).

Pennsylvania had brought suit against the Small Business Administration (SBA) alleging that its designation of the state as a "Class B" disaster area⁷ in the wake of Hurricane Agnes constituted arbitrary and capricious conduct.⁸ As *parens patriae*, Pennsylvania sought to vindicate the wrongs done to its citizens resulting from the SBA's alleged misconduct.⁹ The United States District Court for the District of Columbia dismissed the action, holding that Pennsylvania lacked standing to sue.¹⁰ On appeal, Pennsylvania launched a headlong attack on the breadth of the federal exemption, arguing that it applies only when "abstract questions of political power" are raised.¹¹ The appellants claimed that, although a state may not challenge the power of the federal government by questioning the constitutionality of a federal statute, it may challenge the arbitrary and capricious acts of federal officials. This distinction was premised on the theory that a constitutional attack seeks to circumvent congressional intent, whereas an attack on the administration of a statute seeks instead to comply with the congressional will.¹² Furthermore, Pennsylvania asserted that there was no longer any reason to maintain the traditional federal exemption from *parens patriae* actions.¹³ Pointing

7. The differences between a "Class A" and "Class B" designation lie in the administration of the relief effort. A "Class A" disaster area is administered from Washington, D.C., while a "Class B" area is administered by the Regional Administrator. 36 Fed. Reg. 7290 (1971). The level of assistance provided to a "Class A" area is no greater than that provided to a "Class B" area. The harm suffered by Pennsylvania, and the reason for the suit, is not readily apparent. However, in seeking to enjoin discontinuance of the relief effort, Pennsylvania alleged that the designation had been made to promote the "personal political aspirations" of the defendant, Thomas S. Kleppe, Administrator of the Small Business Administration. Preliminary Statement of Plaintiff at 5, *Pennsylvania v. Kleppe*, Civil No. 74-9 (D.D.C., filed Aug. 12, 1974).

8. Brief for Appellant at 5, *Pennsylvania v. Kleppe*, 533 F.2d 668 (D.C. Cir. 1976).

9. 533 F.2d at 671.

10. *Pennsylvania v. Kleppe*, Civil No. 74-9 (D.D.C., filed Aug. 12, 1974). The court's reasoning was not explained, as Judge William B. Jones dismissed the case for lack of standing without discussion.

11. Brief for Appellant at 10, *Pennsylvania v. Kleppe*, 533 F.2d 668 (D.C. Cir. 1976).

12. This argument was buttressed by the fact that *Massachusetts v. Mellon*, 262 U.S. 447 (1923), involved a constitutional, rather than an administrative, challenge. See note 4 *supra*.

13. Pennsylvania argued that *Massachusetts v. Mellon*, 262 U.S. 447 (1923), should not be followed due to "the passage of time and the concomitant expansion by judicial decisions of what interests a State may properly protect suing as *parens patriae*." Brief for Appellant at 14, *Pennsylvania v. Kleppe*, 533 F.2d 668 (D.C. Cir. 1976). Pennsylvania was referring to a general expansion of the state's *parens patriae* functions. See text accompanying notes 23-28 *infra*.

to recent Supreme Court decisions generally expanding the rights of organizations to sue on behalf of their members,¹⁴ appellants reasoned by analogy that the same policy considerations should apply when a state seeks to represent its citizens in actions against the federal government.

The District of Columbia Circuit, however, unmoved by either Pennsylvania's arguments or a contrary decision by the Ninth Circuit,¹⁵ held that Pennsylvania was barred from suing the federal government.¹⁶ Admitting at the outset that "this case beckons us into one of the least well-illuminated corners of a legal area,"¹⁷ the court analyzed the relevant case law and concluded that the federal government should continue to be exempt from state *parens patriae* actions. Of primary importance to the majority was the smooth functioning of the government. The court cautioned that *parens patriae* suits by states against the federal government would disrupt federal powers¹⁸ and undermine the necessary separation of state and national *parens patriae* functions,¹⁹ thereby impairing longstanding federalist principles. Judge Lumbard²⁰ dissented from the majority opinion. Apparently impressed with Pennsylvania's arguments, he found the distinction between constitutional and administrative challenges to be crucial in that administrative challenges are intended to force compliance with congressional intent.²¹ Moreover, from a policy perspective, he saw no reason why Pennsylvania should not be allowed to act as *parens patriae* of its citizens, despite the presence of a federal defendant.²²

14. See, e.g., *United States v. SCRAP*, 412 U.S. 669 (1973); *Sierra Club v. Morton*, 405 U.S. 727 (1972).

15. *Washington Util. & Transp. Comm'n v. FCC*, 513 F.2d 1142 (9th Cir. 1975). See note 5 *supra*. *WUTC* was decided on January 20, 1975, shortly after Pennsylvania had filed its brief in *Kleppe* (December 13, 1974). Although the *Kleppe* court did take notice of *WUTC*, appellants urged a rehearing on the case, arguing that the same considerations which led the Ninth Circuit to its decision in *WUTC* should apply in *Kleppe*. Petition for Rehearing and Suggestion for Rehearing En Banc, *Pennsylvania v. Kleppe*, 533 F.2d 668 (D.C. Cir. 1976). The petition was denied, with Judge Lumbard dissenting from the denial. *Pennsylvania v. Kleppe*, Civil No. 74-1960 (D.C. Cir. May 3, 1976).

16. 533 F.2d at 680.

17. *Id.* at 670.

18. *Id.* at 678.

19. *Id.* at 680.

20. Sitting by designation pursuant to 28 U.S.C. § 294(d) (Supp. IV, 1974). See 533 F.2d at 669.

21. 533 F.2d at 682 (Lumbard, J., dissenting). A constitutional challenge is "clearly and obviously a fundamental threat to the federal sovereign power; [an administrative challenge] seeks only to vindicate the will of the people as it has been expressed by their duly elected representatives in the national legislature." *Id.*

22. *Id.* at 682-83.

I. ESTABLISHMENT OF THE *Mellon* DOCTRINE

In feudal times, the sovereign's *parens patriae* prerogative extended only to those citizens who lacked legal capacity, such as infants and incompetents.²³ In this country, the concept has been expanded to allow the state to stand as a representative of its citizens, even though these citizens have legal capacity. However, due to a fear of potential double recovery, there is a reluctance to recognize *parens patriae* claims if the affected individuals are themselves able to bring suit.²⁴ Accordingly, the state must assert a "quasi-sovereign" interest common to most, if not all, of its citizens,²⁵ an interest "in which the State as the representative of the public, has an interest apart from that of the individuals affected."²⁶ Cognizable quasi-sovereign interests were first limited to the health, welfare and safety of a state's citizens,²⁷ but have since been expanded to include the economy of a state.²⁸

States were first allowed to assert these quasi-sovereign interests in 1900.²⁹ Subsequently, numerous states sued as *parens patriae* in order to invoke the Supreme Court's original jurisdiction.³⁰ Although the Court entertained original state *parens patriae* claims against other states³¹ and private entities,³² it refused to do so in actions in which the federal government was the defendant. In *Massachusetts v. Mellon*,³³ the Commonwealth of Massachusetts, suing on behalf of its citizens, challenged the constitutionality of the Maternity Act of 1921.³⁴ The Supreme Court, per Justice Sutherland, applied

23. See *Hawaii v. Standard Oil Co.*, 405 U.S. 251, 257 (1972). For an interesting discussion of the legal and historical foundations of *parens patriae* standing, see Malina & Blechman, *Parens Patriae Suits for Treble Damages Under the Antitrust Laws*, 65 Nw. U.L. Rev. 193, 197 (1970).

24. See *Hawaii v. Standard Oil Co.*, 405 U.S. 251, 264 (1972).

25. Malina & Blechman, *supra* note 23, at 209.

26. *Pennsylvania v. West Virginia*, 262 U.S. 553, 592 (1923).

27. Malina & Blechman, *supra* note 23, at 203.

28. See, e.g., *Hawaii v. Standard Oil Co.*, 405 U.S. 251 (1972); *Georgia v. Pennsylvania R.R.*, 324 U.S. 439 (1945).

29. In *Louisiana v. Texas*, 176 U.S. 1 (1900), Louisiana was granted *parens patriae* standing to challenge a Texas quarantine regulation "because the matters complained of affect her citizens at large." *Id.* at 19.

30. U.S. CONST. art. III, § 2 provides: "In all cases affecting Ambassadors, other public Ministers and Consuls, and those in which a State shall be Party, the Supreme Court shall have original jurisdiction." Thus by alleging damage to a quasi-sovereign interest, and thereby suing in its own name as *parens patriae*, a state was able to bring its case directly to the Supreme Court.

31. See note 3 *supra*.

32. See note 2 *supra*.

33. 262 U.S. 447 (1923).

34. Act of Nov. 23, 1921, ch. 135, 42 Stat. 224.

the most basic principle of federalism to reach its decision: in cases of conflict, the federal government is supreme.³⁵ The Court reasoned that a state can not represent its citizens as *parens patriae* vis-à-vis the federal government because the federal government is itself the *parens patriae* of those same citizens. It would be a logical anomaly for two sovereigns, both of whom claim to represent the best interests of the same set of citizens, to be suing each other. Since the federal government is supreme, the state government must be denied *parens patriae* standing.³⁶

Nevertheless, the Court did not hold that all *parens patriae* actions against the federal government are barred. It implied that there may be occasions when a state may properly intervene to protect the rights of its citizens.³⁷ The opinion did not elaborate on the acceptable limits of such suits, and the Court has not done so since then. However, lower courts, interpreting *Mellon* broadly, have extended federal immunity from *parens patriae* suits beyond *Mellon's* limited holding.³⁸ For example, in *Minnesota ex rel. Lord v. Benson*,³⁹ the same federalist considerations used to decide *Mellon* were held to bar *parens patriae* challenges to the administration of a federal statute. In general, the *Mellon* doctrine immunizes from state *parens patriae* actions not only federal statutes, regulations, and orders, but also the conduct and decisions of federal officials acting in their official capacity.

35. See generally Bickel, *The Voting Rights Cases*, 1966 SUP. CT. REV. 79, 86.

36. [I]t is the United States, and not the State, which represents them as *parens patriae*, when such representation becomes appropriate; and to the former, and not to the latter, they must look for such protective measures as flow from that status.

262 U.S. at 486.

37. We need not go so far as to say that a State may never intervene by suit to protect its citizens against any form of enforcement of unconstitutional acts of Congress; but we are clear that the right to do so does not arise here. Ordinarily, at least, the only way in which a State may afford protection to its citizens in such cases is through the enforcement of its own criminal statutes, where that is appropriate, or by opening its courts to the injured persons for the maintenance of civil suits or actions.

Id. at 485.

38. See note 4 *supra*.

39. 274 F.2d 764 (D.C. Cir. 1960). In a *parens patriae* suit to have an administrative order by the United States Secretary of Agriculture declared unlawful, the court stated:

[t]he United States rather than Minnesota occupies the relationship of *parens patriae* to those who are said here to be adversely affected or aggrieved by this order issued by the Secretary in his capacity as an official of the United States acting under the authority of federal legislation.

Id. at 766.

There have been exceptions to the general rule, however. In *Guam v. Federal Maritime Commission*,⁴⁰ the District of Columbia Circuit allowed Guam *parens patriae* standing to seek review of an FMC-approved rate increase. The court stated that *Benson* was limited to suits challenging actions by the federal government itself and did not apply to cases which involved private utility operators.⁴¹ Although the court asserted that there was a long line of utility cases which had allowed states standing to challenge rate increases, all cases cited in support of this proposition involved a statute that specifically conferred such standing.⁴² *Guam* has accordingly been the basis of a utilities regulatory exception to the otherwise complete bar of the *Mellon* doctrine.⁴³

The Supreme Court itself has departed from its holding in *Mellon* on two occasions. In *New York v. United States*,⁴⁴ New York, joined by other states, sought to invalidate an Interstate Commerce Commission order alleged to discriminate against shippers and receivers of freight in certain regions of the country. The district court found that New York had standing because its proprietary interests as a shipper and receiver were directly affected by the order.⁴⁵ However, the court went on to say that the state also had *parens patriae* standing and could maintain this suit on behalf of its citizens.⁴⁶ The Supreme Court proceeded to the merits of the case without mention-

40. 329 F.2d 251 (D.C. Cir. 1964). Guam alleged that the rate increases granted by the Federal Maritime Commission were unlawful and that its citizens "whose very existence is predicated on the ocean freight supply line" would be aggrieved by the Commission's order. *Id.* at 252.

41. An identical result had been reached earlier in *Puerto Rico v. Federal Maritime Comm'n*, 288 F.2d 419 (D.C. Cir. 1961), although there was no discussion of standing.

42. 329 F.2d at 252-53. The court cited *California v. Federal Power Comm'n*, 296 F.2d 348 (D.C. Cir. 1961), *rev'd on other grounds*, 369 U.S. 482 (1962), and numerous other cases involving the Federal Power Commission. However, the court's reliance on this line of cases is misplaced because the Natural Gas Act provides for state standing to challenge Federal Power Commission orders. 15 U.S.C. § 717r (1970).

43. See *Pennsylvania v. Kleppe*, 533 F.2d 668, 681 (D.C. Cir. 1976); *Washington Util. & Transp. Comm'n v. FCC*, 513 F.2d 1142 (9th Cir. 1975).

44. 331 U.S. 284 (1947).

45. *New York v. United States*, 65 F. Supp. 856, 872 (N.D.N.Y. 1946), *aff'd*, 331 U.S. 284 (1947).

46. But all the States who are parties are political entities which are also regions or districts within the rate-making territories involved and they are directly affected as such and have an interest in behalf of their citizens and communities above and apart from the rights of any particular shipper or receiver of freight to a continuance of existing rates or the maintainance of others. This . . . gives these States standing to sue as *parens patriae* to preserve or enhance the welfare of their citizens by securing to them the proper administration of federal laws

Id.

ing the standing issue. It is mere speculation, therefore, whether the Court rejected, ignored, or even accepted the district court's deviation from the *Mellon* doctrine.

The Supreme Court's decision in *South Carolina v. Katzenbach*,⁴⁷ however, did depart significantly from the *Mellon* doctrine. South Carolina sought to contest the constitutionality of the Voting Rights Act of 1965⁴⁸ and, by bringing suit in its own name, was able to take its case directly to the Supreme Court.⁴⁹ The state alleged that the Act violated the due process clause of the fifth amendment⁵⁰ and the bill of attainder clause of article I⁵¹ in that the state was adjudged guilty of violation of the Act without trial. The Court dismissed these contentions because the state was not a "person" and therefore could not assert these claims.⁵² Only the citizens of South Carolina, as "persons," would have standing to press the claims. Since the state was the sole plaintiff, it was necessarily attempting to assert the "personal" rights of its citizens. The Court noted that South Carolina's only basis for standing was as *parens patriae* of its citizens and stated that these claims were barred by *Mellon*.⁵³ But the Court then turned its attention to what it referred to as the basic question of the case,⁵⁴ which was whether Congress had exceeded its authority under the fifteenth amendment,⁵⁵ and proceeded to consider this issue on the merits, thereby according South Carolina an apparent de facto *parens patriae* standing. There was no indication as to why the Court allowed standing on the fifteenth amendment issue but not on the other claims.⁵⁶

47. 383 U.S. 301 (1966).

48. 42 U.S.C. § 1973 (1970).

49. See note 30 *supra*.

50. U.S. CONST. amend. V provides in relevant part: "No person shall . . . be deprived of life, liberty, or property, without due process of law"

51. *Id.* art. I, § 9 provides in part: "No Bill of Attainder or ex post facto Law shall be passed."

52. 383 U.S. at 324.

53. "Nor does a State have standing as parent of its citizens to invoke these constitutional provisions against the Federal Government, the ultimate *parens patriae* of every American citizen." *Id.*

54. The objections to the Act which are raised under these provisions may therefore be considered only as additional aspects of the basic question presented by this case: Has Congress exercised its powers under the Fifteenth Amendment in an appropriate manner with relation to the States?

Id.

55. U.S. CONST. amend. XV, § 1 provides: "The right of citizens of the United States to vote shall not be denied or abridged by the United States or by any State on account of race, color, or previous condition of servitude."

Id., amend. XV, § 2 provides: "The Congress shall have power to enforce this article by appropriate legislation."

56. Professor Bickel has severely criticized the Court for its course of action in

The Ninth Circuit's decision in *Washington Utilities & Transportation Commission v. Federal Communications Commission (WUTC)*⁵⁷ was the first case to state that the *Mellon* doctrine did not apply to *parens patriae* actions involving the conduct of federal officials. The Washington Utilities & Transportation Commission, as an agency of the State of Washington, sought review of a final FCC order authorizing the construction of a new communications common carrier route by a certain corporation. WUTC asserted standing as *parens patriae* to represent the citizens of the state who stood to be harmed by an increase in telephone rates which would allegedly result from the FCC's order. Although the FCC argued that *parens patriae* standing was barred by *Mellon*, the court disagreed,⁵⁸ stating that *Mellon* applies only when the state raises questions which involve a " 'distribution of powers between the State and the national government.' "⁵⁹ Furthermore, the court said that the *Mellon* doctrine may have been " 'eroded by time.' "⁶⁰ Noting the Supreme Court's de facto grant of *parens patriae* standing in *South Carolina v. Katzenbach*, the opinion cautioned that *Mellon* is now a doctrine of questionable authority.⁶¹

II. THE VALIDITY OF THE *Mellon* DOCTRINE

In *Kleppe*, Pennsylvania sought to exploit these prior departures from the *Mellon* doctrine.⁶² The state advanced the same arguments and cited the

Katzenbach. See Bickel, *supra* note 35, at 87-89. Professor Wright has stated that *Katzenbach* casts doubt on the *Mellon* holding and that "the Court's failure to explain why the state has standing to raise the Fifteenth Amendment objection but not the others is mystifying." C. WRIGHT, LAW OF FEDERAL COURTS 503 (2d ed. 1970). See also *Massachusetts v. Laird*, 400 U.S. 886 (1970). Noting the *Katzenbach* opinion, Justice Douglas argued that *Mellon*'s authority had been "eroded by time" in his dissent from the Court's denial of leave to Massachusetts to file a complaint challenging the constitutionality of the Vietnam War. *Id.* at 889 (Douglas, J., dissenting from denial of leave to file complaint).

57. 513 F.2d 1142 (9th Cir. 1975).

58. The Ninth Circuit also found that the Washington Utilities & Transportation Commission had standing to sue as a proper party under the "injury in fact" and "zone of interest" requirements of *Association of Data Processing Serv. Organizations, Inc. v. Camp*, 397 U.S. 150 (1970). 513 F.2d at 1151. Therefore, the court was not compelled to find *parens patriae* standing in order to allow the Commission to maintain the action.

59. 513 F.2d at 1153, quoting *Georgia v. Pennsylvania R.R.*, 324 U.S. 439, 445 (1945).

60. 513 F.2d at 1154 n.16, quoting *Massachusetts v. Laird*, 400 U.S. 886, 889 (1970) (Douglas, J., dissenting from denial of leave to file complaint). See note 56 *supra*.

61. "It would be improvident to extend a doctrine that is of questionable authority in its original application." 513 F.2d at 1154 n.16.

62. Appellants were unable to incorporate the Ninth Circuit's decision in *WUTC*

same authorities used by the Ninth Circuit to justify its decision in *WUTC*.⁶³ These arguments, however, met with considerably less success in the District of Columbia Circuit. The court downplayed the significance of those cases departing from *Mellon*, concentrating instead on the language used in *Guam* and *Katzenbach* which, the court claimed, served to reaffirm the authority of the *Mellon* doctrine.⁶⁴

Although the *Kleppe* court carefully stated that it expressed no support for the *WUTC* decision,⁶⁵ it attempted to distinguish *WUTC* by limiting it to cases involving a specialized utility regulating agency.⁶⁶ The court reasoned that this specialization "arguably befits it to stand in a *parens patriae* capacity"⁶⁷ because the agency could conceivably be the "best available representative of the plaintiff interests involved."⁶⁸ To the *Kleppe* court, this distinction had the additional advantage of explaining its own decision in *Guam*, which had allowed *parens patriae* standing in a case involving utilities regulation.⁶⁹ This appears to be a distinction without a difference. It is unclear why agencies regulating utilities, and these agencies alone, may maintain *parens patriae* suits against the federal government. In *Kleppe*, the court said that the agency's expertise in the field and the close interaction of federal and state regulation "renders less substantial the federal-

into their argument because their brief was filed prior to this decision. *But see* note 15 *supra*.

63. In addition, the appellants in *Kleppe* asserted that *Mellon* was distinguishable because it dealt with federal action affecting rights "held in common with all other citizens in the United States," Brief for Appellant at 19, whereas the federal action in question in *Kleppe* affected only the citizens of Pennsylvania. Therefore, Pennsylvania would stand as a more proper party to assert the rights of its citizens than did Massachusetts in *Mellon*. The *Kleppe* court, however, did not address itself to this distinction.

64. 533 F.2d at 678 n.55. The court also distinguished the decision in *New York v. United States*, 331 U.S. 284 (1947), as a case in which other states appeared before the Supreme Court, some with the appellant State of New York, and some with the appellee United States. Therefore this case could have appeared to the Court as a controversy between states, in which case *parens patriae* representation by New York would have been proper, since the federal government was not the sole defendant. 533 F.2d at 677 n.55.

65. "Without expressing any view as to the propriety of that decision, we note it is distinguishable from our case . . ." 533 F.2d at 681.

66. *Id.*

67. *Id.* The court stated that *WUTC* could further be distinguished because the Ninth Circuit had found a proprietary basis of standing and therefore "the *parens patriae* basis may be nonessential to the court's holding." *Id.* n.67. *See* note 58 *supra*.

68. 533 F.2d at 681.

69. "It has also been suggested that utility cases raise specially compelling arguments in support of state standing." *Id.* n.68, *citing* *Guam v. Federal Maritime Comm'n*, 329 F.2d 251 (D.C. Cir. 1964). *But see* note 42 *supra*.

ism interest in freedom from state intrusion.”⁷⁰ Left unexplained was why this expertise and close interaction has any less of an effect upon federalism. But even accepting, *arguendo*, the theory that *parens patriae* suits by specialized state agencies do not impair federalist doctrines, there is reason to believe that the application of this theory in *Kleppe* would have resulted in a finding that the plaintiff had standing. The court ignored the fact that the Secretary of Community Affairs was a named plaintiff in the suit. The Pennsylvania Department of Community Affairs is arguably a specialized state agency capable of maintaining a *parens patriae* action against the federal government. Accordingly, the only difference between *WUTC* and *Kleppe* is that *WUTC* involved a utilities commission. There appears to be little reason to grant standing to the former, while denying it to the latter.

Of primary concern to the *Kleppe* court was the basic rationale underlying the *Mellon* decision. Specifically the court focused on the “proper allocation of authorities within the federal system.”⁷¹ To the court, the issue was federalism and not the potential limitations of the *Mellon* line of cases. Since an individual is a citizen of two governments—state and federal—it follows that each government should act as *parens patriae* within its separate jurisdictional area.⁷² When conflicts arise, the federal sovereign interest predominates, due to the supremacy of the federal government, over any state quasi-sovereign interest.⁷³ This reasoning is both logical and efficient; it avoids a disruption of federal authority⁷⁴ and prevents states from engaging federal agencies in costly litigation.⁷⁵

Despite the legal symmetry of this federalist principle, there are profound policy implications in denying states the opportunity to assert the rights of their citizens against the federal government. Significantly, many arbitrary, capricious, and even unconstitutional actions of the federal government will remain unchallenged due only to the lack of an appropriate or willing plaintiff. Although certain agency decisions affect great numbers of citizens

70. 533 F.2d at 681.

71. *Id.* at 676.

72. *Id.* at 677.

73. *Id.*

74. *Id.* at 678.

75. After the district court in *Hawaii v. Standard Oil Co.*, 301 F. Supp. 982 (D. Hawaii 1969), *rev'd*, 431 F.2d 1282 (9th Cir. 1970), *aff'd*, 405 U.S. 251 (1972) allowed the state *parens patriae* standing to sue for damages to its economy under the antitrust laws, other states hastened to file complaints alleging damage to their economy. See generally *State Protection of its Economy and Environment: Parens Patriae Suits for Damages*, 6 COLUM. J.L. & SOC. PROB. 411 (1970). This is an indication that states would also be quick to bring *parens patriae* actions against the federal government if the bar of *Mellon* were relaxed or abandoned. Overloaded courts are doubtless aware of this fact.

as a group, these decisions may have only a minor effect upon each individual citizen. A good example of such agency action is a rate increase by a federal regulatory commission. The individual impact is so small that potential plaintiffs are apt to forego legal action.

The adoption of class action suits⁷⁶ was specifically aimed at remedying such a situation. But the Supreme Court's recent decision in *Eisen v. Carlisle & Jacquelin*⁷⁷ promises to curtail sharply the number of future class actions, especially those which could otherwise be represented by the state as *parens patriae*.⁷⁸ Therefore, in many instances, the state, as *parens patriae*, is now the only plaintiff willing and able to assert claims which, although insignificant on an individual basis, are huge in the aggregate. The combined effect of *Eisen* and *Kleppe* is effectively to preclude redress of any such claims against the federal government.⁷⁹

It is by no means clear why *Mellon* should continue to bar *parens patriae* actions against the federal government in the future. *Mellon* rests on the proposition that the federal government is *parens patriae* supreme; however, as a practical matter, it is difficult to understand why and how the federal government is better able than state governments to assert the citizens' interests.⁸⁰ It would be more appropriate to grant *parens patriae* standing to that sovereign best able to act in this capacity.⁸¹

76. FED. R. CIV. P. 23.

77. 417 U.S. 156 (1974). *Eisen* held that under Federal Rule of Civil Procedure 23(c)(2) each class member who is reasonably identifiable must be notified of the class action. The effect of *Eisen* is to impose a huge cost burden on the organizers of large class actions.

78. In order to sue as *parens patriae*, the state must assert a quasi-sovereign interest, something common to a majority of its citizens. The class of citizens which the state can represent as *parens patriae*, then, is very large. Similarly, the classes of citizens most seriously affected by the *Eisen* decision are also those which are very large.

79. The Supreme Court has addressed itself to the fact that the denial of *parens patriae* standing may cause certain wrongs to remain unremedied. In *Hawaii v. Standard Oil Co.*, 405 U.S. 251 (1972), it said that class actions were preferable to *parens patriae* actions to remedy the wrongs of large numbers of citizens. 405 U.S. at 266. This, however, was before the Court restricted the effectiveness of class action suits in *Eisen*. Furthermore, Congress has recently passed legislation intended to nullify the *Hawaii* decision, which had restricted the use of *parens patriae* antitrust suits. See Pub. L. No. 94-435 (Sep. 30, 1976). This law specifically authorizes states to bring *parens patriae* treble damage antitrust actions.

80. In the petition for rehearing, Pennsylvania, citing the tenth amendment, argued that the *Kleppe* decision "severely intrudes upon the sovereignty of all states, which sovereignty co-exists with that of the federal government, but which, in matters of state cognizance, is superior to the federal government." Petition for Rehearing and Suggestion for Rehearing En Banc at 9, *Pennsylvania v. Kleppe*, 533 F.2d 668 (D.C. Cir. 1976).

81. There was support for this proposition in *Kleppe*. In distinguishing *WUTC*, the

The basic purpose of *Mellon* was to safeguard the principles of federalism by strengthening the federal government vis-à-vis the states. But today, that decision is arguably jeopardizing the federal system because the federal government may have become too strong.⁸² It is performing more and more functions with the concomitant intrusion into areas once considered solely within the sovereignty of the states. Federal power has eclipsed state power, and a readjustment of this power balance is necessary. The Supreme Court is aware of this fact, and last term, in *National League of Cities v. Usery*,⁸³ served notice that it is re-evaluating federalist doctrines.⁸⁴ It is conceivable therefore, that the Court may choose to review the *Mellon* doctrine, especially in light of the conflict between the District of Columbia and Ninth Circuits.⁸⁵

III. CONCLUSION

Mellon need not be a doctrine carved in stone.⁸⁶ *Parens patriae*, as a

court indicated that the utility regulating commission may have been entitled to maintain the *parens patriae* suit because it was the best available plaintiff. 533 F.2d at 681.

82. The appellants in *Kleppe* alluded to this argument: "Recent abuses teach that to provide the federal government with immunity from suit is not good policy and would be violative of the principles of 'Our Federalism.'" Plaintiff's Points and Authorities In Opposition to Defendant's Motion to Dismiss This Action at 5, *Pennsylvania v. Kleppe*, Civil No. 74-9 (D.D.C., filed Aug. 12, 1974).

83. 96 S. Ct. 2465 (1976). The Court held that Congress could not apply minimum wage and maximum hour provisions of the Fair Labor Standards Act to state and municipal employees because the provisions would interfere with the functions performed by the sovereign state and local governments.

84. "[T]here are attributes of sovereignty attaching to every state government which may not be impaired . . . because the Constitution prohibits [Congress] from exercising the authority in that manner." *Id.* at 2471.

85. There is now a direct conflict between the Courts of Appeals for the Ninth Circuit and the District of Columbia Circuit The likelihood of a Supreme Court resolution of the matter has been very much enhanced as a result of this judicial clash.

Strausberg, *The Standing of a State as Parens Patriae to Sue the Federal Government*, 35 FED. B.J. 1, 19 (1976).

86. Raoul Berger has argued that there is no historic reason to require a personal interest in a public action.

[T]he notion that the Constitution demands injury to a personal interest as a prerequisite to attacks on allegedly unconstitutional actions is historically unfounded Public suits instituted by strangers to curb action in excess of jurisdiction were well established in English law at the time Article III was drafted.

Berger, *Standing to Sue in Public Actions: Is it a Constitutional Requirement?* 78 YALE L.J. 816, 840 (1969). *But see* Warth v. Seldin, 422 U.S. 490 (1975); Broderick, *The Warth Optional Standing Doctrine: Return to Judicial Supremacy?* 25 CATH. U.L. REV. 467, 530 n.333 (1976).

common law doctrine, is amenable to judicial expansion and, in general, has been expanded in recent years. As a strictly legal matter, *Mellon* still stands as a bar to *parens patriae* actions against the federal government. In this context, the *Kleppe* decision better interprets existing case law than does the Ninth Circuit's decision in *WUTC*. However, *Mellon* appears to have outlived its usefulness, and, in light of recent developments in both law and government, a judicial reassessment of this time honored doctrine is needed.

John B. Williams

SECURITIES LAW—Intent to Deceive, Manipulate, or Defraud Must be Alleged in a Private Action for Damages Under Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

The elements which must be alleged in a private civil action¹ for damages under section 10(b) of the Securities Exchange Act of 1934² and Securities and Exchange Commission rule 10b-5³ have been alternatively expanded and

1. An implied civil action under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1970), was first recognized in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). It is now well established that a private cause of action may be brought for a violation of section 10(b). See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971); *Crist v. United Underwriters, Ltd.*, 343 F.2d 902, 903 (10th Cir. 1965).

2. 15 U.S.C. § 78j (1970). Section 10(b) provides that:

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 make any untrue statement of a material fact or to omit to state a 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*. (emphasis added)

3. 17 C.F.R. § 240.10b-5 (1976). SEC rule 10b-5 provides that:

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,

narrowed by the courts throughout the history of the Act. While earlier cases required allegations of the elements of common law fraud,⁴ later ones relaxed the traditional requirements in order to further the remedial purposes of the federal securities laws.⁵ However, the trend to construe section 10(b) expansively has recently yielded to a narrower interpretation of the provision.⁶ This concern for limiting the scope of section 10(b), which has become one of the most litigated antifraud provisions,⁷ has been reaffirmed by the Supreme Court in *Ernst & Ernst v. Hochfelder*,⁸ which held

(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 as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

4. The elements of an action for common law fraud (tort action in deceit) are: False representation of fact, knowledge or belief that the representation is false (*scienter*), intent to induce the plaintiff to rely on the misrepresentation, justifiable reliance by the plaintiff, and damage to the plaintiff as a result of such reliance. W. PROSSER, *THE LAW OF TORTS* 685-86 (4th ed. 1971).

5. *See* *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (proof of reliance is not necessary where the facts withheld are material and where there is an obligation to disclose); *SEC v. Great American Indus., Inc.*, 407 F.2d 453, 463 (2d Cir. 1968) (Kaufman, J., concurring), *cert. denied*, 395 U.S. 920 (1969) (common law fraud is no longer the outer limit of liability under rule 10b-5, but rather the rule is closer to unfairness than to what lawyers and laymen think of as fraud); *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962) (privity between plaintiff and defendants is not necessary). For a discussion of the reasons for the expansive reading of rule 10b-5, see A. BROMBERG, *SECURITIES LAW, FRAUD—SEC RULE 10b-5* § 12.8, at 281 (1967).

6. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Supreme Court reaffirmed the doctrine expressed in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), that only an actual purchaser or seller of securities may maintain a private action for damages under section 10(b) and rule 10b-5. Although the Court recognized that this limitation on standing will preclude some valid claims, it felt that important policy considerations justified a limitation on the number of potential plaintiffs. 421 U.S. at 737-49. The Court also seems to be interpreting other federal securities laws in a highly restrictive fashion. In *Foremost-McKesson, Inc. v. Provident Securities Co.*, 432 U.S. 232 (1976), the Court held that section 16(b) of the Securities Exchange Act of 1934, which was designed to prevent a beneficial owner of more than 10 percent of a corporation's stock from realizing short-swing profits on the basis of inside information, applies only to those who were such owners *before* the purchase in a purchase-sale sequence.

7. A. BROMBERG, *supra* note 5, § 2.5, at 45-46. Other general antifraud provisions include section 11(a)(2) of the Securities Act of 1933, 15 U.S.C. § 77k (1970); section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77i (1970); section 17(a) of the Securities Act of 1933, 15 U.S.C. § 78q (1970) and SEC rule 15c 1-2, 17 C.F.R. § 240.15c1-2 (1976).

8. 425 U.S. 185 (1976).

that an allegation of an intent to deceive, manipulate, or defraud on the part of a defendant is a necessary element of a private action for damages.

The plaintiffs in *Ernst & Ernst* were customers of First Securities Company of Chicago, a small brokerage firm. Lester Nay, the president and majority stockholder of First Securities, had persuaded them to invest in "escrow" accounts which later proved to be spurious. The defendant, Ernst & Ernst, an independent certified public accounting firm, was the auditor for First Securities during the time of the fraudulent transaction. In its audit, Ernst & Ernst failed to inquire into the nature of the "mail rule" which Nay had established in order to effect his fraudulent scheme. Nay had required that all mail addressed to him at the firm was to be opened by him alone. The plaintiffs sought damages from Ernst & Ernst⁹ under rule 10b-5 for aiding and abetting Nay's fraud by the firm's negligent failure to discover this irregular practice. They claimed that the accounting firm had negligently failed to follow proper auditing procedures that would have led to the discovery of the fraudulent scheme.

The District Court for the Northern District of Illinois granted Ernst & Ernst's motion for summary judgment¹⁰ after finding that the accounting firm had conducted the audits according to generally accepted accounting standards.¹¹ Although the court accepted the standard of the profession as the requisite standard of conduct, it rejected Ernst & Ernst's argument that an allegation of negligence was insufficient to support a 10b-5 aiding and abetting claim.

The Seventh Circuit reversed the district court,¹² holding that a cause of action for aiding and abetting a 10b-5 securities fraud will lie when the plaintiff alleges that the defendant had a duty of inquiry and disclosure, that the defendant breached this duty, that the plaintiff would have been benefitted had the duty been performed, and that there was a causal connection between the breach of duty and the facilitation of the underlying fraud. Although the court found a statutory duty of inquiry and a related duty to disclose material irregularities, it remanded the case for a determination of whether a failure to uncover the "mail rule" was a breach of the duty of inquiry and disclosure and whether there was a causal connection

9. During receivership proceedings against First Securities, which began after Nay had committed suicide, all but two of the plaintiffs asserted claims based on the accounts and were given relief. The court held Nay liable as a primary perpetrator of the fraud and First Securities as an aider and abetter. *SEC v. First Securities Co.*, 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

10. *Hochfelder v. Midwest Stock Exch.*, 350 F. Supp. 1122 (N.D. Ill. 1972).

11. The courts are in conflict as to whether compliance with generally accepted accounting standards is sufficient to avoid accountant liability. *See note 64 infra.*

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

between the breach of this duty and the facilitation of the fraudulent operation.¹³

In reversing the court of appeals' decision, the Supreme Court held that the plaintiff must allege scienter on the part of a defendant in order for an action to lie in a 10b-5 private claim for damages. Writing for the majority,¹⁴ Mr. Justice Powell found that the language of section 10(b) definitively supports a scienter requirement. In dissent, Mr. Justice Blackmun, joined by Mr. Justice Brennan, conceded that the majority's analysis was technically consistent but emphasized that this narrow interpretation would have a deleterious effect on the innocent public. Since the accountant's certification could potentially cause investors great monetary loss, the dissent contended that the accountant-defendant should be liable for both negligent and intentional conduct.

I. NUMEROUS STANDARDS ARTICULATED BY THE CIRCUIT COURTS OF APPEALS

Section 10(b) of the Securities Exchange Act of 1934 is part of a network of federal legislation that regulates securities trading for the purpose of protecting investors and promoting standards of fair dealing.¹⁵ Broad in scope, it prohibits the use of manipulative and deceptive devices in the purchase or sale of securities and confers administrative authority on the Securities and Exchange Commission to promulgate rules that will ensure the effective prevention of fraudulent practices.¹⁶ In 1942, pursuant to its administrative authority, the Securities and Exchange Commission promulgated rule 10b-5 to define further the nature of the proscribed devices.¹⁷ However, neither the enabling provision nor the administrative rule articulates the requisite state of mind that makes the prohibited conduct actionable. As a consequence, the courts have implied numerous standards.¹⁸ Using a

13. *Id.* at 1119.

14. Chief Justice Burger and Justices Stewart, White, Marshall and Rehnquist joined in the opinion with Mr. Justice Powell. This was the same majority that upheld the restrictive *Birnbaum* doctrine in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). See note 6 *supra*.

15. Congress passed the Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1970) and the Securities Exchange Act of 1934, (codified in scattered sections of 15 U.S.C.) as a response to the fraudulent practices in the securities markets and the resulting stock market crash of 1929. For a discussion of the purpose of the legislation, see H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-5 (1933) for the Securities Act of 1933; and S. REP. NO. 792, 73d Cong., 2d Sess. (1934) for the Securities Exchange Act of 1934.

16. See note 2 *supra*.

17. See note 3 *supra*.

18. Both the private civil action under section 10(b) and the scienter requirement have been implied by the courts. See note 1 *supra*.

common law fraud analysis, some early 10(b) private actions required an allegation of scienter. However, as the litigation developed the courts recognized that federal securities laws must be construed liberally if congressional intent to protect investors was to be accomplished.¹⁹ Consequently some courts modified or eliminated certain common law fraud requirements but chose to retain some form of the element of scienter. Others adopted various types of negligence standards in order to effectuate congressional purpose.²⁰

The circuits which required scienter did not articulate one uniform standard. In *Shemtob v. Shearson, Hammill & Co.*,²¹ the Second Circuit refused to entertain a 10(b) action "in the absence of allegation of facts amounting to scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud."²² The court unequivocally stated that it would be insufficient to allege mere negligence.²³ Based on the *Shemtob* test, the Second Circuit in *Lanza v. Drexel & Co.*²⁴ established a minimum requirement of "willful or reckless disregard for the truth"²⁵ before liability under rule 10b-5 would be imposed. Other circuits did not delineate as carefully the requisite degree of intent. The Tenth Circuit confirmed its adherence to a modified form of common law scienter by stating simply that "there is required something additional by way of scienter or conscious fault than mere negligence," but that neither common law intent to defraud nor "odious or malicious" intent was needed.²⁶ A similar position was adopted by the Fifth Circuit which has declared that "some culpability beyond mere negligence is required for liability."²⁷

19. The scienter required in common law fraud was very hard to prove. A. BROMBERG, *supra* note 5, § 8.4, at 203.

20. The Second, Fifth and Tenth Circuits have embraced some form of a scienter standard while the Seventh and Eighth Circuits have adopted negligence standards, and the Ninth Circuit, a flexible duty standard. See notes 21-40 & accompanying text *infra*. The Third Circuit has not addressed this specific issue. However, Judge Adams, in a separate opinion in *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir. 1972), carefully analyzed section 10(b), rule 10b-5, and the legislative and administrative histories, and stated that fraud or other culpable conduct is required. 458 F.2d at 276-78 (Adams, J., concurring and dissenting). For a good survey of the standards in the various circuits prior to *Ernst & Ernst*, see Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. REV. 562 (1972); and Ruder, *Factors Determining the Degree of Culpability Necessary for a Violation of the Federal Securities Laws in Information Transmission Cases*, 32 WASH. & LEE L. REV. 571 (1975).

21. 448 F.2d 442 (2d Cir. 1971).

22. *Id.* at 445.

23. *Id.*

24. 479 F.2d 1277 (2d Cir. 1973).

25. *Id.* at 1306.

26. *Clegg v. Conk*, 507 F.2d 1351, 1361 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975). *Cf.* *Andrews v. Blue*, 489 F.2d 367, 375 (10th Cir. 1973) (knowledge of the falsity is required).

27. *Vohs v. Dickson*, 495 F.2d 607, 622 (5th Cir. 1974); *accord*, *Sargent v. Genesco*,

Those courts that established scienter standards for 10(b) private actions analyzed, to varying degrees, the purpose of federal securities laws, the language of section 10(b), and the relationship between the various sections of the federal securities laws.²⁸ Although the courts recognized the need for a broad and flexible interpretation in this area,²⁹ they indicated that the application of section 10(b) should be characterized by "restrained flexibility",³⁰ that is a broad interpretation in order to effectuate the remedial purposes of the statute, but one which does not extend liability for negligent acts where there is no conscious fault or some type of scienter.³⁰ Those courts that analyzed the language of the section noted that the operative terms of both the section and the rule—"manipulative or deceptive devices," "fraud," "deceit," "purchase," "sale," and "security"—connote intentional and affirmative conduct.³¹ Finally, the courts that considered the interrelationship of the provisions of the federal securities laws maintained that the establishment of a negligence standard would enable parties to establish a cause of action under section 10(b) when they would otherwise be precluded by restrictions contained in other provisions.³²

Inc., 492 F.2d 750, 761 (5th Cir. 1974); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974).

28. The courts which have established scienter standards have not relied on any factors in particular. *See Clegg v. Conk*, 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975) (remedial purpose of section 10(b) to prohibit fraud); *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (language of section 10(b), remedial purpose of the statute, interrelationship of the sections of the statute); *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971) (no basis for its standard); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970) (remedial purpose of the statute, language of section 10(b)); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951) (interrelationship of the provisions of the statute).

29. *See Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 592 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 739 (10th Cir. 1974); *Herpich v. Wallace*, 430 F.2d 792, 803 (5th Cir. 1970).

30. *See Clegg v. Conk*, 507 F.2d 1351, 1361-62 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975).

31. *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1305 (2d Cir. 1973); *Herpich v. Wallace*, 430 F.2d 792, 802 (5th Cir. 1970).

32. *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951), which pointed out that a negligence standard would enable parties to circumvent the limitations on the class of plaintiffs who may bring actions under section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1970). Section 11 provides a private action for damages resulting from a registration statement that includes untrue statements of material facts or fails to state material facts. The provision may be used by *only* those parties who purchase securities that are the direct subjects of the registration statement. *See Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973), which reasoned that the adoption of a negligence standard would nullify section 20 of the Securities Act of 1934, 15 U.S.C. § 78t (1970). This provision places liability on those persons who control any person liable under federal securities laws and who are in some meaningful manner culpable participants in the fraud perpetrated by the controlled persons.

A compromise approach to the rule 10b-5 state of mind issue was developed by the Ninth Circuit in *White v. Abrams*.³³ Instead of articulating either a scienter or a negligence formula, the court held that a flexible duty standard should be applied to determine "the extent of the duty that rule 10b-5 imposes on the particular defendant."³⁴ The standard requires a case-by-case analysis to determine whether a particular fact situation and the relationship between the parties justifies imposing liability under the rule.³⁵

Negligence had been sufficient for civil liability under section 10(b) in the Seventh and Eighth Circuits.³⁶ In *Tomera v. Galt*,³⁷ the Seventh Circuit found that "Rule 10b-5 claimants need not plead nor prove scienter under section 10(b) of the Act."³⁸ It was sufficient for a plaintiff to provide a brief summary of how the fraudulent scheme operated, when and where it took place, and who were the participants. The Eighth Circuit had likewise stated that "proof of 'scienter,' i.e., knowledge of the falseness of the impression produced by the statements or omissions made, is not required."³⁹

The circuits that had articulated negligence standards emphasized the need to interpret federal securities laws liberally in order to accomplish their remedial purpose. However, these courts cited cases which, while articulating a negligence standard, do not provide a rationale to support such a standard. In addition, SEC enforcement actions were used as author-

33. 495 F.2d 724 (9th Cir. 1974).

34. *Id.* at 734-35.

35. The duty would be determined by considering the relationship of the defendant to the plaintiff, the defendant's access to information as compared to the plaintiff's, the defendant's knowledge of the plaintiff's reliance, and the defendant's role in initiating the transaction. *Id.* at 735-36. The Ninth Circuit reiterated its flexible duty standard in *Clark v. Watchie*, 513 F.2d 994, 999 (9th Cir. 1975). For a critical view of the flexible duty standard, see Forseter, *Rule 10b-5 Violations in the Ninth Circuit: "I Know It When I See It,"* 30 BUS. LAW. 773 (1975) and Loss, *Summary Remarks*, 30 BUS. LAW. 163 (1975).

36. There have been several proponents of the negligence standard among the commentators. See Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965); cf. Bucklo, *supra* note 20, at 594-96. But see Meisenholder, *Scienter and Reliance as Elements in Buyer's Suit Against Seller Under Rule 10b-5*, 4 CORP. PRAC. COMMENTATOR 27 (1963).

37. 511 F.2d 504 (7th Cir. 1975).

38. *Id.* at 508. The Seventh Circuit first considered the scienter issue in *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963). The court appeared to embrace a negligence standard in stating that "knowledge of the falsity or misleading character of a statement and a bad faith intent to mislead or misrepresent are not required to prove a violation of the statute . . ." *Id.* at 637. See also *Dasho v. Susquehanna Corp.*, 461 F.2d 11 (7th Cir. 1972).

39. *Myzel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

ity in the negligence standard cases, but since they involve different policy considerations, they may not be clearly applicable to private damage actions.⁴⁰

II. THE SUPREME COURT STANDARD

Faced with a potpourri of standards which were, for the most part, vaguely articulated and of questionable basis, the Supreme Court, in *Ernst & Ernst*, in fashioning its standard, analyzed the language of section 10(b), the legislative history of the Securities Exchange Act of 1934, the interrelationship of the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, and the administrative history of rule 10b-5. The Court opted for a technical approach which appears logically based, but which omits an analysis of the relevant prior case law. Although the Court stated that it did not discuss policy considerations,⁴¹ it is evident that the basis of the decision involved a policy determination of the proper balance between the protection of the investing public and the extent of liability to which professionals should be exposed. The Court chose a middle ground that will limit the liability of defendants to situations where there was intended fraudulent conduct and will provide investors with some, although not complete, protection from harm. Although the Court recognized that it may be unfair to impose liability on parties who have no knowledge of the misconduct, it failed to consider that some defendants have special duties to investors which when breached could cause harm to investors.⁴² A broader reading of sec-

40. See 386 F. 2d at 735. The Eighth Circuit in *Myzel* relied on *Dale v. Rosenfeld*, 229 F.2d 855 (2d Cir. 1956), which was not a 10(b) action and did not discuss the scienter issue; *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961), which contained no citations to support its holding that negligence is a sufficient standard of proof; and the district court decision in *SEC v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y. 1966), which was limited to an SEC enforcement action. See also *Tomera v. Galt*, 511 F.2d 504, 508-09 (7th Cir. 1975). Moreover, each time a negligence standard has been articulated, the conduct at issue would have been actionable under a scienter standard. See *Bucklo*, *supra* note 20, at 563.

41. 425 U.S. at 214 n.33. In discussing why it would not analyze policy considerations, the Court appeared contradictory. It reasoned that an analysis of the policy considerations was unnecessary because the language of section 10(b) settled the issue. Yet since the Court analyzed the legislative history of section 10(b), the intent of the entire body of federal securities laws, the interrelationship of the provisions, and the administrative history of rule 10b-5, it seems logical that the Court would also have discussed policy considerations.

42. The duty of the accountant to the public, for example, may be derived from the Restatement of the Code of Professional Ethics of the American Institute of Certified Public Accountants. See note 63 *infra*.

One commentator also contends that a scienter standard is not as appropriate where accountants are involved since those who will be paying the damages will be the firm partners rather than innocent shareholders. *Bucklo*, *supra* note 20, at 596. However,

tion 10(b) and rule 10b-5 might have been more appropriate for the remedial purpose of federal securities laws.

Not only did the Court interpret section 10(b) and rule 10b-5 narrowly, holding that scienter is a necessary element of a private damage action, but the standard itself—intent to deceive, manipulate, or defraud—is more narrow than any previously enunciated test.⁴³ The narrow *Ernst & Ernst* test does not include the knowing use of a fraudulent device or constructive intent, *i.e.*, reckless behavior, two elements that had previously been included in standards articulated by the circuits.⁴⁴

In deciding the scienter issue on the basis of the language of section 10(b), the Court contended that it did not reject the broad remedial goals of the legislation. Rather, it reasoned that since the individual provisions of the legislation articulated independent standards of liability based on the nature of the prohibited conduct, any analysis of the appropriate standard should focus on the language of the particular section involved. The Court rejected an “effect-oriented” approach⁴⁵ which would interpret the language in light of the congressional objective of protecting investors and thus proscribe any conduct, intentional or negligent, that would have the effect of defrauding investors. Instead, the Court stated that the appropriate standard should be gleaned from the dictionary definition of the words of the provision and from their usage in the securities market. The 1934 edition of *Webster's International Dictionary* was used as authority for the proposition that the words “manipulative,” “device,” and “contrivance” “make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence.”⁴⁶ Moreover, the Court indicated that the word “manipulative” is especially

it may be argued that ultimately the increased costs will not be paid for by the partners but rather by the clients.

43. See notes 21-27 & accompanying text *supra*.

44. See notes 22, 25 & accompanying text *supra*.

45. The “effect-oriented” approach, which the Court rejected, refers to the SEC's position that investor protection is the result which should be achieved by securities laws. Brief for the SEC as Amicus Curiae at 14, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Recently, the Court has not always given the SEC the deference usually afforded an agency administering a statute. Cf. *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232, 259 (1976). The SEC seems to be responding to this posture taken by the Court. Cf. *BNA SEC. REG. L. REP.*, May 26, 1971, at F-1 (No. 354).

46. 425 U.S. at 199. “*Webster's Int'l Dictionary* (2d ed. 1934) defines ‘device’ as ‘[t]hat which is devised, or formed by design: a contrivance; an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice’; and . . . ‘contrive’ in pertinent part is defined as ‘[t]o devise; to plan; to plot . . . [t]o fabricate . . . design’; invent . . . to scheme ‘[M]anipulate’ as ‘to manage or treat artfully of [*sic*] fraudulently’” *Id.* at 199 nn.20, 21.

significant because it is a “term of art” which, when used in the securities market, “connotes intentional or willful conduct designed to deceive and defraud investors by controlling or artificially affecting the price of securities.”⁴⁷

Having disposed of the issue, the Court nevertheless reviewed the legislative history of the Securities Exchange Act of 1934 to determine whether there was any support for a negligence standard. The Court admitted that the congressional hearings and reports provided no guidance as to the scope of section 10(b). However, the Court attached great significance to one reference in the congressional hearings which described section 10(b) as “a catch-all clause to prevent manipulative devices.”⁴⁸ Noting that there was only one specific reference to section 10(b) in the Senate report,⁴⁹ the Court nevertheless gleaned congressional intent to establish a scienter standard from the Senate report’s references to “manipulative devices”⁵⁰ and the availability of a good faith defense in civil actions where fraudulent practices are alleged.⁵¹

The Court then analyzed the interrelationship of the provisions of the securities laws in response to the Securities and Exchange Commission’s amicus argument that a negligence standard in section 10(b) is supported by the explicit requirement of willful conduct in other sections of the securities laws. The Commission had contended that since section 10(b) does not explicitly contain a scienter requirement it should not be interpreted to require more than negligent conduct. However, the Court pointed out that Congress clearly indicated the type of conduct—intentional behavior, negligence, or innocent mistake—that would be required under each provision that provided civil liability in the 1933 and 1934 Acts.⁵² Citing section 11 of the 1933 Act⁵³ as an example, the Court countered the Commission’s argument by indicating that negligence standards are also expressly contained in securities legislation. In addition, the Court noted that each of the civil remedies contained in the 1933 Act that embraces a negligence standard is accompanied by specific procedural limitations that are absent from section

47. *Id.*

48. *Id.* at 201, citing *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934).

49. 425 U.S. at 204-05, citing S. REP. NO. 792, 73d Cong., 2d Sess. 6 (1934).

50. S. REP. NO. 792, 73d Cong., 2d Sess. 7-9 (1934).

51. *Id.* at 13.

52. 425 U.S. at 207. The Court cited sections 11, 12, and 15 of the Securities Act of 1933, 15 U.S.C. §§ 77k, l, o (1970) and sections 9, 18, and 20 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78i, r, t (1970).

53. 15 U.S.C. § 77k (1970).

10(b).⁵⁴ Thus, an extension of liability under section 10(b) for negligent conduct would enable plaintiffs to bring their claims under section 10(b) rather than under the provisions containing procedural restrictions, thereby making these carefully drafted limitations easily avoidable.

Finally, the majority considered the Securities and Exchange Commission's contention that the language in subsections (b) and (c) of rule 10b-5 can be plainly read as including both negligent and intentional conduct. The Court admitted that subsections (b) and (c) of this rule⁵⁵ "could be read as proscribing, respectively, any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not."⁵⁶ However, in contrast with its analysis of section 10(b) of the statute, the Court did not base its interpretation on the plain language of the rule. Instead the Court found support for a scienter standard in the rule's administrative history.⁵⁷ In addition, the Court asserted the controlling principle that the scope of the rule cannot exceed the breadth of its enabling provision. Since the Court had already determined that section 10(b) liability could not be established without scienter, any contrary interpretation of the rule was untenable.⁵⁸

In contrast, the dissent adopted the "effect-oriented" approach, which seeks to proscribe any behavior that results in injury to the innocent investor. Mr. Justice Blackmun pointed out that the investor victim can be harmed by negligent as well as intentional conduct. He reasoned that the language in subsections (b) and (c) of rule 10b-5 which proscribes negligent and intentional behavior is consistent with the Court's past recognition of the need for a flexible interpretation of antifraud legislation. Returning to the court of appeals' focus on the scope of an accountant's responsibility in a securities setting, the dissent concluded that the accountant owes a duty to the public and that a breach of this duty should be actionable under section 10(b).⁵⁹

54. 425 U.S. at 208-09. The Court referred to sections 11, 12(2), and 15 of the Securities Act of 1933, 15 U.S.C. § 77k, l, o (1970).

55. See note 3 *supra*.

56. 425 U.S. at 212-13.

57. The Court recounted the events surrounding the promulgation of rule 10b-5. *Id.* n.32. The Court noted that the rule was drafted quickly after a situation involving intentional conduct. As further support for its position that the rule requires scienter, the Court stated that SEC Release No. 3230 (May 21, 1942) and the Commission's Annual Report of 1942 explained that the purpose of the rule was to protect investors against fraud.

58. 425 U.S. at 214.

59. *Id.* at 218. The dissent asserted that Congress should enact further legislation in order to vitiate the effect of the majority's decision and to carry out the purposes of federal securities laws. *Id.*

III. CONCLUSION

The *Ernst & Ernst* majority's rejection of an "effect-oriented" approach will have a great impact on participants in securities transactions. Damaged investors may now be left without a remedy against accountants,⁶⁰ aiders and abettors,⁶¹ and others who can potentially contribute to their harm.⁶²

60. Injured plaintiffs may, however, be able to obtain redress from accountants by other means. The Court suggested that they might be able to maintain a cause of action under section 17 of the Securities Exchange Act of 1934, 15 U.S.C. § 78q (1970) and rule 17a-5, 17 C.F.R. § 240.17a-5 (1976). 96 S. Ct. at 1381 n.13. Section 17 provides in pertinent part that securities brokers or dealers must "make . . . and preserve . . . such accounts . . . books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors." Rule 17a-5 requires the auditing firm to state in its certificate "whether the audit was made in accordance with generally accepted auditing standards [applicable in the circumstances]." Accountants are subject to injunctive proceedings by the SEC under section 21(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(e) (1970). They also may be disciplined by the SEC in proceedings under rule 2(e) of the SEC Rules of Practice, 17 C.F.R. § 201.2 (1976). Rule 2(e) provides in part that:

[T]he Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws

See in the matter of Tubber T. Okuda, SEC Accounting Series Release No. 170 (Jan. 27, 1975) (accountant temporarily suspended from practice before the SEC but later given right to apply for reinstatement); In the matter of Arthur Andersen & Co., SEC Accounting Series Release No. 157 (Jul. 8, 1974) (accounting firm censured by the Commission and findings published); In the matter of Touche Ross & Co., SEC Accounting Series Release No. 153 (Feb. 25, 1974) (accounting firm censured, ordered to adopt certain procedures, investigated and restricted as to undertaking of professional engagements).

61. Although rule 10b-5 does not specifically punish aiders and abettors, the courts have recognized that actions may be brought against aiders and abettors of rule 10b-5 violations. For a comprehensive analysis of aiding and abetting cases, see *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974); *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); *Saltzman v. Zern*, [1975-76 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,521 (E.D. Pa. 1976).

Since the Court decided *Ernst & Ernst* on the issue of scienter it did not consider whether an implied aiding and abetting action exists under section 10(b) or what the necessary elements would be in such an action. 96 S. Ct. at 1380 n.7. However, the Court suggested that it would imply such an action and that scienter would be one of the requirements. First, the Court stated that all civil damage actions under the section and the rule require an allegation of scienter. Second, the Court cited *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), where a defendant was found liable for providing affirmative and knowing assistance to a securities dealer who was engaged in violations of section 10(b) and rule 10b-5. Third, the Court cited *Ruder, Multiple Defendants in Securities Law Fraud*

In refusing to find liability based on a negligent performance of work, the Court displays a greater concern for business interests than for the protection of the public.⁶³ This marks a departure from the trend to hold accountants and other professionals to a higher standard than is generally required by the profession.⁶⁴

The decision has left several related issues unresolved. It is not clear whether constructive intent may be implied when there is gross negligence.⁶⁵

Cases: Aiding and Abetting Conspiracy, In Pari Delicto, Indemnification and Contribution, 120 U. PA. L. REV. 597, 620-645 (1972), in which the author supports the aiding and abetting doctrine and contends that liability under an aiding and abetting theory requires proof that the secondary wrongdoer knew of the illegal act and gave positive assistance to the primary defendant.

62. It has been suggested that this decision does benefit plaintiffs in one way. The six year statute of limitations generally applicable to common law fraud suits in which scienter is required would now seem to be applicable to antifraud suits under the federal securities laws. BNA SEC. REG. L. REP., Mar. 31, 1976, at A-3 (No. 346).

63. However, the code of ethics of the accounting profession makes accountants responsible to the public. The Restatement of the Code of Professional Ethics of the American Institute of Certified Public Accountants provides that:

A distinguishing mark of a professional is his acceptance of responsibility to the public

. . . .

The ethical Code of the American Institute emphasizes the profession's responsibility that has grown as the number of investors has grown, as the relationship between corporate managers and stockholders has become more impersonal and as government increasingly relies on accounting information.

Restatement of the Code of Professional Ethics of the American Institute of Certified Public Accountants, 2 CCH ACCOUNTANCY L. REP. ¶ 65,501 (1975).

64. See, e.g., *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), cert. denied, 397 U.S. 1006 (1970) (conformity with generally accepted accounting principles is no defense to a criminal prosecution); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, [1975-76 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,660 (2d Cir. 1976) (accountant's duty to investors is governed by the policy of securities laws that investors must be provided with all the facts needed to make intelligent investment decisions). *Contra*, *Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs*, 455 F.2d 847 (4th Cir. 1972) (generally accepted accounting principles were a minimum standard); *Donovan Constr. Co. v. Woolsey*, 358 F. Supp. 375 (W.D. Ark. 1973) (normal accounting procedures refute claim of fraud); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968) (accountants not held to a standard higher than that of the profession). Commentators have written a number of informative articles on the topic of accountant responsibility. See, e.g., *Symposium on Accounting and the Federal Securities Laws*, 28 VAND. L. REV. 1 (1975). The professional responsibility of securities lawyers is also an issue that has been receiving increased attention. See Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 COLUM. L. REV. 412 (1974). The subject of the October 1974 ABA National Institute was the responsibilities of lawyers and accountants. See *Proceedings—ABA National Institute—Advisors to Management, Responsibilities and Liabilities of Lawyers and Accountants*, 30 BUS. LAW. 1 (1975).

65. In a case decided after *Ernst & Ernst*, the Seventh Circuit found a defendant-bank

In addition, the Court has not ruled on the state of mind that must be alleged in an action for injunctive relief.⁶⁶ However, the posture taken by the Court seems to indicate that future decisions involving these issues and others related to the scope of section 10(b) and rule 10b-5 may accord a narrow interpretation to federal securities laws when a contrary analysis would create potentially unlimited liability for defendants or would inexorably broaden the class of potential plaintiffs.⁶⁷ Thus, it appears that the only vehicle for full protection of the public will be through additional legislation.⁶⁸

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liable under rule 10b-5 for grossly negligent conduct. *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976).

66. The circuits have generally held that proof of scienter is not a required element in SEC actions for injunctive relief under section 10(b) and rule 10b-5. *See SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972); *cf. SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). *But see SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). For a discussion of the policy considerations involved in providing different requirements for private damage actions and injunctive suits, see Judge Friendly's much cited concurring opinion in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 864 (2d Cir. 1968) (Friendly, J., concurring) and Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1061 (1969). After the *Ernst & Ernst* decision was handed down, the Office of the General Counsel of the Securities and Exchange Commission sent a memorandum to its staff attorneys which contained advice for avoiding the effect of the decision in Commission injunctive proceedings. BNA SEC. REG. L. REP., May 26, 1976, at F-1 (No. 354). Nevertheless, one district court has read *Ernst & Ernst* to require scienter in a suit for injunctive relief brought by the SEC. *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226 (S.D.N.Y. 1976); *cf. SEC v. World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976).

67. Although the *Ernst & Ernst* Court did not analyze policy considerations, it did note that a negligence standard would create an undue broadening of the class of plaintiffs who may sue under section 10(b). 425 U.S. at 214-15 n.33. The Court pointed out that the concern for a broadening of the class of potential plaintiffs was also expressed in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) and *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

68. *See note 59 supra.*