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Subtitle: 7 10.6.5
TO: Greg Palm                                      DATE: February 4, 1976
FROM: Lewis F. Powell, Jr.

MEMORANDUM

Ernst & Ernst

You were quite right in saying that this is not an easy case to write. I have no difficulty with the correctness of our basic analysis, but nevertheless find it a difficult and delicate task to put an opinion together that satisfies.

I return herewith your draft of 1/16/76. In view of the number of changes made, and to facilitate your further editing, Sally has prepared a partially "cleaned up" copy reflecting my editing. I give this to you, together with your original draft from which you will be able to see exactly what I have done.

I have adhered to the basic structure of your draft. Nor was I able to reduce the length appreciably, and possibly not at all.

As I have devoted all the time now available to me on this case (with others backed up awaiting my attention), I would appreciate your resuming the editing and revising process. In undertaking this, in addition to the changes I have made and my marginal suggestions, I have the following thoughts:
1. The contrast you have drawn throughout the opinion is between "knowing or intentional misconduct", on the one hand, and negligence or "negligent misfeasance", on the other. What is the derivation of this terminology? The briefs and arguments, for the most part, spoke simply in terms of "scienter" and "negligence". Judge Adams in Korn (at p. 287) used language that I like:

"An intent to deceive, manipulate or defraud."

Adams, p. 285, also referred to Judge Friendly's formulation as including "recklessness" that amounts to fraud. What would you think of our using the term "scienter" and defining it early in the opinion, using the Adams/Friendly terminology? Also, is there a reason for use of the term "misfeasance" in conjunction with "negligence"? In connection with choice of terminology, 10(b) uses "deceptive device or contrivance" and Rule 10b-5, in two of its subsections uses the term "fraud".

2. I notice that Adams opinion in Kohn, in quoting the Rule, includes its caption: "Employment of Manipulative and Deceptive Devices". In the briefs, however, I recall no reference to this caption. If, indeed, the published rule includes the caption, we should make some reference to it in III-D where we address the meaning of subsection (2).
3. I am under the impression that there is a good bit of repetition in our references to the sections of the two Acts providing for "express" liability. We rely on these sections in several different places in the opinion. This is probably desirable, but you might keep this in mind in the editing process.

4. We do not discuss the absence of "privity" in the common law sense between Ernst & Ernst and respondents. I view this as an important fact, and indeed one that could be controlling with me. We took the case, however, to resolve the conflict as to scienter, and I do not think a majority of the Court would be willing to dispose of it on the absence of privity. We should address this question in a footnote. I would welcome your thought as to what should be said.

5. You have indicated to me the reason for not including a discussion of "policy considerations". I was impressed, however, with Judge Friendly's discussion of such considerations in his concurring opinion in *Texas Gulf Sulphur*. He was there focusing on the effect of a mere negligence rule on management of corporations in determining what information to disclose to stockholders. I agree with Judge Friendly that a serious policy consideration is present in that context. I wonder, also, whether a similar - or perhaps even more serious - policy consideration is not present in a case like this one where liability is sought to be imposed upon an accountant.
in the absence of privity, and also in the absence of any reliance by the plaintiffs on what the accountant did. You might try your hand at a footnote summarizing generally the relevant policy considerations, noting that we need not elaborate on these in view of the language and history of 10(b).
MEMORANDUM

TO: Greg Palm
FROM: Lewis F. Powell, Jr.
DATE: February 18, 1976

We must do something with footnote 20. Apart from its unacceptable length (as a single note), it overdignifies some rather far-fetched argument (really "grasping at straws") advanced in this case.

As to reliance on Cochran's reference to "negligence", I would dispose of that quite summarily by saying that taken, in context, it was a general observation made in a discussion of § 8 that was amended prior to passage to require willful participation as a prerequisite to liability. I would conclude a brief paragraph (a sentence or two) with your statement that "the comment, in context, sheds no light whatever on the meaning of § 10(b)".

The remainder of note 20, in its present form, considers arguments advanced by industry representatives in hearings before the Committees. Rather than identify specific arguments, I would say merely that the Commission also seeks support for its position by relying on arguments made by industry representatives at the legislative hearings. A second sentence should be added consolidating the last two sentences presently in the note, namely, to the effect that testimony
during the course of Committee hearings, particularly by opponents to the legislation, is entitled to relatively little weight even when specifically relevant. (Citing your three cases). In this general connection, you might see if there is anything helpful in Schwagmann Bros. v. Calvert Corp., 341 U.S. 384, at 395.

L.F.P., Jr.
MEMORANDUM

TO: Mr. Greg Palm
FROM: Lewis F. Powell, Jr.

DATE: February 19, 1976

No. 74-1042 Ernst & Ernst

I return herewith the latest draft, reflecting some editing and the addition of a number of riders. Also, I deliver a couple of memos on specific points.

Between the two of us, a draft has gone through so much piecemeal editing that it is difficult to judge whether it is in satisfactory form. Indeed, if we had not been short of secretarial help, I would have had the entire draft and notes recopied before undertaking my review. I had considerable trouble tying the footnotes to the text and even keeping the pages straight. In terms of substance, I continue to have some difficulty with the extent to which we rely on the language of 10(b) and the transition from Part II to Part III. I think the language of 10(b) comes very close to being so clear and unambiguous, in light of other provisions of the Acts, as to require no consideration of legislative history. I prefer, nevertheless, to leave Part III in our opinion, but I do not wish to imply - in our transition to Part III a any lack of confidence in Part II as actually controlling.

Thank you for your note 29 with respect to "policy considerations". I may try to revise and condense this, or I may abandon the idea entirely.
As to procedure from now on, I suggest the following:

1. Review my editing and changes, and discuss with me any questions of substance or major language changes that you think appropriate.

2. I do not think the draft is in satisfactory form to give to the printer. Therefore, I suggest that you give the notes to Gail and the text to Sally, each to copy such pages as may be necessary to give the printer something that is clean and clear enough to minimize printing time and error. I doubt that any printer could figure out where to go from the present state of things.

3. Except as to points that you specifically bring to my attention, I will not again review the draft until it is in printed form as a Chambers Draft. I believe the best way to progress this opinion is to get it in print. Then you, your editor (Carl, I believe) and I can go to work on it with the view to making it as coherently and carefully written as possible.

4. I intended saying above that, in reviewing this again, I hope you will omit or condense any footnote that does not contribute something necessary or worthwhile to the opinion. Some of the notes seem to me to be quite marginally relevant.

5. As you may know, each of us is called on now at Friday Conferences to state the status of circulated opinions. I certainly want to circulate Ernst & Ernst prior to the
Court Conference on Friday, March 5. This means that I will have to have a Chambers printed draft no later than the weekend of March 28-29.

L.F.P., Jr.
MEMORANDUM

TO: Greg Palm
FROM: Lewis F. Powell, Jr.

DATE: February 19, 1976

No. 74-1042 Ernst & Ernst

I am not content with Part III, at least on the basis of my understanding of the situation.

The petitioner for certiorari did not present § 17(a) as an issue, and no cross petition presented it. As I dictate this, I have had no opportunity to review the bill of complaint. My recollection, however, is that it is predicated solely on 10(b) and 10b-5.

My recollection is that, at the oral argument, Mr. King spoke of amending the complaint to aver a cause of action under 17(a). (It is possible that my recollection - which is not sharp - is related to a proposed amendment for some other purpose).

This litigation has been going on for many years. If there is any way to avoid it, I do not wish to saddle the lower federal courts with another year or two of pointless litigation. I think there is no merit whatever to the 17(a), but persistent plaintiffs may find it profitable nevertheless to continue the litigation.
If indeed the complaint does not allege such a cause of action, and in the absence of any effort prior to this Court to amend the complaint, I would dispose of this issue simply and briefly in a footnote to the effect that respondents belatedly, after the petition for certiorari had been filed and granted attempted to raise an issue not specified in their complaint. Accordingly, the issue is not before us. I would simply reverse the case and if they want to initiate a new proceedings let them go to it below but without any assist from us.

L.F.P., Jr.
We might add something along the following lines at an appropriate place in the opinion. It should come up near the beginning or at the end.

We took this case to resolve the long-standing conflict as to the standard of liability under § 10(b). As we find its language and history dispositive of the issue, there is no occasion to consider whether policy considerations - that may have influenced the lawmakers - are relevant to the ascertainment of congressional intent.

We do note that the standard of liability urged by respondents would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the two Acts. Last Term, in Blue Chip Stamps, 421 U.S. at 747-748, the Court pertinently observed:

(here copy the quote from Blue Chip that Greg has in his first draft of this note)

This case, on its facts, may illustrate an extreme example of the reach of the standard urged by respondents. They
sought to impose substantial personal liability for damages for alleged negligent conduct upon which respondents conceded that they did not rely. Acceptance of their view would indeed extend the "hazards" of rendering expert advice under the Acts to new frontiers, raising serious policy questions not yet addressed by Congress.
March 10, 1976

No. 74-1042 - Ernst & Ernst

Dear Lewis,

I am glad to join your opinion for the Court in this case.

Sincerely yours,

Mr. Justice Powell

Copies to the Conference
March 11, 1976

Re: No. 74-1042 - Ernst & Ernst v. Hochfelder

Dear Lewis:

Please join me.

Sincerely,

Mr. Justice Powell

Copies to the Conference
March 15, 1976

Re: No. 74-1042 - Ernst & Ernst v. Hochfelder

Dear Lewis:

Please join me in your very good opinion in this case.

Sincerely,

Mr. Justice Powell

Copies to Conference
March 25, 1976

RE: No. 74-1042 Ernst & Ernst v. Hochfelder, et al.

Dear Harry:

Please join me in your dissenting opinion in the above.

Sincerely,

Mr. Justice Blackmun

cc: The Conference
March 26, 1976

Re: 74-1042 - Ernst & Ernst v. Hochfelder

Dear Lewis:

Please join me in your circulation of March 11.

Regards,

Mr. Justice Powell

Copies to the Conference
Respondents in this case were customers of a small brokerage firm largely owned by its president, Leston B. Nay. Respondents were induced by Nay to invest in a fraudulent securities scheme. The firm went bankrupt and Nay committed suicide.

Petitioners in this case, Ernst & Ernst, had audited the firm's books for many years. They did not discover the fraud because Nay was careful to maintain no records. His technique included a rule that he alone was authorized to open all mail addressed to his attention.

After the bankruptcy, respondents sued the accounting firm alleging that it was negligent in failing to have discovered Nay's rule with respect to opening mail. The theory was that if discovered, that rule should have aroused the suspicion of the auditing firm and that upon investigation, the fraud would have been revealed.

The suit was brought under § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. The Court of Appeals for the Seventh Circuit, reversing the District Court, held that respondents had stated a valid cause of action for damages, even though only negligence had been alleged. There was no allegation of fraud or wilful misconduct by E & E.
Section 10(b) speaks of manipulative and deceptive devices or contrivances. These words reflect a congressional intent to proscribe a type of conduct quite different from negligence. Indeed, the language Congress chose in other sections of the Securities Acts, clearly directed to negligent conduct, stands in sharp contrast to the language of § 10(b).

The legislative history of the 1934 Act, as well as the overall pattern of express civil liabilities created by the Acts, also supports the view that § 10(b) is not directed at merely negligent conduct.

There was no allegation in this case of intentional or willful conduct designed to deceive or defraud investors.

For reasons more fully set forth in the opinion for the Court, we think the Court of Appeals erred in reading a negligence standard into § 10(b) and Rule 10b-5. Accordingly, we reverse its judgment.

* * * *

Mr. Justice Blackmun has filed a dissenting opinion in which Mr. Justice Brennan joins. Mr. Justice Stevens took no part in the consideration or decision of the case.
MEMORANDUM TO THE CONFERENCE:

There are three cases being held for ERNST & ERNST, two of which are related and will be discussed together:


The petitions in these cases arise from a complex stock fraud. A number of persons, including an employee of the petitioner brokerage firm in No. 74-1407 [hereinafter Rodman & Renshaw] conspired to drive up the price of the stock of a certain corporation in order to facilitate a merger. Petitioners in No. 74-1366 [hereinafter Schaefer] were purchasers of the shares during the period in which their market price was artificially inflated. They brought this civil action under § 1 of the Sherman Act and various sections of the Securities Act of 1933 and the Securities Exchange Act of 1934.

CA 7 held that Schaefer had a cause of action under § 10(b) and Rule 10b-5 despite the express remedy for price manipulation in § 9 of the 1934 Act and that the applicable state statute of limitations for civil actions under § 10(b) was equitably tolled because Rodman & Renshaw had facilitated the fraud of their employee through negligence. The court further held that Schaefer’s Sherman Act claim was incompatible with the damage remedies under the Securities Acts.
Rodman & Renshaw assert that an implied cause of action under § 10(b) and Rule 10b-5 should not be permitted where the facts alleged constitute a legitimate claim under § 9(a)(2) of the 1934 Act since this will permit plaintiffs to circumvent the statute of limitations provided under § 9(e). They also challenge the equitable toll of the statute of limitations, and contend that if there is a § 10(b) claim, § 9(e), rather than state law, provides the relevant period of limitations.

The question whether an implied cause of action is appropriate under § 10(b) for stock price manipulation in view of the express cause of action under § 9(a)(2), is certainly not frivolous. The procedural restrictions provided by § 9(e) would indeed be circumvented by permitting actions under § 10(b). Section 9(a)(2) covers manipulative conduct on national securities exchanges for the "purpose of inducing the purchase or sale of such security by others." The applicability of § 10(b) is not limited to national exchanges and it contains no special notice requirement other than general scienter. Thus, this is a case in which the implied cause of action under § 10(b) would totally nullify the restrictions on the express action under § 9(a)(2). Compare Ernst & Ernst, slip op. 22-24 & n. 31 with SEC v. National Securities, Inc., 393 U.S. 453, 468 (1969).

Rodman & Renshaw cite no cases in direct conflict with CA 7's holding. Moreover, the attractiveness of this case as a vehicle for resolving this issue is diminished by the fact that this is an appeal from pre-trial motions for summary judgment and the district court expressly noted that there was a disputed issue of fact whether the § 9(e) statute of limitations had in fact run in this case. Depending upon how the "purpose" clause of § 9(a)(2) is construed, the action here thus might be sustainable under that section.

The basis for CA 7's resolution of the tolling issue is not entirely clear. In reaching its conclusion
the court relied principally on its decision in Ernst & Ernst which held that negligent facilitation of fraud may justify tolling. But it also noted that in the original complaint Schaefer had alleged direct participation by Rodman & Renshaw in the fraud. The issue whether the statute of limitations under § 9 should be applied in § 10(b) actions apparently was not raised below. Rodman & Renshaw do not raise the issue of the appropriateness of premising a § 10(b) action on allegations of negligent facilitation of fraud. In any event, this case would not necessarily be controlled by Ernst & Ernst, as the perpetrator of the fraud here was a Rodman & Renshaw employee.

Ernst & Ernst has no direct bearing on the appropriate resolution of the issues raised in the Rodman & Renshaw petition, none of which in my view merit review at this time. Accordingly, I will vote to deny the petition in No. 74-1407.

***

As to the implied repeal of the Sherman Act as urged by Schaefer, CA 7's holding that the existence of the damage remedies under the Securities Acts rendered "superfluous" private remedies under the antitrust laws is questionable. As the Solicitor General points out in his amicus brief, however, the circumstances of this case are rather unique. Neither Schaefer nor the S.G. is aware of any prior cases in which manipulations of securities, as distinguished from commodities, have been challenged as violative of both the antitrust and securities laws. I agree with the S.G. that the case does not merit review by this Court and, accordingly, will vote to deny the petition in No. 74-1366.
This case concerns the application of § 10(b) and Rule 10b-5 to dealers in commercial paper. CA 7 held that commercial paper with a maturity of 90 days constituted "securities" within the meaning of the Securities Exchange Act of 1934, despite the definition of "security" in § 3(a)(10) of that Act which expressly states that the term "shall not include ... any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months ... ." The court further held that the petitioner, a dealer in commercial paper, was liable for civil damages under § 10(b) and Rule 10b-5 to purchasers of such paper for failure to make an adequate investigation of the financial strength of the issuer corporation. Although CA 7 purported not to rely on a "mere negligence" standard, it is evident from the opinion that petitioner was held liable without any proof of "scienter," as that term is used in Ernst & Ernst. Petitioner's liability was premised on the fact that it had failed to make a "reasonable investigation" of the issuer, CA 7 noting that petitioner had "acted in the mistaken, but honest belief that financial statements prepared by certified public accountants correctly represented the condition of the issuer . . . ." Pet. App. 1.

Petitioner challenges each of these holdings. Although the issue of the scope of the term "security" under the 1934 Act is important, in view of the liability standard under § 10(b) and Rule 10b-5 adopted by CA 7, I will vote to grant, vacate, and remand in light of Ernst & Ernst.

L.F.P., Jr.

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74-1042 Ernst & Ernst v. Hochfelder
PETITION FOR REHEARING

May 15, 1976 Conference
List 3, Sheet 3

No. 74-1042

ERNST & ERNST
v.
HOCHFELDER

1. Resps seek rehearing in this case decided on Mar. 30, 1976, on the
"sole issue" that this Court was wrong in stating that resps had only proceeded on
a theory of negligence. Thus, resps contend, summary judgment was inappropriate.
Resps contend that negligence was not mentioned in the complaint. The only mention
of negligence was in answer to an interrogatory in which they said they were not
charging petr with intentional fraud but with inexcusable negligence. Resps then
contend that this case charges petr with deliberate failure to perform a duty. This, resps contend, is fraud, not negligence.

2. Resps appear to be trying to say that the answer to the interrogatory should be ignored. However, the Court noted it in footnote 5 and Part III. The dissent in Ernst & Ernst does not discuss this issue.

Kovacic

5/4/76

DK