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THROUGH THE LOOKING GLASS: THE EIGHTH CIRCUIT VIEWS SCIENTER

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"When I use a word," Humpty Dumpty said, in rather a scornful tone, "it means just what I choose it to mean—neither more nor less."

"The question is," said Alice, "whether you can make words mean so many different things." ¹

Like Alice in Wonderland, judges, juries and lawyers involved in securities litigation often encounter words that have many meanings. One of those words is "scienter." Does it mean "an actual intent to defraud?" Can it mean "recklessness?" If so, what does "recklessness" mean? One suspects that each judge, juror and lawyer, like Humpty Dumpty, might have his own special meanings for these words.

Recently, the United States Court of Appeals for the Eighth Circuit stepped through this looking glass. In Van Dyke v. Coburn Enter., Inc.,² the Eighth Circuit gave an expansive definition to the word "scienter" as it is used in cases involving the Securities Exchange Act of 1934³ and Securities & Exchange Commission (S.E.C.) Rule 10b-5.⁴ Because of the procedural setting of the case, however, Van Dyke failed to give a full explanation of the term. Like Alice, trial judges, juries and lawyers are despairingly left to ask: "Would you tell me please, . . . what that means?" ⁵

In Van Dyke, the definitional issue regarding "scienter" arose on an appeal from a judgment following a jury verdict. The plaintiffs were four Minnesota farmers involved in the business

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¹ L. CARROLL, Through the Looking-Glass, in THE COMPLETE WORKS OF LEWIS CARROLL 196 (1939) (emphasis in original).
² 873 F.2d 1094 (8th Cir. 1989).
⁵ L. CARROLL, supra note 1, at 197.
of raising and selling artichokes. In 1982 they invested in Coburn Enterprises, which owned a plant used for processing artichokes into anhydrous alcohol—197 proof or greater. After some time, the investment turned sour. In part, the farmers sued for violation of S.E.C. Rule 10b-5. Coburn Enterprises asserted various counterclaims. 6

The plaintiffs' claim under Rule 10b-5 proceeded to the jury upon the following instruction:

The plaintiffs, in order to recover on their 10b-5 claim, must show that the defendants acted knowingly, that is, with a mental state embracing intent to deceive, manipulate, or defraud. In order to establish this element the plaintiffs must prove by a preponderance of the evidence that the defendants stated material facts which they knew to be false or stated untrue facts with reckless disregard for their truth or falsity or knew of the existence of material facts which were not disclosed and they should have realized their significance in the making of an investment decision or knew of the existence of material facts which were not disclosed although they knew that knowledge of those facts would be necessary to make their other statements not misleading. 7

After the jury returned a verdict against them, the plaintiffs challenged this instruction. Among other things, they contended that the "instruction did not include recklessness," as it is used within the definition of "scienter." 8 The court disagreed with the plaintiffs and found that "reckless disregard for . . . truth or falsity" was included in the instruction. 9 The court also found that, while a further definition of recklessness might have been helpful, it could not say under the facts at issue that the plaintiffs were prejudiced in any manner by the absence of such explanation.

On its limited terms, the court's decision was correct. There was no reversible error for the plaintiffs. Had the plaintiffs prevailed, however, the defendants would have been substantially aggrieved, and entitled to reversal. For the defendants, the instruction was inadequate for two reasons: (1) it included an instruction on recklessness that was not supported by the

6. Van Dyke, 873 F.2d at 1097.
7. Id. at 1099–100 (quoting district court's jury instruction No. 24).
8. Id. at 1100.
9. Id.
facts of the case, and (2) it failed to give any explanation of the term “recklessness.”

To provide guidance for trial judges, juries and lawyers, the Eighth Circuit should address each of these issues in future decisions. For further understanding of these issues, one must step back into the history of Rule 10b-5 litigation. In doing so, one gains the feeling of Alice stepping through the looking glass.

The Supreme Court’s decision in *Ernst & Ernst v. Hochfelder* is the central case on the scienter doctrine under Rule 10b-5.\(^\text{10}\) *Hochfelder* involved a claim against an accounting firm, Ernst & Ernst, by plaintiffs who had lost their investment in a small brokerage firm for which Ernst & Ernst was the auditor. The firm was found to have been operated fraudulently. Relying upon prevailing law, the plaintiffs based their claim against Ernst & Ernst upon the theory that the accountants had been negligent in failing to discover the fraud.\(^\text{11}\)

Ernst & Ernst took its arguments to the Supreme Court after a favorable summary judgment motion was reversed by the Seventh Circuit Court of Appeals. The Supreme Court ruled for Ernst & Ernst.\(^\text{12}\) It held that negligence was not enough to satisfy Rule 10b-5. Rather, “scienter”—meaning an intent to deceive, manipulate, or defraud—was required. In a footnote, the Court explained:

> In this opinion the term “scienter” refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.\(^\text{13}\)

The Supreme Court based its opinion upon the language and the legislative history of both the Securities Exchange Act of 1934 and the Securities Act of 1933. In particular, the Court found that the term “manipulative,” when used in combination with the terms “device” and “contrivance,” indicated

\(^{10}\) 425 U.S. 185 (1976).

\(^{11}\) *Id.* at 190. Ernst & Ernst claimed that if defendant had used “appropriate auditing procedures,” the faulty internal practices of the firm would have been discovered. *Id.*

\(^{12}\) *Id.* at 193.

\(^{13}\) *Id.* at 194 n.12.
an intent to prohibit something more than simple negligence. The Court felt that this language clearly addressed intentional acts. Moreover, the Court noted that some sections of the Securities Exchange Act and the Securities Act clearly do prohibit negligent conduct. Other sections of the Acts clearly prohibit only intentional conduct. Thus, Congress had been quite careful in crafting the scope of the various sections of these Acts. Finally, to the extent that legislative history was available, it tended to confirm that the drafters meant to address intentional conduct.

In Hochfelder, the Supreme Court declined to explain further what it meant by “scienter.” Rather, it left that job to the circuit courts of appeal. Thus far, all of the courts of appeal that have considered the issue have found that scienter can mean more than just intentional fraud. Under certain circumstances, the circuit courts all have found that scienter can include behavior characterized as “recklessness.”

For one in Alice’s position, the questions now become: When can “scienter” mean “recklessness,” and what does “recklessness” mean? These are all issues that the Eighth Circuit should eventually address.

In almost all of the cases, the circuit courts of appeal have held that recklessness only satisfies the scienter requirement in certain limited circumstances. Those limited circumstances arise where there is some preexisting relationship or duty between the plaintiff and the defendant. The cases cited by the Eighth Circuit in Van Dyke amply illustrate this point. The

14. Id. at 197.
15. Id.
16. Id. at 200.
17. Id. at 201.
18. See Woods v. Barnett Bank of Fort Lauderdale, 765 F.2d 1004, 1010 (11th Cir. 1985) (severe recklessness can satisfy the scienter requirement where an alleged aider and abetter under Rule 10b-5 owed a preexisting duty to the defrauded party); Dirks v. Securities and Exch. Comm’n, 681 F.2d 824, 844-45 (D.C. Cir. 1982) (cases have held that a recklessness standard is appropriate where the alleged violator has a duty to disclose or refrain from trading), rev’d on other grounds, 463 U.S. 646 (1983); Sharp v. Coopers & Lybrand, 649 F.2d 175, 193-94 (3d Cir. 1981) (severe recklessness standard could be applied where defendant, another accounting firm, owed a duty of careful supervision to the investors), cert. denied, 455 U.S. 938 (1981); Broad v. Rockwell Int’l Corp., 642 F.2d 929, 960-62 (5th Cir. 1981) (severe recklessness standard could be applied in a case involving a claimed breach of a fiduciary duty), cert. denied, 454 U.S. 965 (1981); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44-47 (2d Cir. 1978) (severe recklessness standard could be applied in a case in which the
principle established in these circuit court cases is consistent with the Supreme Court's holding in *Hochfelder*. The emphasis upon manipulative devices and contrivances reflects a clear intent to address intentional wrongdoing. However, where there is some preexisting relationship between the parties, greater demands may be placed upon the defendants. The relationship itself can be part of the device or contrivance. Reckless conduct within that relationship may well satisfy the language and intent of Rule 10b-5.

In *Van Dyke*, there was no such preexisting relationship between the parties. Thus, the instruction that recklessness would suffice to prove scienter should not have been given. In addition, once the jury instruction including recklessness was given, more explanation of the term should have been included. Jurors should not be allowed to apply their independent meanings to this multi-faceted term.

On this issue as well, the circuit courts of appeal have reached a clear consensus. The language generally adopted comes from the United States Court of Appeals for the Seventh Circuit in *Sundstrand Corp. v. Sun Chemical Corp.*:

> [R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it. 19

As the court noted in *Sundstrand*, this definition should be viewed as the functional equivalent of intent. 20 The United States Court of Appeals for the Second Circuit has also recognized that, when dealing with Rule 10b-5, the court will require "the kind of recklessness that is equivalent to wilful
defendant owed a fiduciary duty to the plaintiff), *cert. denied*, 439 U.S. 1039 (1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1043-45 (7th Cir. 1977) (severe recklessness standard could be applied in a case involving a "quasi-fiduciary" who had a duty to disclose material facts), *cert. denied*, 434 U.S. 875 (1977). *See also Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 94-97 (5th Cir. 1975) (scienter must be of the high "conscientious intent" variety where there was no preexisting duty to disclose). *But see Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir. 1978) ("the ambit of § 10(b) [is] to reach a broad category of behavior, including knowing or reckless conduct"), *cert. denied*, 439 U.S. 970 (1978).

19. *Sundstrand Corp.*, 553 F.2d at 1043-45 (quotation omitted).
20. *Id.*
Because of the posture of the case, the Eighth Circuit never reached this issue in Van Dyke. Had the plaintiffs not prevailed, however, it would have had to address the issue. The court should then have found that more explanation of the term "recklessness" was required.

If the Van Dyke court had reached the issue, it would also have had to find that at least one clause of the instruction fell short of both the Sundstrand definition and Hochfelder itself. The jury was instructed, in part, that there could be liability if the defendants knew of the existence of material facts which were not disclosed, and they should have realized their significance in the making of an investment decision. The phrase "should have realized" left open the possibility that the jury could have found the defendants liable on the basis of negligence alone.

Fortunately, neither of these errors resulted in any prejudice to the parties. The lesson, however, is that Van Dyke cannot be taken by trial courts or lawyers as the final word on scienter. More explanation will be required as the issues discussed here are squarely presented in future cases. The jury instruction which was found satisfactory in Van Dyke does not fit every case that may arise under Rule 10b-5. It should be given only where there is a preexisting relationship or duty between the parties. When the instruction is given, it should be worded so as to assure that liability will not be based only upon a finding of negligence.

These are difficult issues for all involved. Life on the other side of the looking glass is confusing. Often words do have more than one meaning, and this is surely one such instance. Perhaps Humpty Dumpty's reflections are again appropriate:

"That's a great deal to make one word mean," Alice said in a thoughtful tone.

"When I make a word do a lot of work like that," said Humpty Dumpty, "I always pay it extra."


23. L. Carroll, supra note 1, at 197.