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IN THE SUPREME COURT OF THE UNITED STATES

ERNST & ERNST, Petitioner,	:	
v.	:	No. 74-1042
OLGA HOCHFELDER, et al., Respondents.	:	

Washington, D. C.,

Wednesday, December 3, 1975.

The above-entitled matter came on for argument at 10:04 o'clock, a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice

APPEARANCES:

ROBERT L. BERNER, JR., ESQ., Baker & McKenzie, 130 East Randolph Drive, Chicago, Illinois 60601; on behalf of the Petitioner.

WILLARD L. KING, ESQ., King, Robin, Gale & Pillinger, 135 S. LaSalle Street, Chicago, Illinois 60603; on behalf of Respondents Hochfelder, et al.

WILLARD J. LASSERS, ESQ., Elson Lassers and Wolff, 11 South LaSalle Street, Chicago, Illinois 60603; on behalf of Respondents Allison, et al.

APPEARANCES [Cont'd]:

PAUL GONSON, ESQ., Associate General Counsel, Securities and Exchange Commission, Washington, D. C. 20549; on behalf of the Securities and Exchange Commission as amicus curiae.

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C O N T E N T S

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments first this morning in Ernst & Ernst against Hochfelder.

Mr. Berner, you may proceed whenever you're ready.

ORAL ARGUMENT OF ROBERT L. BERNER, JR., ESQ.,

ON BEHALF OF THE PETITIONER

MR. BERNER: Mr. Chief Justice, and may it please the Court:

The basic issue in these cases is whether Rule 10b-5 is to be turned into a national negligence statute affecting all conduct in any way touching on the purchase or sale of a security.

This issue is presented in the Petition for Certiorari as "Whether Respondents may predicate a cause of action against Petitioner for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, on allegations and proof of negligence alone, or whether there must be alleged and proved something more than negligence, some fraud, some knowledge of the fraud, or some reckless or willful conduct tantamount to fraud."

There are three other issues in this case which are important to the Petitioner and the Respondents, because a disposition of any one of them can dispose of this litigation; and they are:

Whether Ernst & Ernst, as a matter of law, audited

First Securities with all due diligence;

Whether the Respondents' conduct is such as to estop them from bringing their claims against Ernst & Ernst; and

Whether the Respondents can avoid the bar of the statute of limitations.

These issues, of course, are best understood in the context of the facts, which briefly are that First Securities was a small broker-dealer in Chicago. It was owned by Leston B. Nay. The Respondents, for many years, were regular securities customers of First Securities, and, as such, in their regular securities transactions, received all of the documentary paraphernalia that a securities customer ordinarily receives. They would receive purchase of sale forms, confirmation of sales, accountaings; all the documents that emanate from a broker-dealer.

Most or all of the Respondents were also friends, or had some personal or social relationship with Nay or with Mrs. Nay, and, as a result, Nay was able to persuade the respondents to invest in what he called an escrow.

He told them that he had befriended a small loan company that was required by law to maintain a cash escrow. Their investments would be perfectly safe, and that it paid 12 percent interest in some cases, 9 percent in the other.

Of course, the escrow was fictitious, and there was no small loan company; but these people paid their funds to

Nay by personal checks made payable to him personally. And he evidenced the investments, the escrow investments, by personal notes of his or by letters. All, however, on correspondence coming from -- or on the letterhead of First Securities Company.

None of the transactions involving this escrow ever were reflected on the books and records of First Securities. The Respondents conducted all of their transactions with respect to the excrow with Nay personally, as compared with the transactions they had when dealing with First Securities as regular securities customers.

The Petitioner, Ernst & Ernst, was the auditor of First Securities from sometime in the middle Forties until 1967. The Respondents' relationship with First Securities as regular securities customers and as escrow investors began in the early Forties in some cases and continued up until 1968.

In June of 1968, Nay's Ponzi scheme caught up with him and he shot and killed himself.

QUESTION: He killed his wife first, didn't he?

MR. BERNER: Yes, sir. Shot and killed his wife and then killed himself.

That was, I believe, June 6, 1968.

The SEC, within a day or two, initiated a receivership proceeding, which is still pending. And the Respondents have made their claims in that receivership proceeding.

But in 1971 they sued Ernst & Ernst under Section 10(b) and Rule 10b-5, claiming that Ernst & Ernst caused their loss.

QUESTION: Does the record show that in every transaction for the excrow account the checks were paid to Nay /sic/ personally and not to First Trust?

MR. BERNER: Yes, sir.

In the litigation against Ernst & Ernst, there were a number of depositions taken of all of the people connected with Ernst & Ernst's audit, with the audit by Ernst & Ernst. The documents in Ernst & Ernst's possession relating to their audits over 25 years, such as they still had, were examined by the Respondents, and then a motion for summary judgment was filed and granted in favor of Ernst & Ernst in the District Court, on the grounds that Ernst & Ernst's conduct in the audits was blameless.

The District Court also found that the statute of limitations barred these claims, and found that the Respondents' own conduct acted as estoppel.

That summary judgment was appealed to the Court of Appeals for the Seventh Circuit, which reversed, finding that there could be a genuine issue of material facts as to whether or not Ernst & Ernst's conduct in connection with the audit might have been negligent, and they pointed to two transactions, two types of conduct:

One, it was the existence of a mail procedure at First Securities; and the other was an allegation that Nay did not take regular vacations.

With respect to the -- let's refer to it as the "mail rule". I should explain it. That was simply an office procedure at First Securities, which provided that all mail delivered to First Securities, addressed to an individual, to his attention or to him personally, would be delivered to him, put on his desk. Nay, being the owner and president of --

QUESTION: Put on his desk, unopened?

MR. BERNER: Unopened, yes, sir.

According to the record, in the affidavit of John Walsh, of Haskins & Sells, that procedure existed at substantially all the brokerage houses -- well, most of the brokerage houses in Chicago at that time, and probably most of them in the country.

Nay, however, had an additional provision, which restricted anyone else at the office from opening his mail. As a result, when he was not in the office, his mail was not opened.

The Court of Appeals found that this could create an issue of fact as to whether or not Ernst & Ernst audited diligently, and they reversed. And in doing so, the Court of Appeals announced a standard for aiding and abetting liability under 10b-5 --

QUESTION: Mr. Berner.

MR. BERNER: Yes, sir?

QUESTION: Is the term "aiding and abetting" a familiar one to members of the security bar?

MR. BERNER: It's becoming familiar.

QUESTION: Where did it come from?

MR. BERNER: It comes from the -- I think it comes from the criminal law originally, yet it --

QUESTION: How does it get over into the civil law?

MR. BERNER: Well, I think it first came over in Fischer vs. Kletz, a case in the Southern District in the late Sixties, and in the Seventh Circuit in Brennan vs. Midwestern Insurance; the Seventh Circuit adopted the analogy. I believe it comes over because usually an aider and abetter has very little if anything to do with the fraud and very little knowledge, if any, usually no knowledge of the fraud. But it's a term which someone has given substantial assistance, a knowing assistance in connection with some wrong. And it's been imported from the criminal law and there's some old SEC administrative decisions which use the concept.

But it is not a well-known concept yet in the securities law.

The standard that the Seventh Circuit adopted is a negligent standard. It leaves no room for -- at least it does not require any element of scienter; that is, any element of

knowledge of the fraud, of reckless conduct tantamount to fraud. It's a pure negligence standard.

And, as such, --

QUESTION: Negligent aiding and abetting?

MR. BERNER: Yes, sir, negligent aiding and abetting, and it is, I believe, the first case in the federal jurisprudence -- I'm certain it's the first case in the securities laws -- that adopts that standard, that a person can negligently aid and abet a securities violation under 10b-5 or other violations.

The Ninth Circuit has adopted a standard which does not require the element of scienter, although the case in which they adopted it clearly had that element.

But the majority of the Circuits, the Second, Fifth, Sixth and Tenth Circuits at least, who have specifically addressed themselves to the question, have required something more than negligence in terms of culpability, for liability in a private money damage action under Rule 10b-5.

And those Circuits are correct, I believe, if the statute and the legislative history and the reasoning behind those is looked at. As Mr. Justice Powell pointed out in his concurring opinion in Blue Chip, when the language -- when a statute is being construed, the place to start is the language of the statute.

Rule 10b-5 speaks of manipulative and deceptive

devices. That's not clear what that is, but that certainly is fraud language. That's not blameless language or negligent language that talks of fraud. And the Rule also is replete with words of fraud.

In fact, Professor Loss has commented, and Judge Friendly in the Second Circuit, have each stated that if the rule, if Rule 10b-5 is held to encompass merely negligent conduct, it goes beyond the mandate of the section in which it draws its life.

QUESTION: Where did (b)(2) come from?

MR. BERNER: (b)(2) --

QUESTION: That's (b)(2) in this case.

MR. BERNER: Well, Clause (b)(2) in Rule 10b-5?

Well, I believe that all of Rule 10b-5 was drafted at the same time, in the early 1940's, by the SEC. Now, there is similar language in the Investment Company Act. The SEC points to some New York corporation law as perhaps suggesting the language.

QUESTION: But (b)(2) doesn't refer -- it doesn't have that fraud language.

MR. BERNER: No, it doesn't, and it --

QUESTION: So where did --

MR. BERNER: -- it doesn't have language as to fault at all. It simply speaks of a misrepresentation or an omission.

But I believe the proper view of the three clauses

of 10b-5 is that they get to basically the same kind of behavior.

In this Court's case in Capital Gains Research in this --

QUESTION: But, part of your submission, then, that (b)(2) just isn't within the reach of -- if it's construed this way, not to require scienter of any kind, that it just isn't authorized by the statute?

MR. BERNER: Yes, sir.

The legislative history, of course, is not conclusive. Nowhere does it conclusively say that Section 10(b) requires something more than negligence. But it gets near to that, because a reading of the legislative history makes it clear that these provisions in the securities laws are designed to get to dishonest behavior. The phrases, "honesty in the marketplace", "high ethical standards", those phrase permeate the legislative history.

It is, I think, absolutely clear from the legislative history that these Acts are not designed to get to the competence of somebody, but his honesty. And that certain abuses that -- again in Capital Gains Research, that Mr. Justice Goldberg points to are abuses of honesty.

QUESTION: Do you suggest that the statute deals in terms of affirmative action rather than omissions?

MR. BERNER: No, I believe it deals in terms of both

affirmative actions and omissions. An omission can be as culpable as an affirmative action.

The standard which the majority of the Circuits urge, and which we support, would not constitute a retreat to 1934, when the Act was drafted. It would not require a retreat to all common law elements of fraud, as we understood them at that time. We're speaking only of the level of cuplability, and this would not affect the direction that this Court and other courts have taken on the other elements which constitute a 10b-5 action: elements of reliance, materiality, causation, and the like.

We submit that requiring something more than negligence in terms of culpability would simply be a continuation of the direction that Rule 10b-5 and Section 10(b) has been taking, and would prevent an abrupt change in direction which endorsement of the Seventh Circuit's opinion would constitute.

With respect to Ernst & Ernst's conduct, even if a simple negligence standard were permitted for Rule 10b-5, it is clear, we submit, on the record that as a matter of law Ernst & Ernst conducted its audit of First Securities with all due diligence. Ernst & Ernst's duties to audit First Securities was to audit in accordance with generally accepted auditing standards.

And the uncontroverted evidence, the affirmative

evidence in this case is unequivocal, it is to the effect that Ernst & Ernst conducted its audit in accordance with generally accepted auditing standards.

The evidence submitted by the Respondents is evidence that goes to the question of whether or not First Securities Company maintained high internal accounting controls, strong internal accounting controls. But, of course, that's not the issue. Whether or not a company has strong or weak internal accounting controls is not determinative of whether or not an auditor audits in accordance with generally accepted auditing standards.

The internal accounting controls are controls arrangement procedures within a company, that are designed to insure that company that its assets and liabilities are correctly reflected on the books and records. And if a company has strong controls, the auditor then has more confidence in them, and need not extend his procedures unduly to confirm that. If the controls are weak, he has to engage in more procedures.

But whether or not they are strong or weak is not determinative of whether the auditor audits correctly.

QUESTION: Well, the Respondents had a couple of affidavits that -- and I thought that the mail rule would have surely alerted auditors to do more than Ernst & Ernst did here.

MR. BERNER: Well, I think that the Respondents have submitted three affidavits. One is by a man named Michael

Garst, who is a retired National Bank Examiner.

QUESTION: Well, can we really parse this kind of a thing on -- when it's simply a reversal of a motion for summary judgment in the Seventh Circuit, as to whether the affidavits did or did not make out a conflict on the question of proper audit; or isn't it more logical for us to concentrate on the negligence versus something more issue?

MR. BERNER: Well, that is an issue that, as I mentioned in the beginning, the question of negligence or not can also win this case for Ernst & Ernst; and, as a result, at least in those terms, that it's quite important for Ernst & Ernst.

And I believe that a reading of the three affidavits submitted by the Respondents makes it fairly clear that the Respondents -- two of the three are auditors; one is not an auditor. Of the two auditors, one has never audited a brokerage house, but he at least is an auditor.

And they say that as a matter -- it's a matter of personal opinion that they express, that they would do -- one says, "would employ additional audit procedures if you found this rule".

Well, of course, he hasn't reviewed the system at First Securities like the affiants whose affidavits are submitted on behalf of Ernst & Ernst did; and they know what the system was, and they know what procedures were there. And, as

a result, they say, even taking into account the mail rule, the audit was conducted with all due diligence and in accordance with generally accepted auditing standards.

The other response -- the Respondents' affidavits simply say: taking the mail rule by itself, they would consider that a possible weakness, and they may do something, they may employ additional procedures or not; but they don't get to the question. And the question is: did Ernst & Ernst audit in accordance with generally accepted auditing standards?

Now, even more than that, the Respondents have charged, particularly in their briefs submitted to this Court, that Ernst & Ernst's conduct could be considered as reckless or fraudulent. They charge that even if the proper standard is followed by this Court, the case should be remanded.

And we submit that this is incorrect. Because the conduct of Ernst & Ernst was fully disclosed, fully discovered, is fully out in the open, and on the record. It was on the record for the District Court; it was on the record before the Court of Appeals; and it's here.

And it's not just a record that was developed during this case, in the other litigation, related litigation in which the Respondents were involved, which resulted in a full trial on the merits, spawned at least three other appeals. A lot of information was developed. In fact, all of the items, the three or four items about which the Respondents complain in

their brief -- I mean in their -- yes, in their brief, were all outlined in the complaint itself. So this is nothing new.

QUESTION: Did they allege reckless or willful misconduct in their complaint?

MR. BERNER: No. They allege that Ernst & Ernst knew or should have known.

But, as the brief of the Hochfelder respondents points out, they never characterized that conduct, they simply -- they didn't say it was simply negligent, they submitted it, the facts, to the court.

And it is our view that it should not be permitted at this stage on the basis of the same record to apply a few more adjectives and thus send the case back for another view of the same facts, simply with different adjectives in mind. This is not a new theory they're proposing. They are simply proposing that -- they are continuing to propose that Ernst & Ernst's conduct was wrong.

QUESTION: Did they argue in the Seventh Circuit that there was sufficient evidence, or would be a trial to support a finding of recklessness or willfulness?

MR. BERNER: It was not that clear in the Seventh Circuit. They did not emphasize that. But the Seventh Circuit opinion, I believe, is quite clear that no finding of -- no finding of recklessness or fraud could be found. The Seventh Circuit opinion, the Seventh Circuit had stretched some to find

the possibility of negligence.

QUESTION: Well, the Seventh Circuit said, in fact, that at common law Ernst & Ernst couldn't be held --

MR. BERNER: That's correct.

QUESTION: -- under the Ultramares statute, didn't it?

MR. BERNER: That's correct. That's correct. Which would eliminate a finding of fraudulent or reckless conduct. That's correct.

QUESTION: Was there a claim here in the pleadings of reliance on the Ernst & Ernst certificate?

MR. BERNER: No, sir, not direct reliance. In fact, the record is clear that the plaintiffs did not rely on Ernst & Ernst and on their audit. They had never seen the audit. They didn't know Ernst & Ernst, they didn't know of them.

The theory, as best I can make it out, is that if Ernst & Ernst had audited properly, it would have told the Midwest Stock Exchange and the SEC that there were weak internal accounting controls at First Securities.

QUESTION: And that would derive from the mail, the opening of his mail, --

MR. BERNER: Opening of the mail --

QUESTION: -- and the time he didn't take vacations?

MR. BERNER: Well, the record doesn't support that he didn't take vacations. But -- as a matter of fact, the record

is clear to the contrary. But vacations, weak internal accounting controls -- and there are two other elements. One was the fact that Nay borrowed from his company; and the other was that there was a temporary net capital violation in 1967. Both of those were litigated in part of this suit below that was directed against the Midwest Stock Exchange. And both of those were found to be -- by the Seventh Circuit and the District Court, as not instances of negligence on the part of the Midwest.

Now, Ernst & Ernst was simply to report those to the Midwest. The gist of the complaint, as I understand it, is that Ernst & Ernst reported those informally rather than formally.

I'm not sure of the legal distinction, but that appears to be what it is.

And those are not audit problems. For instance, the excessive barrowings, they are called, by Nay, they were always less than the earned surplus. Nay owned the company. And the amounts he borrowed were always less than the earned surplus of the company, considerably less.

They were all reported on the financial statements, just as the requisite SEC instructions require.

The Respondents claim that the debt should have been reserved, because they said Nay was hopelessly insolvent. Well, they overlook the fact that the debts were reserved,

reserved 100 percent. Under net capital computations, debts from an officer or partner or director of a broker-dealer must be carried as a zero asset in determining net capital. And that was done in these instances.

So those are the other instances, Mr. Chief Justice.

So we submit that a remand on the issue of recklessness or fraud would be particularly inappropriate. There is not a new theory that is being urged by the Respondents, there are merely new adjectives that are being applied to Ernst & Ernst's conduct, the same conduct that has been fully before all of the courts.

I would like briefly to touch upon the two other issues --

QUESTION: Well, may I ask -- I think the Commission suggests that they should have an opportunity to amend their complaint to affect the theory of reckless or intentional rather than negligent conduct.

MR. BERNER: Yes, sir.

QUESTION: What do you think -- what do you say to that?

MR. BERNER: I think the Commission's suggestion is improper. The Commission's brief was filed several weeks after the brief of the Hochfelder respondents, where the use of the words "reckless" and "fraudulent" first occurred. And the SEC, the Commission referred to that brief and says perhaps the

case should be remanded.

However, the SEC bases that, apparently, on the fact they believe a new theory is being -- may be argued. We don't consider this a new theory.

QUESTION: Incidentally, would that suggestion involve us with the statute of limitations question?

MR. BERNER: Well, the statute of limitations questions exist now. And the statute would be the same. It would not affect the applicable statute.

If I may, I would like --

QUESTION: Mr. Berner, let me ask you: If the general rule is that even an intervenor is not allowed to raise a new theory in a case, would the SEC, simply as an amicus, have any right to raise a new theory at this stage?

MR. BERNER: Well, we felt that the suggestion was gratuitous, and is not supported by any case authority as to their standing. It appears on the last page of their brief.

QUESTION: Doesn't it suggest something like a common law action?

MR. BERNER: A common law action -- 10b-5 is not the only statute or the only theory upon which a plaintiff can proceed in a securities case. In a common law --

QUESTION: Assume they did, on what theory did they proceed, on 10(b)?

MR. BERNER: No, only on 10b-5.

QUESTION: Yes. Well now, if the SEC suggestion is construed to be a suggestion for a common law claim, then it is a different theory, is it not? I put that "if".

MR. BERNER: Well, I don't -- I would not call it a different theory. I think they would still be alleging fraud. They may have found another way to get at Ernst & Ernst. But I wouldn't consider that a different theory.

I'd like to reserve a few minutes, if I may.

MR. CHIEF JUSTICE BURGER: Very well, Mr. Berner.

Mr. King.

ORAL ARGUMENT OF WILLARD L. KING, ESQ.,

ON BEHALF OF RESPONDENTS HOCHFELDER, ET AL.

MR. KING: Mr. Chief Justice, and may it please the Court:

In 1968, a man calling himself Leston B. Nay, a member of the Midwest Stock Exchange and president of First Securities Company of Chicago, murdered his wife and killed himself. He left a suicide note in which he said that his company was bankrupt because of his thefts committed over a period of thirty years.

His suicide note also said that a certain escrow, in which he had sold investments to the customers of First Securities Company, was spurious. Nay had persuaded these plaintiffs, long-time customers of First Securities Company, to let that company sell their standard securities and invest

the proceeds in this fictitious escrow.

There was no escrow. Nay converted their money to his own use immediately upon its receipt.

Nay's suicide note also asked that Ernst & Ernst be notified. Why? What part had Ernst taken in Nay's horrid story?

For twenty years, Ernst had certified, each year, to Midwest Stock Exchange that First Securities Company -- a balance sheet of First Securities Company, showing it to be solvent, when in fact it was utterly insolvent.

In each of those thirty years, Ernst had certified to Midwest Stock Exchange that it had reviewed the internal accounting controls of Nay's company, as it was required to do by the standards of its profession.

Actually, the company had no internal accounting control, because Nay had an adamant office rule that all mail received by the company addressed to him or to the company for his attention could only be opened, seen or read by him. When he was away for a few days, the mail, by his command, piled up, unopened, on his desk.

Nay secreted the incoming mail on his desk, the great mass of his correspondence with his escrow victims was found locked in his desk. Ernst never reviewed the internal accounting control. If it had done so, it would have uncovered Nay's fraud.

Now, what is internal accounting control?

QUESTION: You say it would have necessarily uncovered the mail rule that you've just described?

MR. KING: Yes, Mr. Chief Justice.

What is internal accounting control?

In 1939, the SEC published a volume on that subject, which established the very simple definition of that term. Internal accounting control means that the work of each officer and employee must be counterchecked by the work of another. It means that no fraud or crime can exist without collusion between two or more persons. It means that no one person can profit by a fraud because his fraud will be discovered by another person.

QUESTION: With whom do you suggest there was collusion here? You say it takes two, at least two to accomplish this.

MR. KING: There was no collusion here that I suggest. I was giving the definition of internal accounting control, as stated by the SEC on the basis of the testimony of twelve leading American public accountants, in 1939. I did not suggest collusion.

The essence of internal accounting control is required duality.

In 1939, the SEC published the complete transcripts of the testimony of twelve leading American public accountants,

each of whom testified to this definition of required duality as internal accounting control.

One of those experts was the senior partner of Ernst & Ernst.

This occurred in the SEC's investigation of the colossal frauds at McKesson & Robbins, a multi-million-dollar drug concern whose securities were listed on the New York Stock Exchange. The president of that company was an ex-convict under a fictitious name, who operated the company with the aid of his three brothers, also under various fictitious names. They inflated the sales and inventories by many millions. Like Nay, the president shot himself when his fraud was discovered.

McKesson had been audited by a nationally known public accounting firm, and the SEC condemned its failure to check the internal accounting control.

One of the McKesson criminals required that all of the incoming mail be put unopened on his desk. He never took a vacation.

Under these circumstances, the SEC questioned each of the twelve leading American public accountants on the duty of a public accountant with respect to checking the incoming mail. It showed each of them a bulletin of the American Institute of Certified Public Accountants, under a caption, "Safeguards surrounding the handling of incoming mail." Each

of the twelve leading public accountants testified that a public accountant must not fail to check the routine of examining the handling of incoming mail, and find it to be controlled so that no one could secrete that mail.

QUESTION: Well, Mr. King, supposing they do fail to check into that, that would still be no more than negligence, would it?

MR. KING: I suggest that it would be the grossest sort of negligence, and gross negligence of a public accountant is evidence of fraud.

QUESTION: Well, that's just a lot of words. Negligence, gross negligence, evidence of fraud. So those are three fairly separate things. And I don't think it helps analysis to simply garble them all together.

MR. KING: I didn't mean to garble them, Mr. Justice.

QUESTION: Mr. King, do I understand you are now arguing there was fraud on the part of Ernst & Ernst?

MR. KING: Our complaint does not allege either negligence or fraud.

QUESTION: But in your interrogatories, you expressly disclaim any charge of fraud.

MR. KING: That is right, yes.

QUESTION: Are you standing on that interrogatory, or are you now changing your position?

MR. KING: Of course I stand upon it, Mr. Justice.

QUESTION: Well then, you're not charging fraud.

MR. KING: Well, I ask, if necessary, leave to amend the complaint to charge gross negligence equivalent to fraud.

QUESTION: In this Court?

MR. KING: Yes. Well, this Court has previously, in cases involving summary judgment, permitted the case to be reversed for amendment of the complaint.

QUESTION: So you are asking that the case be remanded to allow you to amend your complaint to charge fraud?

MR. KING: That is correct.

QUESTION: Now, when was this suit instituted?

MR. KING: In 1971.

QUESTION: And this is the first time this has occurred to you? More or less.

MR. KING: Well, it only occurred to me when this Court allowed certiorari on the opinion of the Seventh Circuit.

I had been describing the McKesson report of the SEC. Since that report, since 1939, the SEC, in two cases, has suspended a broker from the Exchanges for tolerating Nay's mail rule.

The Advisory Committee of Broker-Dealers to the SEC, in its volume entitled "Guide to Broker-Dealer Compliance", has stated: No personal mail should be permitted in an office, nor any mail distributed unopened to any salesman or other employees.

In opposition to Ernst's motion for summary judgment, the plaintiffs filed the affidavit of Fred J. Duncombe, a former president of the Illinois Society of Certified Public Accountants, and a former member of the board for certifying them.

Mr. Duncombe's affidavit stated that he would not have certified the balance sheet of a company employing Nay's mail rule because such a company had no internal accounting control.

To the same effect, the plaintiffs filed in opposition to the summary judgment the affidavit of Gerhard Mayer, a distinguished public accountant of thirty years' experience.

Ernst filed, in support of its motion for summary judgment, the affidavit of its partner, Jerry Hooker, who had been in charge of the First Securities Company audit.

Hooker's affidavit stated that Nay's mail rule was not relevant to internal accounting control. On his deposition, Hooker testified that he would not have objected to Nay's mail rule if he had known about it. He was clearly unacquainted with the elementary rules of his profession. His affidavit is contrary to the affidavits of the two distinguished public accountants that the plaintiffs filed.

It is contrary to the testimony of the twelve leading American public accountants published by the SEC, in 1939. It is in the teeth of the two cases where the SEC has suspended

a broker from the Exchanges for tolerating Nay's mail rule.

I submit that no summary judgment may be issued on that affidavit.

I turn now to privity, or, as Judge Cardozo called it, near privity between the plaintiffs and Ernst.

These plaintiffs had been long-time customers of First Securities Company. Nay made the proposal of the escrow to them in the office of the company. Nay made the proposal of the escrow to them under this plaque. This plaque was Nay's principal tool for perpetrating his fraud.

By this plaque, Nay defrauded these people of their life savings, aggregating approximately one million dollars. It reads: "Midwest Stock Exchange, organized 1882, where high standards of commercial honor and integrity are maintained and just and equitable principles of trade and business prevail.

"This certificate of membership is issued to Leston B. Nay of First Securities Company of Chicago."

That plaque was kept there for twenty years by Ernst's false certification of the balance sheet of First Securities Company. That plaque would have come down if Ernst had ever delivered a correct balance sheet. That plaque would have come down if Ernst had ever told Midwest Stock Exchange that First Securities Company had no internal accounting control.

That plaque would have come down if Ernst had ever

told Midwest that Nay secreted the incoming mail. Twice the SEC has suspended brokers from the Exchanges for tolerating that rule.

QUESTION: Mr. King, neither you nor Mr. Lassers has cited in yoir briefs the Blue Chip opinion, although your opposition cites it repeatedly. Is there a reason for this? Do you feel that the Blue Chip case has no bearing on this one?

MR. KING: I think their footnote -- there's a footnote in the Blue Chip case that might have a bearing on 17(a)(5), but I would -- our complaint didn't mention 17(a)(5), and I would avoid it.

Nay represented this escrow to these plaintiffs as a First Securities Company project. The evidence of that in the Court of Appeals first Nay decision, in the 463rd Fed 2d, is overwhelming.

When one of the plaintiffs asked to withdraw his escrow investment, Nay said to him: "Your money is safe at First Securities."

And Ernst's certificate was given wholly for the benefit of these customers of the company, and not at all for the benefit of Midwest Stock Exchange. Its whole aim was the protection of the customers of the company.

I suggest that we thus have a situation approaching privity, as Judge Cardozo said, between Ernst and these

plaintiffs.

QUESTION: Mr. King, the Court of Appeals stated that plaintiffs admitted lack of reliance on the financial statements prepared by Ernst & Ernst, --

MR. KING: We never saw the financial statement. What we did see was this plaque which was kept there by that certificate.

QUESTION: But you never saw the financial statement?

MR. KING: We never saw it.

QUESTION: And you agree your clients, therefore, did not rely on what you contend are the failures of Ernst & Ernst correctly to audit the accounts of this company?

MR. KING: I agree that we never saw the financial statement, but I think our loss was a direct result of Ernst's failure to properly audit the company; their failure to discover Nay's mail rule, which would have terminated Nay's operations. He couldn't continue those operations if an auditor reported that he secreted the incoming mail.

QUESTION: What if all the factual situation was the same, and Mr. Nay had a sideline dealing in second mortgages, and did that through the private mail rule, and that the whole scheme involved forgeries of the second mortgages; would you think that the same kind of liability would follow in that kind of a case?

MR. KING: Well, I think you could assume an

isolated transaction by Nay --

QUESTION: No, I mean a series.

MR. KING: A series of isolated transactions --

QUESTION: Dozens of them.

MR. KING: But that's not this situation. Here he represented that this escrow was a First Securities project.

QUESTION: And he was using the money in the company.

MR. KING: That -- I'm not sure.

QUESTION: Well, why was the company bankrupt?

MR. KING: That was originally,back in 1938, a tremendous debt of some $474,000.

QUESTION: Well, why was the company -- what was he doing to the company that led to its failure? This escrow arrangement, how did that contribute to the failure of the company?

MR. KING: His failure was the suicide when he no longer could put off the bank out in Colorado to whom he was short some 475 -- the company was short some $474,000.

And, mind you, this is incorporated for $35,000. The company was utterly, hopelessly insolvent from the instant Ernst started to audit.

MR. CHIEF JUSTICE BURGER: Mr. King, you're cutting into your colleague's time now.

MR. KING: Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Lassers.

ORAL ARGUMENT OF WILLARD J. LASSERS, ESQ.,

ON BEHALF OF RESPONDENTS ALLISON, ET AL.

MR. LASSERS: Mr. Chief Justice, and may it please the Court:

I'd like to start off by responding to Mr. Justice Powell's comment or question as to whether we're, for the first time in this Court, now arguing that the conduct of Ernst & Ernst was reckless.

Our answer to that question is that we are not arguing it for the first time. Because what happened was we tried the case below on the theory that all we had to show was a failure of Ernst & Ernst to observe proper auditing standards. And that case was tried on that basis in the District Court and in the Seventh Circuit. And what --

QUESTION: When you say it was tried, are you talking about the case against Ernst & Ernst?

MR. LASSERS: Yes, sir.

QUESTION: I thought it went off on a grant of summary judgment.

MR. LASSERS: It was, yes. I'm sorry, I didn't -- yes. Right. Summary judgment. Right. Yes.

And then when, in this Court, in the certiorari petition, Ernst & Ernst for the first time raised the issue that something more was needed, and we say: Well, now, if something

more is needed, we are prepared to prove something more.

Second, I'd like to respond to Mr. Justice Blackmun's comment --

QUESTION: Before you start on that, I return to the response to interrogatories, on page 86 of the Appendix, in which you say, "We do not contend that Ernst & Ernst employed any scheme or artifice to defraud."

Do you now refutiate that?

MR. LASSERS: No, sir. Because what we're saying there was we do not contend that Ernst & Ernst was in league with Nay. What we do say is that if this Court holds that Ernst & Ernst -- that recklessness is the standard, then we're prepared to prove recklessness.

After all, you can commit a fraud, if you disregard, you close your eyes to the obvious. That, too, is a fraud.

And coming to Mr. Justice Blackmun's comment about the Blue Chip case. As I read Blue Chip, I don't think it's applicable because, as I read Blue Chip, it holds that there has to be a purchase and a sale. We grounded our case on Section 10(b), and it was clearly a purchase and a sale.

QUESTION: Was there -- on the negligence basis, would there be a cause of action under State law? Against Ernst & Ernst.

MR. LASSERS: Under State law?

QUESTION: Yes.

MR. LASSERS: I don't know, I can't answer that. I haven't researched Illinois law on that question.

Now, I'd like to comment on the mail rule --

QUESTION: Mr. Lassers, in this case, for four years you took discovery?

MR. LASSERS: Yes, sir.

QUESTION: Extensive discovery?

MR. LASSERS: Well, yes. Yes.

QUESTION: And did you find enough for fraud?

MR. LASSERS: I think we found enough to prove recklessness.

QUESTION: Well, why don't you allege it?

MR. LASSERS: What?

QUESTION: Well, why didn't you allege it then?

MR. LASSERS: Well, we did our discovery after we filed our complaint.

QUESTION: Well, you still could have amended your complaint, couldn't you?

MR. LASSERS: No, but --

QUESTION: Couldn't you?

MR. LASSERS: We could -- well, we could have asked. But if --

QUESTION: Well, did you ask?

MR. LASSERS: No, sir, because Ernst & Ernst never raised this issue that we had to prove recklessness until we

got here.

QUESTION: Well, it's your lawsuit.

QUESTION: It's your lawsuit.

MR. LASSERS: That certainly is true. But we felt that we had alleged enough.

QUESTION: But if you got a claim for negligence and a claim for fraud, certainly you allege both of them, don't you? You don't say negligence is good enough to get by on, so we won't worry about fraud, even though we can --

MR. LASSERS: Well, fraud is, of course, a much more difficult thing to prove.

But -- and I'd like to say this about the mail rule, because I don't think the full flavor of the mail rule has come through to the Court.

And that is this: It wasn't just that there was a rule in the abstract that the auditor failed to find, what happened was that he went in, the auditors went in every year, at the beginning of every audit, they would spend two or three days, they would come in in the morning at nine o'clock, before the mail was untied from the bundles, and their duty was to examine the mail as it came in, and they watched the mail being untied from the bundles and they saw the clerk then abstract the letters that were for Mr. Nay and put them off to one side, and the auditors never raised a question about that for fifteen years. And it went through two or three auditors.

Now then, the other matter that Mr. Berner alluded to, very late in the game -- yes, sir?

QUESTION: What do you suggest the auditors should have done? Should have said, "Why do you do that?" And the answer would have been, "Well, because Mr. Nay likes to open his own mail."

MR. LASSERS: All right. I say that at that point, and Mr. Mayer, our expert CPA, says that that would have been enough to trigger a warning to him that further investigation was at issue.

QUESTION: Well, that would be the further investigation: --

MR. LASSERS: Right.

QUESTION: -- "Why do you hold that mail for Mr. Nay" --

MR. LASSERS: Right.

QUESTION: --"while he's away on vacation?"

"Well, because he likes to open his own mail."

MR. LASSERS: Right. Then they would have -- then Mr. -- our expert said he would have -- if he hadn't been allowed, in effect, to look at that mail, and if that practice hadn't been stopped, in an extreme he would have withdrawn from the audit. He would have withdrawn from the engagement.

QUESTION: I understood your colleague to have said that an accountant, an accounting firm is not to certify unless

another person in the organization sees the mail.

MR. LASSERS: Well, I don't -- I don't know that we would go that far.

But what I want to say --

QUESTION: But you would go that far if the auditor weren't permitted to look at it?

MR. LASSERS: Well, I think that -- our autior says that he wouldn't have certified if that were the practice.

QUESTION: I see.

MR. LASSERS: Now, I want to stress to the Court Section 17(a) of the 1934 Act, which I think is essential to this action here, because that is the section which says that brokers have to keep books and records, and it says that the auditor must -- you must have a certified audit once a year. So that the audits that Ernst & Ernst were performing were not audits that were being undertaken voluntarily, these were audits pursuant to the SEC's command, and the audits had to be filed and certified with the SEC.

Our point is that the failure to observe the mail practices indicated to the auditors, or should have indicated that there was a violation of internal accounting control. Under the SEC regulations, the auditors were required to check internal accounting controls, and that, therefore, they failed in their statutory and regulatory duties.

Yes?

QUESTION: Mr. Lassers, is 17(a) before us on this petition for certiorari?

MR. LASSERS: Yes, sir. Yes, sir.

QUESTION: Did you file any cross-petition?

MR. LASSERS: No, sir, but as I understand the rule, that we relied on 17(a) in the Seventh Circuit, and the Seventh Circuit decided the case on the basis of 17(a), and we are a respondent, and therefore we're in a position to assert anything that is in support of the judgment below.

QUESTION: Let me ask you, you mean that if we reverse the Court of Appeals on the 10(b), that we could affirm the judgment on 17(a)?

MR. LASSERS: Well, our position --

QUESTION: I didn't know that -- is there a private cause of action under 17(a)?

MR. LASSERS: Well, there may be. Now, that issue has not been decided by this Court. It has not been decided by --

QUESTION: Well, the Court of Appeals didn't say so, did it?

MR. LASSERS: No, it did not.

QUESTION: Well, then we could not affirm on 17(a).

MR. LASSERS: Our position on 17(a) is -- we are suing under Section 10(b), and our position on 17(a) is --

QUESTION: Well, if we reverse on -- say, if we

reverse the Court of Appeals on 10 -- if decided against you on 10(b), then you've lost the case, haven't you?

MR. LASSERS: No, sir, Your Honor, because --

QUESTION: Well, then, you -- what about 17(a) then?

MR. LASSERS: Well, our position on 17(a) is we are suing under 10(b), and our position is that Section 17(a) sets up the duty and it also sets up the standard that has to be adhered to under 10(b).

QUESTION: Yes, but you don't know whether you could stay in court under 17.

MR. LASSERS: Well, that would be an issue before this Court, whether there is an implied cause of action under Section 17, as such.

QUESTION: Well, the Seventh -- the Court of Appeals certainly didn't decide there was.

MR. LASSERS: No, they reserved the question.

QUESTION: Well, --

MR. LASSERS: But -- and as I read the Seventh Circuit, they held that there was a -- that the Section 17 set up the duty and the standard --

QUESTION: Only -- only if we wanted to decide an issue the Court of Appeals didn't decide, is 17 here.

MR. LASSERS: Well, I think 17 is here in the sense of setting up the standard, and that we're suing under 10(b) about the standard of care that the auditor is responsible for is

laid out very precisely under 17.

Now, the final point I want to make has to do with another violation, and that has to do with the net capital violation that occurred very late in the game. What happened there was this, and here I think that Ernst & Ernst did in effect file a false audit certificate.

They came in and as part of their auditing they were required to examine the question whether the net capital rule of a company had been violated. And they found that there was a violation, they called it to the attention of Midwest; Midwest said, "Don't say anything about it." They didn't say anything about it, and they went ahead and they filed their -- gave First Securities a clean bill of health with the SEC.

QUESTION: Mr. Lassers, could I ask you a question which I should have asked your colleague, Mr. King? Is he the author of a leading biography on Chief Justice Fuller?

MR. LASSERS: Yes, he is.

QUESTION: Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Gonson.

ORAL ARGUMENT OF PAUL GONSON, ESQ.,

ON BEHALF OF THE SECURITIES AND EXCHANGE

COMMISSION AS AMICUS CURIAE

MR. GONSON: Mr. Chief Justice, and may it please the Court:

The basic position of the SEC in this case, assuming

that the auditor's conduct below was not more than negligent, is that the judgment should be rendered for Ernst & Ernst. And this is so on a very simple basis.

Because the plaintiffs in this case, Respondents here, in their capacity as escrow investors, were not reasonably foreseeable by Ernst & Ernst, and, as they concede, they did not rely on any audit prepared by Ernst & Ernst.

Now, we share with Ernst & Ernst and with the amicus American Institute of Certified Public Accountants a reluctance to expose accounting firms to potential damages in vast amounts for negligence in cases where it strikes one's basic sense of fairness that such damages should not be imposed.

But Ernst & Ernst comes to this Court in this quite unusual case, factually, quite an untypical case, and asks that the baby be thrown out with the bath water. It asks this Court to enunciate a rule that, if accepted, would also bar recovery in the meritorious cases, the more typical cases, the cases where a sense of fairness would say to one that perhaps damage judgments should be awarded.

Now, if this Court wishes to develop such a broad rule respecting the liability of auditors for negligence, then we have offered in our brief -- and which I'll speak to briefly today -- what we think is a sound approach in doing so.

But in developing such a broad rule in this case, this Court would then be called upon to strike an appropriate

balance between two important competing policies.

On the one hand, there is the necessity of maintaining high professional standards of accountants, because of their extremely important role with respect to the federal securities laws. This country's system of such laws is dependent on the disclosure, the integrity of disclosures which are made to investors. And auditors are recognized as having a public duty in that respect, to safeguard the interests of the public who read their reports, more so than an interest to safeguard the auditor's clients.

Auditors are called upon to certify financial statements contained in a wide variety of documents required to be given to investors by public companies and to be filed with the SEC. In many instances, the opinion of the auditing firm is essential before securities may be offered to the public, or placed privately. Thus, the continued confidence of the public in the securities laws of this country has to rest, to some great extent, on the shoulders of the accounting profession.

Now, when I say this I don't mean to suggest that auditors are insurers of the honesty of their clients, certainly they are not, and they have no obligation affirmatively to seek out fraud; nor should they have any liability of any kind for honest professional judgments which turn out, on hindsight, to have been erroneous.

But the auditor is in a peculiarly advantageous

position to detect and to stop fraud in its insipiency.

The question here is: what if he fails to do that, through negligence, and investors are injured?

Now, we doubt that this Court would wish to say that there never could be a case under any circumstances under 10b-5 where an injured investor might recover damages against an auditor whose professional conduct fell below the standards of his profession.

QUESTION: Mr. Gonson, is there anything the Securities and Exchange Commission itself can do to a fraudulent auditor?

MR. GONSON: Well, certainly. There are remedies that are available to the Securities and Exchange Commission. It could sue an auditor for an injunction, pursuant to the provisions of the Securities Exchange Act; and, under appropriate circumstances, it could bring disciplinary proceedings under Rule 2(e) of its Rules of Practice.

This Court has recognized in several cases that private causes of action are an effective supplement to the SEC's own enforcement procedure.

QUESTION: Well, you seem to anticipate my next question: Have you taken any action against Ernst & Ernst?

MR. GONSON: In this case? Not to my knowledge, Your Honor.

QUESTION: What role, if any, do you think Section

17(a) of the Exchange Act plays, or ought to play?

MR. GONSON: Well, this raises a question, to which, of course, Justice White alluded earlier, and that is that it does not appear to have been ruled on in the court below.

QUESTION: The court below discussed it in part -- what -- part 2 or part 3 of its opinion. Part 2 of its opinion.

MR. GONSON: Yes. It's a question as to whether --

QUESTION: Just in saying that it was a statutory --

MR. GONSON: Yes, that a private right of action could be created; and beyond there, of course, there would be the question whether, in this case, the requirements of 17(a) as it existed at the time of this action were met, which is a separate factor here.

QUESTION: Well, you're going, as I understand you, a little beyond the metes and bounds of this case in talking generally about what the rule ought to be. And it was in that connection that I asked you the question, What role, if any, do you think -- What function, if any, do you think Section 17(a) ought to play in deciding the question of civil liability of accountants? To investors, under 10(b).

MR. GONSON: Well, that rule, of course, would -- I am speaking much more broadly than with respect to just the audit of broker-dealers --

QUESTION: That's what I thought.

MR. GONSON: -- and that rule is of course a rule that relates to the auditor of broker-dealers.

And the Commission has not prepared a position, Your Honor, today with respect to what role Section 17(a) should play in this case.

Rather, we're addressing ourselves to the role of Section 10(b) and 10b-5.

QUESTION: Okay.

MR. GONSON: Now, we think that an appropriate balance, then, must be struck between a sufficiently broad standard of culpability to reinforce this important right of investors to receive accurate information, and the need to avoid unfairness to particular accountants by subjecting him for damages to negligence to persons who did not rely on his conduct.

Now, the question is, how is this balance to be struck? Where should the Court look to for guidance to structure the contours of an appropriate damage remedy?

Before I do get to that, I want to make two brief points.

First, in this case, we do agree with the Respondents that negligent conduct is sufficient to establish a violation of Section 10 and Rule 10b-5, but it does not follow that every negligent violation should give rise to a money damages remedy. Thus we separate out the two questions.

The first, is there a violation of the section; and, second, what should the remedy be?

I agree with Mr. Berner, Ernst & Ernst's counsel, that the legislative history on 10(b) is far from conclusive, but I offer to this Court that there is nothing in the phrase, "any manipulative or deceptive device or contrivance", which limits conduct only to that which is done intentionally.

Indeed, when Congress wanted to limit the Act to willful conduct, both with respect to violations and with respect to civil liability for those violations, it specifically said so.

QUESTION: But don't the terms "manipulative" and "deceptive" both, at least to the common mind, convey a sense of intent as well as the objective result of the action? Can you negligently manipulate something?

MR. GONSON: Well, I would respectfully disagree, Your Honor. I think that the phrase, "manipulative and deceptive", refers not to any particular state of mind, but, rather, to the conduct, or to the effective conduct. If one looks at the phrases that Congress used in the various civil liability provisions which are set forth in our brief and in the other briefs, and when they wished to connote conscious or intentional wrongdoing they use phrases like this, they said, "did not know".

QUESTION: Well, what is a manipulative practice

that could be negligently carried on?

MR. GONSON: I'm not sure what a manipulative practice that could be negligently carried on is, but I think I know what a deceptive practice that could be negligently carried on is, and that's the kind of a practice where a person, through failure to adhere to the standards of his profession, like an accountant, causes financial statements to be deceptive, and to mislead persons.

QUESTION: Well, of course the statute doesn't use the word "practice", it uses "device or contrivance", nouns that are derived from verbs -- from the verbs, "devise" or "contrive", and those are affirmative verbs, those are not negligent verbs.

MR. GONSON: That's true, Your Honor. I would not disagree with that.

But I would point out that in section 9 of the Securities Exchange Act, in the subdivisions -- in that section, this is the section that deals with the prohibition against effecting transaction under Securities Exchange for the purpose of influencing the price. And that section and several sub-sections prohibits these practices "for the purpose of" doing such-and-such.

And the civil liability section, which is Section 9(e) imposes liability on a person who "willfully violates"; so at least we have in some sections an indication of the state

of culpability required.

We have in 10(b) at least an ambiguous phrase, and I would suggest that in this situation we look to the admonition of this Court, as emphasized again and again, that when the Court is construing the federal securities laws, and particularly Rule 10b-5, since they are remedial legislation these laws should be construed not technically and not restrictively, but flexibly, in order to effectuate the remedial purposes.

QUESTION: We are dealing here with a cause of action that has been implied, aren't we? And the problem is how to construe the law with respect to the standard of performance that's to be required.

Now, why shouldn't we look to some other provisions in the Act, to see what -- for some guidance? Then, if you did, what would be the nearest guide to this standard? Congress has provided a whole range of standards in various sections, all the way from strict liability to negligence to deliberateness.

MR. GONSON: That's right, Your Honor.

QUESTION: Now, what section is most -- is nearest to this one? Is there any?

MR. GONSON: Well, we do note in our brief, Your Honor, we're now going to the question of remedy as distinguished from the question of whether there was a violation, I believe.

QUESTION: Well, no, I just -- you say that negligence

is enough. Well, under some sections of violative law, negligence is not enough.

MR. GONSON: I'm saying that, Your Honor, even though in a particular case a person may be held to have negligently violated the law, it still might be improper to enforce damages under --

QUESTION: Well, I understand that. I understand that. But I still want to know -- at the outset, we want to know whether the proof of negligence is enough.

Now, Congress has said in some sections that where it has provided the standard itself, it has said that negligence is not enough.

MR. GONSON: Your Honor, that's correct. We --

QUESTION: And aren't there some sections that are pretty close to this that require more than just negligence?

MR. GONSON: Yes, Your Honor. There are a series of sections that require -- that would impose liability absolutely, without fault, as you've indicated; and there are --

...

QUESTION: That's just negligence.

MR. GONSON: That's correct.

-- and there are sections, on the other hand, that would impose liability only for more than negligence. But there are a series of sections that do impose liability on a duty to discover kind of theory, and which give defenses to persons, to show that they made a reasonable investigation and

in the exercise of making that investigation they had no basis upon which to discover that the information contained was false and misleading.

And that, I suppose, is close to a negligent standard. And we think that if, in applying the question of whether damages should be assessed, rather than deciding on negligence yes, or negligence no, it is helpful to look to the pattern of civil liabilities that do exist in the Act, and we have done that in our brief, and we have extrapolated from them what we think is a very useful guide.

And if we apply these principles to damage actions under Section 10(b) and Rule 10b-5, then recovery would be permitted for violations which were committed only negligently under three circumstances: one, the defendant knew or had reason to believe that the plaintiff would rely on his conduct; secondly, the plaintiff did in fact so rely; and, thirdly, the amount of the plaintiff's damages are fairly ascertainable.

QUESTION: But that's not this case.

MR. GONSON: No, sir; that is not this case. And because --

QUESTION: What case are you arguing, then?

MR. GONSON: I am speaking largely to a possible rule that this Court, if it desires to, could issue on the subject of auditor negligence may do.

QUESTION: I see.

MR. GONSON: In this case we believe that applying those guidelines, that the record would not justify a recovery for the plaintiffs.

QUESTION: I understand.

QUESTION: Mr. Gonson, how, in this case, just following the literal text of the rule, can you say that whatever Ernst & Ernst did that might have violated subsection (b) was done in connection with the purchase or sale of any securities?

MR. GONSON: Well, I suppose that the Respondents would take the position that --

QUESTION: Well, you're taking a position, too, that they could be held liable here, so it isn't just what the Respondents would say.

MR. GONSON: Oh, I'm sorry, Your Honor, I misunderstood your question.

I believe that the issuance by Nay of these notes to these investors was the issuance of securities, and I would think that upon that, the "in connection" phrase probably is satisfied by the reading of this Court in the Superintendent case, that this activity sufficiently touches upon that transaction.

QUESTION: Even though these people never relied on the statement, and never saw them apparently?

MR. GONSON: Well, I'm not urging for that result, Your Honor, but I think that the "in connection with" phrase

could be satisfied by tying the issuance of the note by Nay to the conduct which covered up his transactions.

QUESTION: But if it winds up that we ought to affirm on the principles you suggest rather than those followed by the Court of Appeals, what, as to Ernst & Ernst, do you contemplate is left of the case when it gets back to the District Court?

MR. GONSON: The complaint does not allege negligence, nor does it allege intentional or reckless conduct; it simply alleges facts. It alleges that there was a failure of the auditors to perform properly.

The issue of negligence seems to have arisen later in the case.

We don't know -- we were invited into the case, of course, at this level, before this Court. We do not know whether, if they had been advised early in the game, that they would have pleased something more than negligence. Perhaps wanton or heedless conduct.

And so we were reluctant, even though we tend to agree that judgment should be for Ernst & Ernst, to foreclose them from the possibility of making that argument, if it's their command.

QUESTION: But it would have to be an argument on something more than negligence?

MR. GONSON: Yes, Your Honor.

QUESTION: There would have to be an amendment which alleged at least recklessness.

MR. GONSON: Well, there would have to be, I think, proof that would establish recklessness.

QUESTION: Also an amendment, would there not have to be?

MR. GONSON: Well, the complaint does not, as I say, allege any standard, it simply alleges facts.

Thank you.

MR. CHIEF JUSTICE BURGER: Thank you.

Mr. Berner, do you have anything further? You have about three minutes remaining.

REBUTTAL ARGUMENT OF ROBERT L. BERNER, JR., ESQ.,

ON BEHALF OF THE PETITIONER

MR. BERNER: With respect to the question that has attracted some attention, as to what is alleged in the complaint, what the theories are and what the facts are, I would point to the third defense of Ernst & Ernst in its answer filed in this case.

It's at page 24 of the Appendix. In which the statement is made that "Ernst & Ernst had no knowledge of any conduct of Nay alleged to be fraudulent in the Second Count. Without such knowledge, Ernst & Ernst could not aid or abet Nay's alleged fraudulent conduct."

I believe this should answer questions as to whether

the possibility of proving, or the issue as to recklessness or fraud was ever raised in this case. It was raised in the answer to the complaint.

QUESTION: Would you say that you could aid or abet without any knowledge, would be quite different from the use of those terms as words of art in the field of criminal law, would it not?

MR. BERNER: Well, my point is that when we -- by this defense we raise the issue as to the level of culpability, and this defense tends to set out fairly clearly that the Petitioner, who was defendant below, would take the position that without some knowledge, some scienter, there could be no recovery.

This is in response to the discussion as to whether the Respondents should be permitted to return to the District Court and not amend their complaint, as I understand it, but simply to make a new argument, which we think is unwarranted.

I would like also to point out that the record establishes very clearly that Ernst & Ernst in fact did review the system of internal accounting controls.

And with respect to the mail rule, it has never been shown in this case, and there is no evidence which supports the causal connection. This issue was not included in the petition for certiorari, but was argued below.

And to explain the immateriality of a mail rule,

if Nay had said to these people, "Please address your mail to me, to Lock Box 1, or First Securities Company Lock Box 1", that he opened himself, they would have done it. And to think that to require an accountant to review all of the incoming mail of all of the officers and directors of a brokerage house, in circumstances such as this, to think that that is -- that itself is a derogation of generally accepted auditing standards and is fraud, we submit is absurd.

And, finally, I would say --

QUESTION: I thought that part of the alleged fraudulent conduct and scheme on the part of Nay was that he used First Securities, he used their stationery and he used the office, and the communications were sent to him at First Securities. And if he had told the plaintiffs, "When you communicate with me about this escrow business, you have to do it through Lock Box 1", that might well have raised their suspicions. That's the point of --

MR. BERNER: Well, --

QUESTION: That's part of the fraud, was using First Securities. Wasn't it? As alleged.

MR. BERNER: That's as alleged. But --

QUESTION: Yes.

MR. BERNER: -- it also is reasonable to assume that he specifically told these people to address all mail to him in connection with the escrow to his attention or to him

personally, because, as the record indicates, he told them he didn't want anyone at First Securities to know about these investments. He didn't want -- this was a company whose name he never revealed, and it should be -- it should remain confidential.

QUESTION: Yes.

QUESTION: So that, from your point of view, would alert as much -- should have alerted them as much as the hypothetical that Mr. Justice Stewart gave to you a moment ago about the Lock Box.

MR. BERNER: It should have alerted the Respondents.

QUESTION: Yes.

MR. BERNER: Yes, sir. Right.

QUESTION: May I ask a question? One of the allegations by Respondents, relating to the net capital deficit, is that there was a concealment by Ernst & Ernst.

If you've addressed that, I don't recall it.

MR. BERNER: I did not. The net capital violation was a temporary violation as of October 31, 1967. It was a $9,000 net capital violation that Ernst & Ernst discovered in the course of its audit, and which it reported to the Midwest Stock Exchange.

And the Midwest Stock Exchange advised -- at the time of reporting it, they also advised the Midwest Stock Exchange that the net capital violation had been remedied, and there was

no longer a violation at the time of reporting, which was several weeks after the date as of which the audit was being made.

And the officer of the Midwest Stock Exchange, Mr. Rothing, advised Ernst & Ernst to -- not to note the net capital violation on the year-end audit, because it had been corrected.

QUESTION: The full extent of it was only $9,000?

MR. BERNER: Yes, sir.

QUESTION: This was an oral report, was it not?

MR. BERNER: No, this was on the certified financial statements that were to be submitted to the Midwest Stock Exchange.

QUESTION: But the communication between Ernst & Ernst and the Stock Exchange --

MR. BERNER: Oh, yes, sir, it was oral, but it's memorialized in a memorandum. It's in the record. It is undisputed. There's no dispute about the facts I have just mentioned.

QUESTION: But I think there's some point made of the fact that this was done orally and not officially and in writing; isn't that correct?

MR. BERNER: Well, as I understand it, yes, the argument is that it was done informally rather than formally.

QUESTION: Right, informally.

MR. BERNER: I'm not sure what "formally" means.

QUESTION: Well, among other things, I think maybe it means just the oral nature of it.

QUESTION: But didn't you say it was confirmed in writing?

MR. BERNER: No, the fact of the telephone conversation between Mr. Hooker and Mr. Rothing is the subject of a memorandum that's in the record.

QUESTION: A unilateral memorandum, isn't it?

MR. BERNER: I beg pardon?

QUESTION: Of a one-way -- a unilateral memo.

MR. BERNER: Yes. And Mr. Rothing testified as to the conversation in related litigation.

QUESTION: Right.

MR. BERNER: And testified that he instructed Ernst & Ernst not to include the existence of this, by then cured, violation.

QUESTION: Right.

QUESTION: What is the total amount of damages claimed in this case?

MR. BERNER: The total amount of damages is $1,056,000 plus attorneys' fees. That is compared to the annual fee received by Ernst & Ernst of between $2,000 and $2500 for making, for performing these audits.

The damages have been reduced by approximately

$200,000 which the Respondents will be receiving, as they indicate in their brief, out of the receivership proceeding.

Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.

The case is submitted.

[Whereupon, at 11:27 o'clock, a.m., the case in the above-entitled matter was submitted.]

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