



---

Summer 6-1-1994

## Freedom of Contract: The Trojan Horse of Rule 10b-5

Margaret V. Sachs

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/wlulr>



Part of the [Contracts Commons](#), and the [Securities Law Commons](#)

---

### Recommended Citation

Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 Wash. & Lee L. Rev. 879 (1994).

Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol51/iss3/4>

This Article is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact [christensena@wlu.edu](mailto:christensena@wlu.edu).

# Freedom of Contract: The Trojan Horse of Rule 10b-5

Margaret V Sachs\*

## *Introduction*

Before the late 1980s, traditional contract law played virtually no role in private litigation under section 10(b)<sup>1</sup> of the Securities Exchange Act of 1934<sup>2</sup> and rule 10b-5.<sup>3</sup> The reason was perceived incompatibility

---

\* Associate Professor, University of Georgia School of Law A.B. 1973, Harvard University; J.D. 1977, Harvard Law School. The author wishes to express her appreciation to Barbara Black, Douglas M. Branson, Lynne L. Dallas, Helen A. Garten, James D. Gordon III, Robert W. Hillman, Therese H. Maynard, Alexander M. Meiklejohn, Robert C. Power, Joel Seligman, Morgan Shipman, Larry D. Soderquist, and Edward D. Spurgeon for their helpful comments on earlier drafts of this article.

1. Section 10 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1988) [hereinafter § 10(b)].

2. Securities Exchange Act of 1934, 15 U.S.C. § 78(a)-(kk) (1988) [hereinafter 1934 Act].

3. Rule 10b-5, promulgated by the Securities and Exchange Commission (SEC) in 1942, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light

The 1934 Act is regulation intended to supersede "the philosophy of *caveat emptor*,"<sup>4</sup> whereas traditional contract law promotes bargaining free of regulation.<sup>5</sup> In the late 1980s, however, the tide turned. Since that time, private rule 10b-5 litigation has become riddled with the vocabulary of traditional contract jurisprudence—the statute of frauds,<sup>6</sup> merger clauses,<sup>7</sup> attorneys' fees clauses,<sup>8</sup> choice of law clauses,<sup>9</sup> releases,<sup>10</sup> and the formation of an agreement.<sup>11</sup> Thus, today lower

- of the circumstances under which they were made, not misleading, or  
 (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,  
 in connection with the purchase or sale of any security

17 C.F.R. § 240.10b-5 (1994) [hereinafter rule 10b-5].

Neither rule 10b-5 nor § 10(b) expressly creates a private right of action. *See supra* notes 1 and 3. Beginning with *Kardon v National Gypsum Co.*, 69 F Supp. 512 (E.D. Pa. 1946), however, lower federal courts implied a private action for violations of the rule. The Supreme Court first recognized a private right of action under rule 10b-5 in *Superintendent of Ins. v Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). The Court has subsequently observed that the "existence of this implied remedy is simply beyond peradventure." *Herman & MacLean v Huddleston*, 459 U.S. 375, 380 (1983). For discussions of the Supreme Court's § 10(b) and rule 10b-5 jurisprudence, see David M. Phillips, *An Essay: Six Competing Currents of Rule 10b-5 Jurisprudence*, 21 IND. L. REV 625 (1988); Margaret V Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV 96 (1985); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV 385 (1990).

4. *Central Bank of Denver, N.A. v First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1445 (1994) (quoting *Affiliated Ute Citizens of Utah v United States*, 406 U.S. 128, 151 (1972)).

5. *See* GRANT GILMORE, DEATH OF CONTRACT 6-7 (1974).

6. *See* cases cited *infra* note 24.

7. *See* cases cited *infra* note 28.

8. *See* cases cited *infra* notes 31 and 32.

9. *See, e.g.*, *Bonny v Society of Lloyd's*, 3 F.3d 156, 161-62 (7th Cir. 1993); *Riley v Kingsley Underwriting Agencies, Ltd.*, 969 F.2d 953 (10th Cir.) (upholding validity of choice of law and forum selection clauses), *cert. denied*, 113 S. Ct. 658 (1992).

10. *See, e.g.*, *Finn v Prudential-Bache Secs., Inc.*, 821 F.2d 581 (11th Cir. 1987) (2-1 decision concerning validity of release), *cert. denied*, 488 U.S. 917 (1988).

11. *See, e.g.*, *Rudinger v Insurance Data Processing, Inc.*, 778 F Supp. 1334, 1338-39 (E.D. Pa. 1991) (finding agreement to exist); *Southwest Realty, Ltd. v Daseke*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,256, at 96,173 (N.D. Tex. May 9, 1990) (finding no agreement to exist).

federal courts<sup>12</sup> often derail rule 10b-5 actions in reliance on the same contract devices that earlier case law rejected as inimical to investor interests.<sup>13</sup>

Consider as an illustration the statute of frauds. It enters rule 10b-5 litigation in connection with whether the plaintiff has met the judicially created requirement for standing<sup>14</sup>—being a "purchaser" or "seller" of securities.<sup>15</sup> The 1934 Act defines a "purchase"<sup>16</sup> to include a "contract to purchase"<sup>17</sup> and a "sale"<sup>18</sup> to include a "contract to sell."<sup>19</sup> Yet the 1934 Act nowhere requires that these contracts be in writing.<sup>20</sup> When a rule 10b-5 plaintiff asserts standing to sue based on an oral contract, is the state statute of frauds a valid defense? Early case law answered emphatic-

12. State courts have been thought to lack jurisdiction over private rule 10b-5 litigation in accordance with the 1934 Act's exclusive jurisdictional grant in § 27, 15 U.S.C. § 78aa (1988). For the argument that § 27 does not govern private rule 10b-5 actions, see Margaret V. Sachs, *Exclusive Federal Jurisdiction for Implied Rule 10b-5 Actions: The Emperor Has No Clothes*, 49 OHIO ST. L.J. 559 (1988).

13. The author believes that private rule 10b-5 litigation is a valuable tool for enforcing the federal securities laws. See Sachs, *supra* note 3, at 132-37 (discussing enforcement function of private rule 10b-5 actions). *But cf.* Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV L. REV 961, 971-74 (1994) (describing controversy over value of private rule 10b-5 litigation).

14. The requirements for standing could not simply be inferred from the language of § 10(b) because the 1934 Congress did not contemplate private actions under that section. See *infra* notes 136-37 and accompanying text.

15. The Supreme Court upheld the purchaser-seller requirement in *Blue Chip Stamps v Manor Drug Stores*, 421 U.S. 723, 755 (1975). This judicially created doctrine originated in *Birnbaum v Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

16. Section 3(a)(13) of the 1934 Act, 15 U.S.C. § 78c(a)(13) (1988) [hereinafter § 3(a)(13)].

17. Section 3(a)(13) provides: "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire." 15 U.S.C. § 78c(a)(13) (1988).

18. Section 3(a)(14) of the 1934 Act, 15 U.S.C. § 78c(a)(14) (1988) [hereinafter § 3(a)(14)].

19. Section 3(a)(14) provides: "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." 15 U.S.C. § 78c(a)(14) (1988).

20. See *supra* notes 17 and 19 (providing definitions of "purchase" and "sale" under 1934 Act).

ally no: "Of course, state statutes of frauds do not bar recovery under [rule] 10b-5."<sup>21</sup> According to the view now gaining ground, however, an investor with an oral contract lacks standing to sue.<sup>22</sup> This view posits that the statute of frauds for securities transfers in Article 8 of the Uniform Commercial Code<sup>23</sup> applies full force to rule 10b-5 and must be "enforced rigorously"<sup>24</sup>

Merger clauses furnish a second illustration. Investors' contracts with sellers and brokers commonly include a clause providing that the writing supersedes any earlier representations or agreements, whether oral or

21. *Fogarty v Security Trust Co.*, 532 F.2d 1029, 1034 (5th Cir. 1976). Courts rejected the statute of frauds for the following reasons: remedial statutes such as § 10(b) should be read broadly, *e.g.*, *Desser v Ashton*, 408 F Supp. 1174, 1177 (S.D.N.Y. 1975), *aff'd mem.*, 573 F.2d 1289 (2d Cir. 1977); state law such as the statute of frauds is irrelevant to a federal statute, *e.g.*, *Markovich v Vasad Corp.*, 617 F Supp. 142, 146 (E.D. Pa. 1985); a writing requirement for broker-customer transactions is impractical, *see Horst v W T. Cabe & Co.*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,213, at 92,463-64 (S.D.N.Y. Oct. 31, 1977). Other cases rejecting the statute of frauds were *Reprosystem, B.V v SCM Corp.*, 727 F.2d 257, 265 (2d Cir.), *cert. denied*, 469 U.S. 828 (1984); *Omega Executive Servs., Inc. v Grant*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,889, at 95,655 (S.D.N.Y. May 25, 1979); *Kingstone v Oceanography Dev Corp.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,387, at 93,347 n.7 (S.D.N.Y. Apr. 11, 1978); *cf. Threadgill v Black*, 730 F.2d 810, 811-12 (D.C. Cir. 1984) (finding oral contract to suffice for standing, but without specifically mentioning statute of frauds). *But cf. Northland Capital Corp. v Silver*, 735 F.2d 1421, 1427 n.8 (D.C. Cir. 1984) (spotting but not resolving question of applicability of statute of frauds); *Geeting v Prizant*, 664 F Supp. 343, 346 (N.D. Ill. 1987) (same); *Bartels v Algonquin Properties, Ltd.*, 471 F Supp. 1132, 1149 (D. Vt. 1979) (same); *Colonial Realty Corp. v Brunswick Corp.*, 337 F Supp. 546, 553 (S.D.N.Y. 1971) (same); *Ross v Licht*, 263 F Supp. 395, 400 (S.D.N.Y. 1967) (same); *but see Southeastern Waste Treatment, Inc. v Chem-Nuclear Sys., Inc.*, 506 F Supp. 944, 955 (N.D. Ga. 1980) (upholding statute of frauds requirement for rule 10b-5).

22. Dismissal would not be required, however, where the statute of frauds contains a relevant exception. *See Markovich*, 617 F Supp. at 146 (statute of frauds would not bar rule 10b-5 action where the contract had been performed).

23. U.C.C. § 8-319 (1977).

24. *Pommer v Medtest Corp.*, 961 F.2d 620, 625 (7th Cir. 1992). *See Kagan v Edison Bros. Stores, Inc.*, 907 F.2d 690, 691 (7th Cir. 1990); *Pelletier v Stuart-James Co.*, 863 F.2d 1550, 1555 (11th Cir. 1989). *But cf. Chariot Group, Inc. v American Acquisition Partners, L.P.*, 751 F Supp. 1144, 1149 (S.D.N.Y. 1990) (rejecting statute of frauds in dictum but nonetheless dismissing action on ground that no contract existed), *aff'd mem.*, 932 F.2d 956 (2d Cir. 1992).

written.<sup>25</sup> Suppose an investor nonetheless relies on oral representations. If the investor later claims that the oral representations were fraudulent, is the merger clause a valid defense? In the vast majority of early cases, these clauses were not dispositive.<sup>26</sup> Today, on the other hand, the presence of a merger clause<sup>27</sup> is virtually certain to lead to dismissal of an investor's oral fraud action.<sup>28</sup>

---

25. For example, in *Jackvony v RIHT Fin. Corp.*, 873 F.2d 411 (1st Cir. 1989), the merger clause provided that the contract "constitutes the entire agreement and supersedes all prior agreements and understandings, both written and oral with respect to the subject matter." *Id.* at 416. Similarly, in *One-O-One Enters., Inc. v Caruso*, 848 F.2d 1283 (D.C. Cir. 1988), the merger clause provided that the contract "supersede[d] any and all previous understandings and agreements." *Id.* at 1285.

26. One court held that the presence of a merger clause was irrelevant to rule 10b-5, citing both § 29(a) of the 1934 Act and the approach taken by common law fraud. *See Lanza v Drexel & Co.*, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,826, at 90,101 n.14 (S.D.N.Y. Oct. 9, 1970), *aff'd*, 479 F.2d 1277 (2d Cir. 1973). The merger clause was at most one factor for consideration at trial in the following cases: *Rogen v Ilikon Corp.*, 361 F.2d 260, 268 (1st Cir. 1966); *Doody v E.F. Hutton & Co.*, 587 F. Supp. 829, 832 (D. Minn. 1984); *Caliber Partners, Ltd. v Affeld*, 583 F. Supp. 1308, 1311-12 & n.6 (N.D. Ill. 1984); *Esposito v Sweeney*, No. 80-C-2861 (N.D. Ill. May 13, 1982) (LEXIS, Genfed library, Dist file); *Allen Organ Co. v North Am. Rockwell Corp.*, 363 F. Supp. 1117, 1127 (E.D. Pa. 1973). *But cf. Zobrist v Coal-X, Inc.*, 708 F.2d 1511, 1517-18 (10th Cir. 1983) (giving merger clause some consideration in dismissal); *Rowe v Maremont Corp.*, 650 F. Supp. 1091, 1106 (N.D. Ill. 1986) (attaching significance to absence of merger clause), *aff'd on other grounds*, 850 F.2d 1226 (7th Cir. 1988); *NBI Mortgage Inv Corp. v Chemical Bank*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,066, at 91,801 (S.D.N.Y. May 24, 1977) (finding merger clause to warrant dismissal, but presenting alternative ground for dismissal as well); *but see Platsis v E.F. Hutton & Co.*, 642 F. Supp. 1277, 1299 (W.D. Mich. 1986) (giving merger clause substantial weight in dismissal), *aff'd*, 829 F.2d 13 (6th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988).

27. A merger clause with ambiguous wording is not given weight. *See, e.g., Astor Chauffeured Limousine Co. v Runnfeldt Inv Corp.*, 910 F.2d 1540, 1545-46 (7th Cir. 1990).

28. *See, e.g., Jackvony v RIHT Fin. Corp.*, 873 F.2d 411, 416 (1st Cir. 1989); *One-O-One Enters., Inc. v Caruso*, 848 F.2d 1283, 1286-87 (D.C. Cir. 1988); *Davidson v Wilson*, 763 F. Supp. 1465, 1466-67 (D. Minn. 1990), *aff'd*, 973 F.2d 1391, 1401 (8th Cir. 1992); *Jankovich v Bowen*, 844 F. Supp. 743, 747-49 (S.D. Fla. 1994); *Becherer v Merrill Lynch Pierce Fenner & Smith, Inc.*, 799 F. Supp. 755, 768 (E.D. Mich. 1992); *Branch-Hess Vending Servs. Employees' Pension Trust v Guebert*, 751 F. Supp. 1333, 1341 (C.D. Ill. 1990); *Braunstein v. Berman*, No. 89-5344, 1990 WL 192547, at \*8 (D.N.J. Sept. 12, 1990); *Arrizza v Jefferson Guar. Bank*, 696 F. Supp. 204, 208 (E.D. La. 1988); *Taylor v Door to Door Transp. Servs., Inc.*, 691 F. Supp. 27, 35 (S.D. Ohio 1988); *see also Pommer v*

Consider finally a clause obligating the investor to pay attorneys' fees incurred by his seller or broker in connection with the sale or account.<sup>29</sup> If the investor sues the seller or broker under rule 10b-5, does the clause provide a basis for a counterclaim for attorneys' fees? The early cases on this question produced a wide variety of answers.<sup>30</sup> Recent cases are

Medtest Corp., 961 F.2d 620, 625 (7th Cir. 1992) (citing *Jackvony* with approval); cf. *Astor Chauffeured Limousine Co. v Runnfeldt Inv Corp.*, 910 F.2d 1540, 1546 (7th Cir. 1990) (noting that differently worded merger clause would bar oral fraud claim). *But cf.* *Miltland Raleigh-Durham v Myers*, 807 F Supp. 1025, 1050 (S.D.N.Y. 1992) (rejecting "general" merger clause as defense to "specific" fraud allegations); *Connor v First of Mich. Corp.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,350 (W.D. Mich. May 31, 1990) (refusing to grant summary judgment to defendant on basis of merger clause).

29. For example, in *Samuels v. Wilder*, 871 F.2d 1346 (7th Cir. 1989), the clause provided that the investor:

agrees to indemnify the Nominee and to hold Nominee harmless from all liability, loss, expenses, damages, costs and attorney's [sic] fees that Nominee may at any time incur by reason of any type of inquiry, action or suit which may be brought against him or made of him [sic] by any person, firm, corporation, or governmental agency or authority or anyone else by reason of the nominee-ship.

*Id.* at 1351. In *Chee v Marine Midland Bank, N.A.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,806 (E.D.N.Y. Jan. 29, 1991), the investor agreed "to indemnify and hold [the broker] harmless from and to pay [the broker] promptly on demand any and all losses." *Id.* at 98,878. Some fees clauses make the investors liable for attorneys' fees that arise from their own false representations. *See, e.g.*, *Layman v Combs*, 981 F.2d 1093, 1099 (9th Cir. 1992). Such representations may include that the investors had relied only on the private placement memorandum and not on any oral statements. *See id.* Thus, in the latter situation the attorneys' fees clause gives teeth to what amounts to a merger clause.

30. In *Tartell v. Chelsea Nat'l Bank*, 351 F Supp. 1071 (S.D.N.Y.), *aff'd per curiam*, 470 F.2d 994 (2d Cir. 1972), the clause was held enforceable. *See id.* at 1079. In *Jackson v. Oppenheim*, 533 F.2d 826 (2d Cir. 1976), the clause was held unenforceable on the ground that it provided less notice than that in *Tartell*. *See id.* at 831, *see also* *Ging v Parker-Hunter, Inc.*, 544 F Supp. 49, 54 (W.D. Pa. 1982) (granting plaintiff's motion to strike defendant's counterclaim for fees because fees clause was not sufficiently specific). In *Zissu v Bear, Stearns & Co.*, 805 F.2d 75 (2d Cir. 1986), the clause was held unenforceable for lack of specificity, but the court left open the question of whether such a clause was objectionable on federal policy grounds that were not otherwise specified. *See id.* at 79-80. In *Doody v E.F. Hutton & Co.* 587 F Supp. 829 (D. Minn. 1984), the court rejected the clause because of its tendency to operate as a disincentive to sue. *See id.* at 833. In *Maryville Academy v Loeb Rhoades & Co.*, 530 F Supp. 1061 (N.D. Ill. 1981), the court rejected the clause for reasons of "public policy" in connection with primary liability, but not vicarious liability. *See id.* at 1073.

more consistent. Almost all perceive the validity of fees clauses as simply a question of contract law, with the 1934 Act either irrelevant<sup>31</sup> or else satisfied by a clause that gives clear notice of its reach.<sup>32</sup>

Why does rule 10b-5 jurisprudence now embrace the contract law it previously rejected? The turnabout is explainable, but not defensible. One factor is the impact of the Supreme Court's 1987 decision in *Shearson/American Express, Inc. v McMahon*.<sup>33</sup> Read narrowly, *McMahon* held only that an investor with a rule 10b-5 claim is bound by an arbitration clause.<sup>34</sup> Yet *McMahon* left uncertain whether such an investor would likewise be bound by other types of contract clauses. That *McMahon* reached only arbitration clauses seemed to follow from the opinion's stress on the strong federal policy favoring arbitration.<sup>35</sup> Yet the opinion also seemed to imply a tolerance of, or even an invitation to, the more general use of contract law to defeat investors' claims.<sup>36</sup> This broad reading of *McMahon* is simply not viable, however, in the wake of the Court's 1989

---

31. See *McGuire v Miller*, 1 F.3d 1306, 1313 (2d Cir. 1993); *Samuels v Wilder*, 871 F.2d 1346, 1352 (7th Cir. 1989).

32. See, e.g., *Layman v Combs*, 981 F.2d 1093, 1101 (9th Cir. 1992) (finding notice inadequate); *Hill v Equitable Bank*, No. 82-220-CMW, 1991 WL 169371, at \*3 (D. Del. Aug. 28, 1991) (same); *Chee v Marine Midland Bank, N.A.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,806, at 98,881 (E.D.N.Y. Jan. 29, 1991) (same); *Stratmore v Combs*, 723 F. Supp. 458, 463 (N.D. Cal. 1989) (same); see also *Barnebey v E.F. Hutton & Co.*, 715 F. Supp. 1512, 1521-22 (M.D. Fla. 1989) (denying plaintiff's motion to hold clause unenforceable on the ground that plaintiff should be held to his contract); *McCain v Phoenix Resources, Inc.*, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,834, at 94,531 (S.D.N.Y. Nov. 16, 1989) (deferring until trial question of sufficiency of notice). But see *Fulco v Continental Cablevision, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,345, at 96,672 (D. Mass. June 19, 1990) (finding clause unenforceable because of insufficient notice and in the alternative because of its tendency to discourage filing of rule 10b-5 actions).

No court has yet addressed whether an attorneys' fees clause is enforceable against an investor who wins her case. See *infra* note 267 and accompanying text.

For illustrative additional contract devices arising under rule 10b-5, see *supra* notes 9-11 and accompanying text.

33. 482 U.S. 220 (1987).

34. See *Shearson/Am. Express, Inc. v McMahon*, 482 U.S. 220, 238 (1987).

35. See *id.* at 225-27.

36. *McMahon* confined analysis of § 29(a) to a hypertechnical examination of its language. See *infra* notes 86-92 and accompanying text.



decision in *Rodriguez de Quijas v Shearson/American Express, Inc.*<sup>37</sup> Although *Rodriguez* was a replay of *McMahon* within the context of the Securities Act of 1933,<sup>38</sup> the Court did not summarily rely upon *McMahon*'s reasoning. Instead, the *Rodriguez* Court prohibited waiver of any 1934 Act provision necessary to "place buyers of securities on an equal footing with sellers,"<sup>39</sup> and thereby subordinated contract law to investor protection.<sup>40</sup>

The second factor is the influence of the law-and-economics movement, which postulates generally that the ultimate social goal is wealth maximization<sup>41</sup> (also known as efficiency)<sup>42</sup>—a goal whose achievement depends on the enforcement of private contracts.<sup>43</sup> Drumming the virtues of the law-and-economics movement into the federal judiciary are Dean Henry Manne's economics institutes for federal judges, of which one-third of presently sitting federal judges are now graduates;<sup>44</sup> a cadre of former law-and-economics academics—such as Judges Richard Posner and Frank Easterbrook—appointed to the federal bench by President Reagan;<sup>45</sup> and vast quantities of current legal scholarship.<sup>46</sup> The United States Supreme Court

37. 490 U.S. 477 (1989).

38. Securities Act of 1933, 15 U.S.C. § 77(a)-(mm) (1988) [hereinafter 1933 Act]. The legislative history of the 1933 and 1934 Acts is assembled in LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973) [hereinafter LEGISLATIVE HISTORY].

39. *Rodriguez de Quijas v Shearson/Am. Express, Inc.*, 490 U.S. 477, 481 (1989). The *Rodriguez* Court found the arbitration clause enforceable on the ground that the clause did not waive a protection that was essential to securities buyers. *See id.* at 483.

40. *See infra* notes 95-103 and accompanying text.

41. *See* RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 1.2, at 13 (4th ed. 1992).

42. *Id.*

43. *See id.* at 13-15. An outcome is efficient if the gain to society exceeds the loss. *Id.* at 13-14.

44. This information, current as of June 30, 1993, comes from Professor Richard Fielding, Director of the Law & Economics Center at George Mason University. *See also* Parnela Dwyer, *Law and Economics: A New Order in the Court?*, *BUS. WK.*, Nov. 16, 1987, at 93 (stating that Manne claims 40% of sitting federal judges have attended his course).

45. *See* HERMAN SCHWARTZ, *PACKING THE COURTS* 68-70, 89 (1988) (discussing appointments of Posner and Easterbrook); Dwyer, *supra* note 44, at 93 (discussing Posner and Easterbrook and their place in law-and-economics movement).

46. The impact of law-and-economics on legal scholarship is evident from the wide

has, however, recently dealt the law-and-economics movement a blow by holding that its precepts do not control the elements of rule 10b-5. The blow came in the June 1993 decision in *Musick, Peeler & Garrett v Employers Insurance of Wausau*.<sup>47</sup> At issue in *Musick* was whether rule 10b-5 permits a right of contribution among joint tortfeasors.<sup>48</sup> In upholding this right,<sup>49</sup> the Court expressly rejected all efficiency arguments that the parties' briefs presented: "Our task is not to assess the relative merits of the competing rules, but rather to infer how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act."<sup>50</sup>

Despite the Court's clear signals, there is the distinct possibility that lower federal courts will ignore both *Musick* and *Rodriguez*. Indeed, *Rodriguez* is widely cited for upholding arbitration provisions under the 1933 Act,<sup>51</sup> but not for having broken with *McMahon* on how to determine when an investor is contractually bound.<sup>52</sup> *Musick* may well suffer an analogous fate: renown for its approval of contribution coupled with disregard of its rejection of efficiency.

variety of subject areas in which "private ordering" has become analytically critical. See, e.g., Michael I. Krauss, *Tort Law and Private Ordering*, 35 ST. LOUIS U. L.J. 623 (1991); Marjorie M. Schultz, *Contractual Ordering of Marriage: A New Model for State Policy*, 70 CAL. L. REV. 204 (1982); Michael E. Solimine, *Forum-Selection Clauses and the Privatization of Procedure*, 25 CORNELL INT'L L.J. 51 (1992).

47. 113 S. Ct. 2085 (1993).

48. *Musick, Peeler & Garrett v Employers Ins. of Wausau*, 113 S. Ct. 2085, 2086 (1993).

49. *Id.* at 2092.

50. *Id.* at 2089-90. In its 1994 decision rejecting aiding and abetting liability under § 10(b), the Court has again insisted upon the necessity of interpreting rule 10b-5 consistent with the intent of Congress: "The issue is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute." *Central Bank of Denver, N.A. v First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1448 (1994).

51. See, e.g., *Bird v ShearsonLehman/Am. Express, Inc.*, 926 F.2d 116, 118 (2d Cir.), cert. denied, 501 U.S. 1251 (1991); *A/S Ivarans Rederi v United States*, 895 F.2d 1441, 1446 (D.C. Cir. 1990); *Uitley v Goldman Sachs & Co.*, 883 F.2d 184, 186 (1st Cir. 1989), cert. denied, 493 U.S. 1045 (1990).

52. *McMahon* and *Rodriguez* are widely perceived as consistent. See, e.g., 2 THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* § 14.4, at 247, 252-53 (Practitioners' ed. 1990); Lewis D. Lowenfels & Alan R. Bromberg, *Securities Industry Arbitrations: An Examination and Analysis*, 53 ALB. L. REV. 755, 758-69 (1989).

Lower federal courts should resist the allure of efficiency considerations and come to terms with *Musick* and *Rodriguez*. Both decisions call the federal securities laws back to their regulatory roots. In the wake of these decisions, a court should import a contract device into rule 10b-5 only if the device is demonstrably anchored in the language, history, or policies of the 1934 Act.<sup>53</sup>

Part I contrasts the federal securities laws with the approach of law-and-economics. The two diverge sharply, and to merge them carries a price. The law-and-economics approach teaches that to maximize efficiency one must maximize freedom of contract.<sup>54</sup> Hence that approach champions the use of traditional contract devices such as the statute of frauds,<sup>55</sup> merger clauses,<sup>56</sup> and attorneys' fees clauses.<sup>57</sup> These devices

---

53. The author believes that legislative history and statutory policies are essential to the interpretation of the federal securities laws. See Margaret V. Sachs, *Are Local Governments Liable Under Rule 10b-5? Textualism and Its Limits*, 70 WASH. U. L.Q. 19, 26-31 (1992) (discussing importance in securities cases of legislative history and statutory purpose); Margaret V. Sachs, *The International Reach of Rule 10b-5: The Myth of Congressional Silence*, 28 COLUM. J. TRANSNAT'L L. 677, 689-713 (1990) (using legislative history to ascertain appropriate international reach of rule 10b-5); Sachs, *supra* note 3, at 126-37 (using statutory policies to determine whether rule 10b-5 private action should include element of reasonable reliance). It is refreshing to see these matters given their due in *Musick* and *Rodriguez*. Of course, the private action under § 10(b) was judicially implied rather than expressly created by Congress. See *supra* note 3 (describing history of implied right of action). Hence for matters peculiar to the § 10(b) private action, it is necessary to deduce what Congress would have done had it created such an action. See *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1446 (1994) (mentioning need to "infer how the 1934 Congress would have addressed the issue[s] had the 10b-5 action been included as an express provision in the 1934 Act") (quoting *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 113 S. Ct. 2085, 2090 (1993)). See generally Sachs, *supra* note 3, at 114-140 (discussing methodology for deriving congressional intent).

54. See *infra* note 75 and accompanying text.

55. See *infra* note 125 and accompanying text. The statute of frauds is thought to further efficiency by eliminating the uncertainties of oral bargains. See *infra* note 125 and accompanying text. Yet it abridges contractual freedom because the requirement of a writing prevents the parties from choosing to have an oral contract. See Morton J. Horwitz, *The Transformation of American Law*, in *THE ECONOMICS OF CONTRACT LAW* 250, 253-54 (Anthony T. Kronman & Richard A. Posner eds., 1979).

56. See *infra* note 220 and accompanying text.

57. See *infra* note 276 and accompanying text.

often derail rule 10b-5 actions,<sup>58</sup> thereby benefiting defendants and the status quo.<sup>59</sup> This in turn contributes to the creation of the very *caveat emptor* world that the federal securities laws were intended to overcome.<sup>60</sup>

Parts II, III, and IV apply *Musick* and *Rodriguez* to the statute of frauds, merger clauses, and attorneys' fees clauses in private rule 10b-5 litigation. Rule 10b-5 case law accepting these devices relies on efficiency rationales and disregards both the statutory text on the one hand and the realities of securities transactions on the other.<sup>61</sup>

Part V examines the cumulative consequences of derailing rule 10b-5 actions through the use of contract devices. The actions most at risk are those involving transfers of close corporation stock,<sup>62</sup> private placements,<sup>63</sup> and customer-broker disputes.<sup>64</sup> These actions perform essential regulatory functions, and their derailment jeopardizes those functions.

### *I. The Regulatory Nature of the 1934 Act*

In its 1993 decision in *Musick, Peeler & Garrett v Employers Insurance of Wausau*,<sup>65</sup> the Supreme Court refused to allow law-and-economics precepts to control the interpretation of the 1934 Act.<sup>66</sup> At issue in *Musick* was whether rule 10b-5 permits a right of contribution

---

58. For cases accepting a statute of frauds defense to rule 10b-5 actions, see *supra* note 24. For cases accepting a merger clause defense to rule 10b-5 actions, see *supra* note 28. For cases holding attorneys' fees clauses enforceable against rule 10b-5 plaintiffs, see *supra* notes 31 and 32.

59. See generally Douglas M. Branson, *A Corporate Paleontologist's Look at Law and Economics in the Seventh Circuit*, 65 CHI.-KENT L. REV. 745, 752-55 (1991) (showing that law-and-economics approach is "Darwinian" at its core).

60. See *supra* note 4 and accompanying text.

61. For a discussion of the statute of frauds defense to rule 10b-5, see Part II *infra*. For a discussion of the merger clause defense to rule 10b-5, see Part III *infra*. For a discussion of attorneys' fees clauses in rule 10b-5 litigation, see Part IV *infra*.

62. See cases cited *infra* note 297.

63. See cases cited *infra* note 298.

64. See cases cited *infra* note 299.

65. 113 S. Ct. 2085 (1993).

66. *Musick, Peeler & Garrett v Employers Ins. of Wausau*, 113 S. Ct. 2085, 2089-90 (1993).

among joint tortfeasors.<sup>67</sup> The parties' briefs urged that resolution of this issue turned on whether a "contribution" rule or a "no contribution" rule was more efficient.<sup>68</sup> The Court's repudiation of this approach was unequivocal: "Our task is not to assess the relative merits of the competing rules, but rather to infer how the 1934 Congress would have addressed the issue."<sup>69</sup>

While the *Musick* Court refused to apply law-and-economics precepts to rule 10b-5, it did not clarify the nature of the tensions between those precepts and the underlying approach of the federal securities laws. This Article offers a few general observations on those tensions in order to lay a basis for discussing the use of the statute of frauds, merger clauses, and attorneys' fees clauses in private rule 10b-5 litigation. These tensions are pronounced with respect to (i) the need for federal regulation of the securities markets; (ii) the extent to which investors could bargain effectively in the absence of regulation; and (iii) the importance of maximizing freedom of contract.

The law-and-economics movement perceives federal regulation at worst to undermine efficiency, and at best to accomplish nothing more than the free market would if the regulation did not exist.<sup>70</sup> The 1933 and 1934 Acts, of course, are the prime targets of this complaint. Enacted in the wake of the 1929 Crash, the subsequent Depression, and the consequent

---

67. See *id.* at 2086. The Court upheld the right of contribution. See *id.* at 2092.

68. See *id.* at 2089.

69. *Id.* *Musick* is not inconsistent with *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). At issue in *Basic* was the certification of a rule 10b-5 class action involving reliance on alleged misrepresentations. *Id.* at 241-49. The class action could not have gone forward if each class member had been required to establish his own reliance, because then individual issues would have predominated. *Id.* at 242. To avoid this result and facilitate the class action, a plurality of the Court allowed the reliance of the plaintiffs to be presumed (subject to rebuttal). *Id.* at 247-48. The presumption was based in significant measure on the "efficient market hypothesis"—the idea that all available information concerning stock and the companies that issue them is impounded in stock prices. *Id.* at 241-42. Thus, economics provided a basis for facilitating class actions on behalf of investors. Economics did not, however, either create or negate an element of the cause of action. Nor did the Court examine whether it was efficient to make investors statutory beneficiaries or to allow rule 10b-5 damages actions.

70. See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 309-14 (1991).

investor losses,<sup>71</sup> the Acts represent Congress's judgment that neither state laws nor stock exchanges, alone or together, could eliminate rampant abuses in the securities industry.<sup>72</sup>

Consider next whether, in the absence of regulation, investors are able to protect their own interests in securities transactions. The law-and-economics movement posits that investors—like everyone else—can bargain their way to beneficial private arrangements without government help.<sup>73</sup> In contrast, the 1933 and 1934 Acts were enacted in significant measure for the protection of investors.<sup>74</sup>

Finally, consider the importance of contractual freedom. The law-and-economics movement seeks to multiply the choices open to bargaining parties on the theory that to do so maximizes efficiency.<sup>75</sup> The 1933 and 1934 Acts, on the other hand, are considerably more paternalistic. To be sure, the Acts leave ample room for individual responsibility and foolish investment choices. Indeed, they are designed largely to ensure that both foolish and wise investment choices occur on a level playing field—a field with mandatory disclosure, prohibitions on fraud, and controls on the market and on credit.<sup>76</sup>

Yet restrictions on freedom of contract are nonetheless a significant part of the 1933 and 1934 Acts. Consider section 29(a) of the 1934 Act,<sup>77</sup>

---

71. See 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 169-71 (3d ed. 1989).

72. See *id.* at 193-225; see also *id.* at 171-80 (discussing various philosophies of federal regulation from which Congress chose).

73. See EASTERBROOK & FISCHEL, *supra* note 70, at 283.

74. The federal securities laws were intended not only to protect investors but also to improve the functioning of the securities markets. See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 2-5 (1934), reprinted in 5 LEGISLATIVE HISTORY, *supra* note 38, item 18, at 2-5; S. REP. NO. 792, 73d Cong., 2d Sess. 2-5 (1934), reprinted in 5 LEGISLATIVE HISTORY, *supra* note 38, item 17, at 2-5; H.R. REP. NO. 85, 73d Cong., 1st Sess. 2-3 (1933), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 38, item 18, at 2-3; S. REP. NO. 47, 73d Cong., 1st Sess. 1-2 (1933), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 38, item 17, at 1-2; see also *Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988); *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-87 (1983).

75. See LARRY E. RIBSTEIN, *BUSINESS ASSOCIATIONS* 10-12 (2d ed. 1990).

76. For an overview of the 1933 and 1934 Acts, see 1 LOSS & SELIGMAN, *supra* note 71, at 227-29.

77 Section 29(a) of the 1934 Act, 15 U.S.C. § 78cc(a) (1988) [hereinafter § 29(a)].

which voids "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder."<sup>78</sup> Section 14 of the 1933 Act<sup>79</sup> is virtually identical.<sup>80</sup> Standing alone, the Court's 1987 decision in *Shearson/American Express, Inc. v McMahon*<sup>81</sup> appeared to emasculate section 29(a).<sup>82</sup> Yet in a portion of *Rodriguez de Quijas v Shearson/American Express, Inc.*<sup>83</sup> that seems to be universally ignored,<sup>84</sup> the Court revisited *McMahon* and gave section 29(a) new life.<sup>85</sup>

At issue in *McMahon* was whether section 29(a) invalidated an arbitration clause contained in an investor's contract with his broker.<sup>86</sup> According to the plaintiffs, the arbitration clause amounted to a waiver of section 27,<sup>87</sup> the 1934 Act's grant to the federal courts of subject-matter jurisdiction over statutory violations.<sup>88</sup> The Court rejected this argument after hypertechnically parsing the text of sections 29(a) and 27.<sup>89</sup> The Court stressed that section 29(a) voids waivers of "compliance" with any provision of the 1934 Act,<sup>90</sup> whereas section 27 "does not impose any duty with which persons trading in securities must 'comply'"<sup>91</sup> The

78. 15 U.S.C. § 78cc(a) (1988).

79. Section 14 of the 1933 Act, 15 U.S.C. § 77n (1988) [hereinafter § 14].

80. Section 14 states that "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." 15 U.S.C. § 77n (1988).

81. 482 U.S. 220 (1987).

82. *Shearson/Am. Express, Inc. v McMahon*, 482 U.S. 220, 228 (1987); see *infra* notes 86-94 and accompanying text.

83. 490 U.S. 477 (1989).

84. *Id.* at 481-83.

85. See *infra* notes 95-103 and accompanying text.

86. 482 U.S. at 227-28.

87. Section 27 of the 1934 Act, 15 U.S.C. § 78aa (1988) [hereinafter § 27].

88. *Id.* Section 27 provides in pertinent part: "The district courts of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder." 15 U.S.C. § 78aa (1988).

89. 482 U.S. at 228.

90. *Id.* (emphasis added).

91. *Id.* (emphasis added).

implication seemed clear that a similar parsing-type approach was mandatory with respect to all contractual waivers of 1934 Act provisions.<sup>92</sup> For this reason, and despite the stress elsewhere in the opinion on the strong federal policy favoring arbitration,<sup>93</sup> *McMahon* could be read as suggesting a tolerance of, or even an invitation to, the more general use of contract law to defeat investors' claims.<sup>94</sup>

Two years later in *Rodriguez*,<sup>95</sup> the Court faced a replay of *McMahon* under section 14 of the 1933 Act,<sup>96</sup> the counterpart to section 29(a) of the 1934 Act.<sup>97</sup> Although upholding the enforceability of the arbitration clause, the *Rodriguez* Court did not rest simply on the reasoning of *McMahon*.<sup>98</sup> Instead, the Court seemed to go out of its way to return to the question of how to distinguish those contractual waivers that are statutorily permissible from those that are not.<sup>99</sup> The focus was no longer on whether there had been a waiver of a statutory duty, but instead on whether the investor had given up something necessary to "place buyers of securities on an equal footing with sellers."<sup>100</sup> The Court concluded that the surrender of the right to litigate does not waive a right essential to buyers.<sup>101</sup> The reason was that, thanks largely to the SEC's expanded oversight of the procedures,<sup>102</sup> arbitration provides investors with adequate protection.<sup>103</sup> Thus, in sharp contrast to *McMahon*, *Rodriguez*

---

92. *See id.*

93. *See id.* at 225-27

94. Professor Hillman makes this point with respect to *McMahon*. *See* Robert W Hillman, *Cross-Border Investment, Conflict of Laws, and the Privatization of the Securities Laws*, LAW & CONTEMP PROBS., Autumn 1992, at 331, 348. He does not distinguish *Rodriguez*, however. *See id.*

95. *Rodriguez de Quijas v Shearson/Am. Express, Inc.*, 490 U.S. 477 (1989).

96. For the text of § 14, see *supra* note 80.

97. For the text of § 29(a), see *supra* text accompanying note 78.

98. *Rodriguez*, 490 U.S. at 481-83.

99. *See id.*

100. *Id.* at 481.

101. *See id.* at 482-83.

102. *See id.* at 483; *see also* *Shearson/Am. Express, Inc. v McMahon*, 482 U.S. 220, 231-34 (1987).

103. 490 U.S. at 483.



provided lower courts with a policy reason for use in identifying invalid contractual waivers.

Nor does section 29(a) give way even when a fully informed investor freely chooses to surrender his rights.<sup>104</sup> As the *McMahon* Court explained, section 29(a) does not rest on contract principles:

The voluntariness of the agreement is irrelevant. Section 29(a) is concerned, not with whether brokers "maneuver[ed customers] into" an agreement, but with whether the agreement "weaken[s] their ability to recover under the [Exchange] Act." The former is grounds for revoking the contract under ordinary principles of contract law; the latter is grounds for voiding the agreement under section 29(a).<sup>105</sup>

The federal securities laws contrast sharply with the approach of law-and-economics.<sup>106</sup> Consequently, to merge them carries a price. The law-and-economics approach teaches that to maximize efficiency one must maximize freedom of contract.<sup>107</sup> Hence the approach champions the use of traditional contract devices such as the statute of frauds,<sup>108</sup> merger clauses,<sup>109</sup> and attorneys' fees clauses.<sup>110</sup> These devices often derail rule 10b-5 actions, thereby benefiting defendants and the status quo.<sup>111</sup> This in turn contributes to the creation of the very *caveat emptor* world that the federal securities laws were intended to overcome.<sup>112</sup>

## II. Contract Devices and Rule 10b-5 The Statute of Frauds

The statute of frauds enters rule 10b-5 litigation in connection with whether the plaintiff has met the judicially created requirement for

104. *Shearson/Am. Express, Inc. v McMahon*, 482 U.S. 220, 230 (1987).

105. *Id.* at 230-31 (citation omitted).

106. *See supra* notes 70-105 and accompanying text.

107. *See supra* note 75 and accompanying text.

108. *See infra* note 125 and accompanying text.

109. *See infra* note 220 and accompanying text.

110. *See infra* note 276 and accompanying text.

111. *See supra* note 59 and accompanying text. For a discussion of the statute of frauds, merger clauses, and attorneys' fees clauses in rule 10b-5 litigation, see *infra* Parts II, III, and IV, respectively.

112. *See supra* note 4 and accompanying text.

standing<sup>113</sup>—being a "purchaser" or "seller" of securities.<sup>114</sup> The 1934 Act defines a "purchase" to include a "contract to purchase"<sup>115</sup> and a "sale" to include a "contract to sell."<sup>116</sup> Yet the 1934 Act nowhere requires that these contracts be in writing.<sup>117</sup> When a rule 10b-5 plaintiff asserts standing to sue based on an oral contract, is the state statute of frauds a good defense?

Statute of frauds defenses to rule 10b-5 actions are much more likely to succeed today than before the late 1980s. The Supreme Court's 1987 *McMahon* decision<sup>118</sup> was an important divide: with one exception,<sup>119</sup> none of the pre-*McMahon* decisions accepted the defense.<sup>120</sup> In contrast, every post-*McMahon* decision that has had to rule on the question<sup>121</sup> has accepted the defense.<sup>122</sup> To justify the statute of frauds, courts rely on an efficiency rationale derived from a misreading of the Supreme Court's 1975 decision in *Blue Chip Stamps v Manor Drug Stores*<sup>123</sup> as well as on a specious construction of 1934 Act text.<sup>124</sup>

The impetus to incorporate the statute of frauds into rule 10b-5 probably has its roots in the law-and-economics movement. That movement gives the statute of frauds high marks for furthering efficiency by eliminating the

---

113. See *supra* note 14 and accompanying text.

114. See *supra* note 15 and accompanying text.

115. See *supra* note 17 (providing 1934 Act definition of "purchase").

116. See *supra* note 19 (providing 1934 Act definition of "sale").

117. See *supra* notes 17 and 19 (providing 1934 Act definitions of, respectively, "purchase" and "sale").

118. *Shearson/Am. Express, Inc. v McMahon*, 482 U.S. 220 (1987).

119. See *Southeastern Waste Treatment, Inc. v Chem-Nuclear Sys., Inc.*, 506 F. Supp. 944, 955 (N.D. Ga. 1980).

120. See cases cited *supra* note 21.

121. In *Chariot Group, Inc. v American Acquisition Partners, L.P.*, 751 F. Supp. 1144 (S.D.N.Y. 1990), *aff'd mem.*, 932 F.2d 956 (2d Cir. 1991), the action was dismissed on the ground that no contract existed on which to premise standing. *Chariot Group*, 751 F. Supp. at 1149. The court noted in dictum that there was no statute of frauds requirement. *Id.*

122. See *Kagan v Edison Bros. Stores, Inc.*, 907 F.2d 690, 691 (7th Cir. 1990); *Pelletier v Stuart-James Co.*, 863 F.2d 1550, 1555 (11th Cir. 1989); see also *Pommer v Medtest Corp.*, 961 F.2d 620, 625 (7th Cir. 1992).

123. 421 U.S. 723 (1975); see *infra* notes 130-156 and accompanying text.

124. See *infra* notes 157-86 and accompanying text.

uncertainties of oral bargains.<sup>125</sup> Ironically, courts have failed to acknowledge that the Article 8 statute of frauds is in a state of siege. Indeed, the American Law Institute may soon eliminate it altogether from Article 8<sup>126</sup> on the ground that it is not a realistic requirement for securities transactions.<sup>127</sup> Moreover, courts have disregarded the poor fit between rule 10b-5 and the statute of frauds,<sup>128</sup> a matter of continuing significance should the statute of frauds ultimately be retained in the Article 8 official text, or, alternatively, in the laws of some or all of the states, despite its removal from the official text.<sup>129</sup>

#### A. *The Efficiency Argument*

Courts favoring the statute of frauds for rule 10b-5 make an efficiency argument on its behalf.<sup>130</sup> The argument is premised on the Supreme Court's 1975 decision in *Blue Chip Stamps*,<sup>131</sup> which denied standing to those claiming that fraud caused them not to trade.<sup>132</sup> Thus, for example, Judge Easterbrook analogized to *Blue Chip Stamps* in a 1990 Seventh Circuit rule 10b-5 case involving the statute of frauds: "*Blue Chip Stamps* stressed the substantial problems of proof and high risk of error entailed in litigating claims that fraud prevented a sale from occurring. Statutes of frauds likewise are concerned with problems of proof. It is easy to say that there was an oral agreement."<sup>133</sup>

To be sure, it would be hard to argue against the statute of frauds if *Blue Chip Stamps* truly gave a green light to any rule that enhanced efficiency by

125. See Horwitz, *supra* note 55, at 253.

126. See *infra* notes 188-89 and accompanying text.

127. See *infra* note 190 and accompanying text.

128. See *infra* notes 193-205 and accompanying text.

129. See 1 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 3 at 7-8 (3d Practitioners' ed. 1988) (discussing "variations in enactment and in interpretation").

130. See cases cited *supra* note 133.

131. *Blue Chip Stamps v Manor Drug Stores*, 421 U.S. 723 (1975).

132. See *id.* at 747-49.

133. *Kagan v Edison Bros. Stores*, 907 F.2d 690, 691 (7th Cir. 1990) (emphasis in original); see *Pelletier v Stuart-James Co.*, 863 F.2d 1550, 1555 n.4 (11th Cir. 1989); *Southeastern Waste Treatment, Inc. v Chem-Nuclear Sys., Inc.*, 506 F Supp. 944, 949, 952-53 (N.D. Ga. 1980).

allaying "problems of proof" and "risk of error." But *Blue Chip Stamps* did no such thing.

*Blue Chip Stamps* involved the doctrine of standing, which does not purport to divide those harmed from those who were not.<sup>134</sup> Rather, it is a "means of foreclosing actions by persons who have been hurt by wrongs, but who, for reasons of legislative, judicial, or social policy, are outside of the class of persons who are given a particular kind of remedy for the injury."<sup>135</sup> The *Blue Chip Stamps* Court could not make the standing requirements for private plaintiffs turn solely on the language of section 10(b)<sup>136</sup> because the Congress that enacted that section did not anticipate private actions.<sup>137</sup> Instead, the Court focused primarily on a policy important to the 1934 Congress<sup>138</sup>—the need to reduce vexatious litigation.<sup>139</sup> While conceding that some rule 10b-5 violations injure those who have neither purchased nor sold,<sup>140</sup> the Court concluded that a prohibition against lawsuits by non-purchasers and non-sellers was an appropriate means of curbing vexatious litigation.<sup>141</sup> Two reasons were given.

The first reason was that rule 10b-5 litigation presented an especially grave threat of vexatiousness: "[T]he mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits but because of the threat of extensive discovery and disruption of normal business activities which may

---

134. *See* *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136, 146 (9th Cir. 1973) (Hufstедler, J., dissenting), *rev'd on other grounds*, 421 U.S. 723 (1975).

135. *Blue Chip Stamps*, 492 F.2d at 146.

136. The language of § 10(b) was not altogether irrelevant to the *Blue Chip Stamps* decision. The Court found at least some support for the purchaser/seller requirement in the words "in connection with the purchase or sale" of any security " *See Blue Chip Stamps*, 421 U.S. at 733.

137. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975); *cf. Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 113 S. Ct. 2085, 2090 (1993) (noting that "the text of § 10(b) provides little guidance [regarding] elements or aspects of the 10b-5 apparatus unique to a private liability arrangement").

138. *See id.* at 740-41.

139. *See id.* This policy emerged from an amendment to § 11 of the 1933 Act enacted in 1934 as part of Title II of the 1934 Act. *See id.*

140. *Id.* at 743.

141. *See id.* at 740-49.

accompany a lawsuit which is groundless. <sup>142</sup> Hence the purchaser/seller requirement

separates in a readily demonstrable manner the group of plaintiffs who actually purchased or actually sold, and whose version of the facts is therefore more likely to be believed by the trier of fact, from the vastly larger world of potential plaintiffs who might successfully allege a claim but could seldom succeed in proving it.<sup>143</sup>

The Court stressed, however, that the threat of vexatiousness did not suffice by itself to justify the purchaser/seller requirement or any other requirement: "[T]here is no general legal principle that courts in fashioning substantive law should do so in a manner which makes it easier for a defendant to obtain a summary judgment. But in this type of litigation, *such a factor is not to be totally dismissed.*"<sup>144</sup>

Because the first reason was insufficient by itself, the second reason became critical. The second reason was that without the purchaser/seller requirement, the plaintiff's case would turn on evidence that could not be verified.<sup>145</sup> Indeed, if non-purchasers and non-sellers could sue under rule 10b-5, the defendants would ordinarily have no way of ascertaining the actual reasons for the plaintiffs' failure to trade.<sup>146</sup> Such litigation would present "[t]he very real risk that the door [would] be open to recovery of substantial damages on the part of one who *offers only his own testimony* to prove that [the defendant's] representations damaged him."<sup>147</sup> To prevent this result, the Court held that rule 10b-5 plaintiffs must be either purchasers or sellers of securities.<sup>148</sup>

Contrary to current lower court decisions,<sup>149</sup> the purchaser/seller requirement does not provide an analogy for the statute of frauds. The reason is that when a plaintiff asserts an oral contract as the basis for her standing, she does not offer evidence that only she controls. Indeed, the

142. *Id.* at 742-43.

143. *Id.* at 743.

144. *Id.* at 742-43 (emphasis added).

145. *Id.* at 746.

146. *See id.*

147. *Id.* (footnote omitted) (emphasis added).

148. *See id.* at 749

149. *See cases cited supra* note 133.

defendant has equal access to the evidence concerning the contract's existence or nonexistence and is well-situated to respond.<sup>150</sup>

To be sure, to prohibit standing based on oral contracts would inevitably eliminate at least some frivolous claims. But that by itself does not bring the statute of frauds within the ambit of *Blue Chip Stamps*. For all of its rhetoric about vexatious litigation, *Blue Chip Stamps* was careful not to give a general green light to rules that would prevent investors from proving their cases. That proof could proceed unless the evidence was inherently unverifiable.<sup>151</sup> Confirmation of this interpretation of *Blue Chip Stamps* came in the Court's 1991 decision in *Virginia Bankshares, Inc. v Sandberg*.<sup>152</sup> There the plaintiffs challenged as fraudulent the reasons given by directors for supporting a merger.<sup>153</sup> The defendants advanced an efficiency argument based on *Blue Chip Stamps*: litigation of "reasons" was said to "invite wasteful litigation of amorphous issues outside the readily provable realm of fact."<sup>154</sup> The Court flatly rejected the argument. In its view, *Blue Chip Stamps* was inapposite because the evidence relevant to the litigation of reasons was "subject neither to a plaintiff's control nor ready manufacture."<sup>155</sup> Hence the Court concluded that statements of reasons were actionable as fraud under the federal securities laws.<sup>156</sup>

---

150. Cf. *Desser v Ashton*, 408 F. Supp. 1174, 1176 (S.D.N.Y. 1975) (noting that other witnesses were available to confirm or refute existence of alleged oral contract), *aff'd mem.*, 573 F.2d 1289 (2d Cir. 1977); *Desser v. Ashton*, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,653, at 90,235 (S.D.N.Y. July 16, 1976) (dismissing rule 10b-5 claim because alleged oral contract was not proven).

151. See *supra* notes 145-48 and accompanying text.

152. 501 U.S. 1083 (1991).

153. See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1088-89 (1991). This case was brought under § 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1988), and 17 C.F.R. § 240.14a-9 (1994), the fraud provisions for proxy solicitations.

154. See *Virginia Bankshares*, 501 U.S. at 1091.

155. *Id.* at 1094.

156. See *id.* at 1095. The Court went on to say that a fraudulently stated reason was actionable only where it misled concerning its subject. *Id.* at 1096. This requirement was deemed necessary because "the temptation to rest an otherwise nonexistent action on psychological enquiry alone would threaten just the sort of strike suits and attrition by discovery that *Blue Chip Stamps* sought to discourage." *Id.* In the Court's view, this additional requirement "do[es] not substantially narrow the cause of action." *Id.*

### B. The Textual Argument

Courts favoring the statute of frauds also rely upon the language of the 1934 Act.<sup>157</sup> They claim that the contracts included in the statutory definitions of "purchase"<sup>158</sup> and "sale"<sup>159</sup> are limited to those that satisfy the statute of frauds.<sup>160</sup> Thus, for example, Judge Easterbrook has said: "'Contract' in the securities acts is a word of legal art. Without signed writings, consideration, and the other legal requirements for enforcement, there is no 'contract;' there is only a promise."<sup>161</sup> Yet Judge Easterbrook does not purport to derive his interpretation from the language, history, or policies of the federal securities laws and hence he leaves unaddressed the following crucial questions: (i) as a matter of general contract law in 1934, did the word "contract" apply to an agreement that failed to satisfy the statute of frauds?<sup>162</sup> (ii) was there in 1934 a statute of frauds applicable to securities contracts?<sup>163</sup> and (iii) why were "contracts" included within the 1934 Act's definitions of "purchase" and "sale"?<sup>164</sup>

In the 1930s the word "contract" embraced both enforceable and unenforceable agreements. Consider the following language from the first *Restatement of the Law of Contracts*, published in 1932: "The term contract is generic. As commonly used, and as here defined, it includes varieties described as voidable, *unenforceable*, formal, informal, express, implied, unilateral, bilateral."<sup>165</sup> Moreover, the 1932 *Restatement* defined an "unenforceable contract" as "one which the law does not enforce by direct legal proceedings, but recognizes in some indirect or collateral way as creating a duty of performance,"<sup>166</sup> and gave as an example a contract

157 See cases cited *infra* note 160.

158. For the statutory definition of "purchase," see *supra* note 17

159 For the statutory definition of "sale," see *supra* note 19.

160. See, e.g., *Kagan v Edison Bros. Stores, Inc.*, 907 F.2d 690, 691 (7th Cir. 1990); *Pelletier v Stuart-James Co.*, 863 F.2d 1550, 1555 (11th Cir. 1989).

161. *Kagan*, 907 F.2d at 691.

162. See *infra* notes 165-69 and accompanying text.

163. See *infra* notes 170-76 and accompanying text.

164. See *infra* notes 177-83 and accompanying text.

165. RESTATEMENT OF THE LAW OF CONTRACTS § 1 cmt. e (1932) [hereinafter 1932 RESTATEMENT] (emphasis added).

166. *Id.* § 14.

failing to satisfy the statute of frauds.<sup>167</sup> Additional contemporaneous sources recognizing unenforceable contracts as contracts were the Uniform Sales Act<sup>168</sup> and the 1933 *Webster's Dictionary*<sup>169</sup>

In addition, there was considerable uncertainty in 1934 about whether securities contracts were even subject to a statute of frauds. There was then no UCC,<sup>170</sup> and only the Uniform Sales Act—not adopted by one-third of the states<sup>171</sup>—provided an even arguably relevant statute of frauds.<sup>172</sup> That statute of frauds applied not just to goods but to choses in action,<sup>173</sup> a category that encompassed securities in the view of a number of courts.<sup>174</sup> Yet the Supreme Court of Pennsylvania held that under the state constitution the statute of frauds could not apply to securities transfers because the Act's title gave traders in securities insufficient notice that they were covered in any respect.<sup>175</sup> Moreover, the Supreme Judicial Court of Massachusetts expressed uncertainty as to whether the statute of frauds applied to contracts involving securities that were unissued as of the contract date.<sup>176</sup> Thus, if Congress had favored a writing requirement for contracts within the 1934 Act, it could not have assumed that the unsettled state law

167 *Id.* § 14 illus. 3.

168. *See, e.g.*, *Edwards Mfg. Co. v Bradford Co.*, 294 F. 176, 181-82 (2d Cir. 1923); *Abraham v Durward*, 180 N.W. 783, 785-86 (N.D. 1920); *Ashley v Preston*, 39 S.W.2d 279, 279 (Tenn. 1931).

169. The word "contract" was defined as "[a]n agreement between two or more persons to do or forbear something, esp. such an agreement that is legally enforceable;" WEBSTER'S NEW INTERNATIONAL DICTIONARY 578 (1933).

170. The UCC first appeared in 1952. 1 U.L.A. iii (1989).

171. *See* 1 WHITE & SUMMERS, *supra* note 129, § 1, at 3.

172. UNIF SALES ACT § 4 (act superseded 1952).

173. *See id.* § 4(1).

174. *See, e.g.*, *De Nunzio v De Nunzio*, 97 A. 323, 324 (Conn. 1916); *Woolley v Loose*, 194 P. 908, 911-12 (Utah 1920).

175. *See Guppy v Moltrup*, 126 A. 766, 767 (Pa. 1924). The court noted that the title of the Uniform Sales Act was "[a]n act relating to the sale of goods." *Id.* at 766. The following year, the Pennsylvania legislature came to terms with *Guppy* by amending the title to read "an act relating to the sale of goods and choses in action." 69 PA. STAT. ANN. tit. 14.69, § 1 n.1 (1931) (repealed 1953). This change is discussed in *Howell v McCloskey*, 99 A.2d 610, 612 n.1 (Pa. 1953). The constitutional vulnerability presumably would have continued in other jurisdictions, however.

176. *See Davis v Arnold*, 165 N.E. 885, 888 (Mass. 1929).



of the period would furnish the requirement. Instead, it would have had to enact a special federal statute of frauds as a part of the 1934 Act. Its failure to take this step indicates that it never intended a writing requirement for 1934 Act contracts in the first place.

Furthermore, contracts appear to have been included in the 1934 Act's definitions of "purchase" and "sale" for a reason that militates against the statute of frauds requirement. Congress's purpose must have been to protect the investor who acts to his detriment by assuming that his contract is a "done deal."<sup>177</sup> If this is correct, the word "contract" should not presuppose satisfaction of the statute of frauds, because the statute can so easily become a "cunning device" for use against investors. Indeed, if only written contracts sufficed, unscrupulous securities sellers and brokers could simply keep contracts oral in the hopes of defeating the investor's standing later on.<sup>178</sup>

The 1934 Congress was aware of dangers of this kind. Concerned that sellers would try to escape their 1933 Act obligations by failing to issue securities certificates to investors, it amended the 1933 Act definition of the term "security" in 1934 to make that impossible. Indeed, as originally enacted in 1933, "security" included "any instrument commonly known as a security"<sup>179</sup> By amendment in 1934, this phrase was changed to "any interest or instrument commonly known as a 'security'"<sup>180</sup> The 1934 Act Conference Report explained that the intent was to have the 1933 Act reach "interests commonly known as 'securities' whether or not such interests are represented by any document or not. Thus the [1933 Act] will apply to inscribed shares, and its provisions cannot be evaded by simply refraining from issuing to the subscriber any documentary evidence of his interest."<sup>181</sup> To be sure, the 1934 Act retained the phraseology "any instrument commonly

---

177 In *Blue Chip Stamps v Manor Drug Stores*, 421 U.S. 723 (1975), the Court acknowledged that holders of contracts have standing to sue under rule 10b-5 because the 1934 Act's definitions of "purchase" and "sale" include executory contracts. *See id.* at 751. The Court did not address why it is that these definitions include contracts. *See id.*

178. Conceivably some such sellers and brokers might prefer a written contract if it contained an unfair bargain that they wished to enforce.

179. 1933 Act, ch. 38, 48 Stat. 74, 74 (1933), *reprinted in* 1 LEGISLATIVE HISTORY, *supra* note 38, item 1, at 74.

180. 1934 Act, ch. 404, 48 Stat. 881, 905 (1934), *reprinted in* 4 LEGISLATIVE HISTORY, *supra* note 38, item 1, at 905 (emphasis added).

181. H.R. CONF. REP. NO. 1838, 73d Cong., 2d Sess. 39 (1934), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 38, item 20, at 39.

known as a 'security' ,<sup>182</sup> but this cannot represent the judgment that anti-investor tactics unacceptable under the 1933 Act were somehow acceptable under the 1934 Act. The 1933 Act was directed principally at primary distributions, and the failure to issue certificates probably seemed a more likely tactic in this context than in the context of secondary trading, the subject of the 1934 Act.<sup>183</sup>

Finally, even if today's definitions controlled construction of the word "contract" as used in the 1934 Act, a statute of frauds requirement would not thereby become more plausible. Consider a contract that is unenforceable because it does not satisfy the statute of frauds in Article 8 of the UCC<sup>184</sup>—the very statute of frauds urged for rule 10b-5<sup>185</sup> According to the UCC, this "[f]ailure does not render the contract void for all purposes, but merely prevents it from being judicially enforced in favor of a party to the contract."<sup>186</sup>

### C. Difficulties Specific to UCC Section 8-319

Courts favoring a statute of frauds requirement for rule 10b-5 endorse section 8-319 of the UCC.<sup>187</sup> These courts fail to acknowledge that the Article 8 statute of frauds is currently in a state of siege. Indeed, the American Law Institute is currently in the process of revising Article 8,<sup>188</sup> with section 8-319 a probable candidate for outright abolition.<sup>189</sup> The

182. 1934 Act, ch. 404, 48 Stat. 881, 883 (1934), reprinted in 4 LEGISLATIVE HISTORY, *supra* note 38, item 1, at 883.

183. For an overview of the 1933 and 1934 Acts, see 1 LOSS & SELIGMAN, *supra* note 71, at 227-29.

184. See U.C.C. § 8-319 (1977).

185. See, e.g., *Pommer v Medtest Corp.*, 961 F.2d 620, 625 (7th Cir. 1992); *Kagan v Edison Bros. Stores, Inc.*, 907 F.2d 690, 691 (7th Cir. 1990); *Pelletier v Stuart-James Co.*, 863 F.2d 1550, 1555 (11th Cir. 1989); *Southeastern Waste Treatment, Inc. v Chem-Nuclear Sys., Inc.*, 506 F Supp. 944, 951 (N.D. Ga. 1980).

186. U.C.C. § 2-201, official cmt. 4 (1990). The policies of § 2-201 are expressly incorporated into U.C.C. § 8-319. See U.C.C. § 8-319 official cmt. 1 (1977); see also 7 WILLIAM D. HAWKLAND, UNIFORM COMMERCIAL CODE SERIES § 8-319.09 at 400 (1986) (discussing effect of noncompliance with U.C.C. § 8-319).

187. See cases cited *supra* note 185.

188. See UNIFORM COMMERCIAL CODE REVISED ARTICLE 8. INVESTMENT SECURITIES (Proposed Final Draft April 5, 1994) [hereinafter Article 8 Proposed Final Draft].

189. See *id.* § 8-113. Section 8-113 provides in pertinent part as follows: "A contract for the sale or purchase of a security is enforceable whether or not there is a writing

reason for the proposed abolition is the perception that the requirement of a writing is not realistic for securities transactions:

With the increasing use of electronic means of communication, the statute of frauds is becoming even less suited to the realities of the securities business. For securities transactions, whatever benefits the statute of frauds may play in filtering out fraudulent claims are outweighed by the obstacles it places in the development of modern commercial practices in the securities business.<sup>190</sup>

In contrast to this explicit attention to actual business realities, courts endorsing the statute of frauds for rule 10b-5 do not even question the practicality of the requirement that they impose.<sup>191</sup>

Moreover, rule 10b-5 fits poorly with section 8-319, a matter of continuing significance should section 8-319 ultimately be retained in the Article 8 official text, or, alternatively, in the laws of some or all of the states, despite its removal from the official text.<sup>192</sup> The poor fit results from several important differences between the 1934 Act and Article 8.

First, the 1934 Act and Article 8 have distinct agendas. The 1934 Act is aimed at "compensating defrauded investors. [d]eter[ring] fraud and manipulative practices in the securities markets, and ensur[ing] full disclosure of information material to investment decisions."<sup>193</sup> None of these matters is addressed by Article 8. Instead, it focuses on something

<sup>190</sup> Section 8-113, official comment 1 states: "This section provides that the statute of frauds does not apply to contracts for the sale of securities, reversing prior law." Cf. UNIFORM COMMERCIAL CODE REVISED ARTICLE 8, INVESTMENT SECURITIES, reporter's introductory note 6 (Draft February 5, 1992) ("The Reporter suggests that consideration be given to deleting the statute of frauds provision now found in § 8-319.").

Article 2 of the UCC (the sale of goods) is currently in the process of revision as well. See *An Appraisal of the March 1, 1990, Preliminary Report of the Uniform Commercial Code Article 2 Study Group*, 16 DEL. J. CORP. L. 981, 1039 (1991). As with Article 8, outright abolition of the statute of frauds is a distinct possibility. See UNIFORM COMMERCIAL CODE REVISED ARTICLE 2. SALES, § 2-201, reporter's note (Draft July 29-Aug. 5, 1994) (stating that "[t]he statute of frauds for contracts is repealed").

<sup>190</sup> Article 8 Proposed Final Draft, *supra* note 188, § 8-113 official cmt. 2.

<sup>191</sup> See cases cited *supra* note 24. This Article does not purport to resolve the question of the practicality of a statute of frauds for securities transactions. It merely notes that current rule 10b-5 case law does not acknowledge the question.

<sup>192</sup> See *supra* note 129 and accompanying text.

<sup>193</sup> *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986).

the federal securities laws leave alone—facilitating the transferability of securities.<sup>194</sup>

Second, on a more practical level, section 8-319 may fail to reach some of the very rule 10b-5 cases in which statute of frauds issues are most likely to arise: those involving a transfer of close corporation stock<sup>195</sup> or a customer-broker dispute.<sup>196</sup>

The problem with injecting Article 8 into rule 10b-5 cases involving close corporation stock derives from the fact that Article 8 and the 1934 Act do not define "security" in precisely the same way. The official comment to the Article 8 definition stresses the point:

This definition has no bearing upon whether an interest is a "security" for purposes of the federal securities laws. By the same token the definitions of "securities" for purposes of those laws has [sic] no bearing upon whether an interest is a security within the definition of this Article.<sup>197</sup>

Under the 1934 Act, close corporation stock is a security,<sup>198</sup> whereas state courts are divided over whether close corporation stock is a security for purposes of Article 8.<sup>199</sup>

194. See U.C.C. § 8-101, official cmt. (1977); see also 7 HAWKLAND, *supra* note 186, § 8-101:01, at 3.

195. See cases cited *infra* note 297

196. See cases cited *infra* note 299.

197. U.C.C. § 8-102, official cmt. 3; see 7 HAWKLAND, *supra* note 186, § 8-101:01, at 3; Ernest L. Folk, *Some Problems Under Article 8 of the Uniform Commercial Code*, 5 ARIZ. L. REV. 193, 199-200 (1964).

198. See *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985) (holding that stock is a "security" under federal securities laws even when its sale is privately negotiated and transfers control). *But cf.* *Marine Bank v. Weaver*, 455 U.S. 551, 560 (1982) (holding that "unique agreement, negotiated one on one by parties, is not a security").

199. See, e.g., Robert C. Mendelson, *Investment Securities Review*, 45 BUS. LAW 2461, 2473-74 (1990) (discussing split in case law); Note, *Stock in a Closely Held Corporation: Is It A Security for Uniform Commercial Code Purposes?*, 42 VAND. L. REV. 579, 582-95 (1989) (same). The two lines of cases draw upon different aspects of the official comments. Compare U.C.C. § 8-102 official cmt. 2, first paragraph, (noting that "a security is a share or participation in an enterprise or an obligation that is of a type commonly traded in organized markets") with *id.*, third paragraph (asserting that stock in close corporation is a security under Article 8). *But cf.* Article 8 Proposed Final Draft, *supra* note 188, § 8-102(13)(iii) (defining a "security" as an obligation "dealt in or traded on securities exchanges or securities markets" or, in the alternative, as "a medium for investment [which] by its terms expressly provides that it is a security governed by this Article").

The problem with merging Article 8 into rule 10b-5 cases involving customer-broker disputes derives from the difference between the two statutory schemes concerning the treatment of principals and agents. Section 8-319 applies only to a contract of a broker who buys or sells on his own behalf rather than as an agent for the customer.<sup>200</sup> Chancellor Hawkland explains:

In most cases, a customer interacts with his broker on a principal-agent basis; the broker acts as the agent for his customer in the purchase or sale of securities. Unless the broker is buying or selling for himself, his transaction with a customer is not a sale [under the UCC]. Therefore, agreements between a broker and his customers generally are not within the Article 8 statute of frauds and need not be in writing.<sup>201</sup>

Rule 10b-5, on the other hand, does not make this distinction. The rule applies to any broker committing fraud in connection with his customer's purchase or sale of a security, regardless of whether the broker acts on his own behalf or as the customer's agent.<sup>202</sup>

Third, recognition of section 8-319 as a defense to a rule 10b-5 action confers upon this section a greater reach in federal law than it has in at least some states. The reason is that state courts are divided over whether section 8-319 provides a defense to actions for common law fraud.<sup>203</sup> In states where section 8-319 is not a defense to common law fraud, its recognition as a defense to rule 10b-5 assaults the very state law principles purportedly being respected. Moreover, in such states a notice problem would arise because plaintiffs will have had no advance warning of the state law "requirement" that caused them to lose their right to sue under rule 10b-5.<sup>204</sup>

---

200. See 7 HAWKLAND, *supra* note 186, § 8-319:02, at 384.

201. *Id.* (footnote omitted).

202. See, e.g., *Bateman Eichler, Hill Richards, Inc. v Berner*, 472 U.S. 299, 302-03 (1985) (rule 10b-5 claim against broker acting as agent).

203. Compare *Kastle v Steibel*, 502 N.Y.S.2d 538, 540 (N.Y. App. Div 1986) (allowing fraud claim) with *Mildfelt v Lair*, 561 P.2d 805, 813-14 (Kan. 1977) (disallowing fraud claim). State courts are also divided on this question with respect to § 8-319's Article 2 counterpart. See Note, *The Statute of Frauds as a Bar to An Action in Tort for Fraud*, 53 FORDHAM L. REV 1231, 1234 & nn. 19 & 22 (1985) (showing split of authority).

204. Cf. *supra* note 175 and accompanying text (discussing sufficiency of notice to securities traders, prior to enactment of UCC, of applicability of statute of frauds).

Nor would it be appropriate to import section 8-319 into rule 10b-5 only where the state in question recognizes section 8-319 as a defense to common law fraud. In the frequent situation involving several jurisdictions, significant conflict of laws problems would arise. More importantly, to allow standing under rule 10b-5 to vary state by state flies in the face of the uniformity of interpretation that has always characterized construction of the rule.<sup>205</sup>

Thus, the statute of frauds requirement for rule 10b-5 is completely inappropriate. It is rooted neither in the language of the 1934 Act<sup>206</sup> nor in the policies embodied in the Supreme Court's decision in *Blue Chip Stamps*.<sup>207</sup> And, section 8-319—at present seemingly close to oblivion<sup>208</sup>—is in any event not co-extensive with rule 10b-5.<sup>209</sup>

### III. Contract Devices and Rule 10b-5. Merger Clauses

Investors' contracts with sellers and brokers commonly include a clause providing that the writing supersedes any earlier representations or agreements, whether oral or written.<sup>210</sup> Suppose an investor nonetheless relies on oral representations. If the investor later claims that the oral representations were fraudulent, is the merger clause a valid defense?

This defense is much more likely to succeed today than before the late 1980s.<sup>211</sup> And *McMahon*<sup>212</sup> is again the divide. The vast majority of pre-*McMahon* cases did not treat merger clauses as dispositive.<sup>213</sup> On the other hand, every post-*McMahon* case has treated merger clauses as a

205. One significant exception to this uniformity had been the limitations period, which looked to state law. See *Ernst & Ernst v Hochfelder*, 425 U.S. 185, 210 n.29 (1976) (dictum). The Supreme Court has recently substituted a uniform federal limitations period. See *Lampf, Pleva, Lipkind, Prupis & Petigrow v Gilbertson*, 501 U.S. 350, 354-62 (1991).

206. See *supra* notes 157-86 and accompanying text.

207. *Blue Chip Stamps v Manor Drug Stores*, 421 U.S. 723 (1975); see *supra* notes 130-56 and accompanying text.

208. See *supra* notes 188-89 and accompanying text.

209. See *supra* notes 192-205 and accompanying text.

210. See *supra* note 25 and accompanying text.

211. See *supra* notes 26-28 and accompanying text.

212. *Shearson/Am. Express, Inc. v McMahon*, 482 U.S. 220 (1987).

213. See *supra* note 26 and accompanying text.

complete defense, or close to it,<sup>214</sup> with only one case parting company<sup>215</sup> and another deferring the question of the effect of the clause until trial.<sup>216</sup> Current rule 10b-5 cases endorsing merger clause defenses invoke efficiency considerations either expressly<sup>217</sup> or indirectly through the medium of the rule 10b-5 element known as reasonable reliance.<sup>218</sup> This endorsement of merger clauses is not prompted by state law, which is split over the wisdom of derailing an oral fraud action in order to enforce a merger clause.<sup>219</sup> Rather, the impetus seems to come from the law-and-economics movement. That movement posits that in order to promote efficiency, writings should trump oral statements.<sup>220</sup>

### A. The Explicit Efficiency Argument

Some spirited arguments in favor of merger clauses have rested expressly on efficiency considerations. One such argument was made by Judge Kozinski in a 1992 Ninth Circuit case in which he urged that "[l]etting parties warrant that they are relying only on those offering materials would avoid the cost, uncertainty, and delay of securities litigation."<sup>221</sup> Judge Kozinski argued that merger clauses should be

214. See *supra* note 28 and accompanying text.

215. See *Miltland Raleigh-Durham v Myers*, 807 F Supp. 1025, 1050 (S.D.N.Y. 1992) (rejecting "general" merger clause as defense to "specific" fraud allegations).

216. See *Connor v First of Mich. Corp.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,350, at 96,689 (W.D. Mich. May 31, 1990).

217. See *infra* notes 221-26 and accompanying text.

218. See *infra* notes 230-37 and accompanying text.

219. See, e.g., E. ALLAN FARNSWORTH, *CONTRACTS* 484 (2d ed. 1990); 1 WHITE & SUMMERS, *supra* note 129, § 2-12, at 113. The *Restatement (Second) of Contracts* stands firmly opposed to the defense. *RESTATEMENT (SECOND) OF CONTRACTS* § 214, cmt. c (1981). Comment c provides: "What appears to be a complete and binding integrated agreement may be a forgery, a joke, a sham, or it may be voidable for fraud. Such invalidating causes are not affected by a merger clause." *Id.* § 214, cmt. c.

220. See *EASTERBROOK & FISCHER*, *supra* note 70, at 307.

221. *Layman v Combs*, 981 F.2d 1093, 1107 (9th Cir. 1992) (Kozinski, J., dissenting for the most part). At issue was the enforceability of an attorneys' fees clause. The clause in question made the investors liable for attorneys' fees that arise on account of the investors' false representations. These representations included that the investors relied only on the private placement memorandum and not on any oral statements. See *id.* at 1099. Thus, the attorneys' fees clause put teeth in what amounted to a merger clause. For this reason, Judge

binding on investors unless the investors give specific advance notice to the contrary to the sellers: "Had they relied on oral representations made by the sellers, they could (and should) have said so before the money was paid and the securities delivered."<sup>222</sup> Judge Kozinski does not address whether it is reasonable to expect investors to ferret out a merger clause from a voluminous offering document of considerable complexity.<sup>223</sup> In the case before him, for example, the merger clause was one of twenty-two "representations and warranties" spanning "more than three pages of single-spaced type."<sup>224</sup>

Also worthy of note are Judge Easterbrook's comments in a 1988 Seventh Circuit case on a matter closely analogous to merger clauses:<sup>225</sup>

A seller who fully discloses all material information in writing should be secure in the knowledge that it has done what the law requires. Otherwise even the most careful seller is at risk, for it is easy to claim: "Despite what the written documents say, one of your agents told me something else." If such a claim of oral inconsistency were enough, sellers' risk would be greatly enlarged. All buyers would have to pay a risk premium to cover this extra cost of doing business.<sup>226</sup>

Neither Judge Easterbrook nor Judge Kozinski purported to anchor these efficiency considerations in the text or policies of the 1934 Act.<sup>227</sup> The implication is that the omission is inconsequential because efficiency considerations are simply rules of reason that the 1934 Act can readily

---

Kozinski chose to address the rationale for merger clauses.

222. *Id.* at 1108.

223. Judge Kozinski did not apply his analysis only to the members of some financially astute inner circle: "We may blunt the cutting edge of this principle when one of the parties is illiterate, or subject to economic duress, or when we see legal filigree buried deep within a long, printed contract." *Id.* at 1106.

224. *Id.* at 1098.

225. *Acme Propane, Inc. v Tenexco, Inc.*, 844 F.2d 1317 (7th Cir. 1988). At issue was whether a writing should take precedence over an inconsistent oral statement. *See id.* at 1322; *see also* *Ryan v Wersi Electronics GmbH & Co.*, 3 F.3d 174, 183 (7th Cir. 1993) (holding that reasonable investor would not consider particular oral statements material in light of writings that he had received).

226. *Acme*, 844 F.2d at 1322.

227. *See Acme Propane, Inc. v Tenexco, Inc.*, 844 F.2d 1317 (7th Cir. 1988); *Layman v Combs*, 981 F.2d 1093, 1103 (9th Cir. 1992) (Kozinski, J., dissenting for the most part).



countenance. This position is no longer tenable after the Supreme Court's *Musick* decision.<sup>228</sup> *Musick* held that the 1934 Act must be construed in accordance with the intent of Congress rather than the precepts of law-and-economics.<sup>229</sup>

### B. *The Efficiency Argument By Indirection: Reasonable Reliance*

Some courts uphold merger clauses by invoking efficiency considerations indirectly through the medium of the rule 10b-5 element known as reasonable reliance.<sup>230</sup> To show reasonable reliance, a rule 10b-5 plaintiff must establish that she acted reasonably—typically defined as without recklessness<sup>231</sup>—in relying on the alleged fraud.<sup>232</sup> On the theory that a plaintiff cannot reasonably rely on oral statements when his contract contains a merger clause, courts dismiss oral fraud actions in which a merger clause is present.<sup>233</sup>

The District of Columbia Circuit's 1988 decision in *One-O-One Enterprises, Inc. v Caruso*<sup>234</sup> is illustrative. The plaintiffs claimed that fraudulent oral representations induced them to enter into a contract with the defendants.<sup>235</sup> Affirming the dismissal of the action for failure to state a claim, Judge (now Justice) Ruth Bader Ginsburg insisted that the plaintiffs could not have reasonably relied on the oral representations in view of the contract's merger clause (referred to as the "integration clause").<sup>236</sup> But she did not let the matter rest with reasonable reliance. Instead, she made it plain that

228. *Musick, Peeler & Garrett v Employers Ins. of Wausau*, 113 S. Ct. 2085 (1993).

229. *See supra* notes 65-69 and accompanying text.

230. *See cases cited infra* note 233.

231. *E.g.*, *Molecular Technology Corp. v Valentine*, 925 F.2d 910, 918 (6th Cir. 1991).

232. *See id.*, *Grubb v FDIC*, 868 F.2d 1151, 1164 (10th Cir. 1989). *See generally* Sachs, *supra* note 3, at 111-14 (discussing current judicial approaches to reasonable reliance).

233. *See, e.g.*, *Jackvony v RIHT Fin. Corp.*, 873 F.2d 411, 416 (1st Cir. 1989); *One-O-One Enters., Inc. v Caruso*, 848 F.2d 1283, 1286 (D.C. Cir. 1988); *Jankovich v Bowen*, 844 F.Supp. 743, 747-49 (S.D. Fla. 1994); *Branch-Hess Vending Servs. Employees' Pension Trust v Guebert*, 751 F Supp. 1333, 1341 (C.D. Ill. 1990); *Arrizza v Jefferson Guar. Bank*, 696 F Supp. 204, 208 (E.D. La. 1988); *cf. Becherer v Merrill Lynch Pierce Fenner & Smith, Inc.*, 799 F Supp. 755, 768 (E.D. Mich 1992) (finding merger clause to invalidate oral fraud claim without expressly invoking reasonable reliance requirement).

234. *One-O-One Enters., Inc. v Caruso*, 848 F.2d 1283 (D.C. Cir. 1988).

235. *See id.* at 1286.

236. *See id.*

the real issue for her was efficiency. "Were we to permit plaintiffs' use of the defendants' prior representations (and defendants' nondisclosure of negotiations inconsistent with those representations) to defeat the clear words and purpose of the Final Agreement's integration clause, 'contracts would not be worth the paper on which they are written.'"<sup>237</sup>

Judge Ginsburg's approach does not take account of certain practical realities. First, under the general contract law of many states, a merger clause does not bar an action for oral fraud.<sup>238</sup> Therefore, a plaintiff in those states, who knew of the state law, would hardly be reckless in assuming that, under federal law, a merger clause would likewise not bar his oral fraud action. Even an investor who lacked such knowledge would not be reckless in assuming that federal law protected him from oral fraud. He might reason that prosecution of fraud would take precedence over enforcement of a merger clause.<sup>239</sup>

Moreover, any assessment of whether it is reasonable to rely on oral fraud must also reckon with the possibility that oral statements are by their nature more seductive than writings. Indeed, the interpersonal dimension may make an oral statement seem more persuasive than would a written statement,<sup>240</sup> or it may reduce the likelihood that the investor will evaluate the statement dispassionately.<sup>241</sup> Courts ought to assess the reasonableness of an investor's reliance in light of this psychological reality

### C. *The Judicial Disregard of Section 29(a)*

Current rule 10b-5 decisions upholding merger clause defenses disregard section 29(a) of the 1934 Act.<sup>242</sup> In all probability, these courts perceive

237 *Id.* at 1287 (quoting *Tonn v Philco Corp.*, 241 A.2d 442, 445 (D.C. 1968)).

238. *See supra* note 219 and accompanying text.

239. This logic is employed by some state courts that disallow merger clause defenses to oral fraud. *See* 1 *WHITE & SUMMERS, supra* note 129, at 124 & n.12.

240. *Cf. Zauderer v Office of Disciplinary Counsel*, 471 U.S. 626, 642 (1985) (observing that attorney's written advertisement "will lack the coercive force of the personal presence of a trained advocate").

241. *Cf. id.* (observing that written advertisement, "unlike a personal encounter initiated by an attorney, is not likely to involve pressure on the potential client for an immediate answer").

242. *See* cases cited *supra* note 28. Judge Kozinski mentions § 29(a) briefly in dissent, but then dismisses it. *See Layman v Combs*, 981 F.2d 1093, 1106-07 (9th Cir. 1992) (Kozinski, J., dissenting for the most part).

section 29(a) through the lens of *McMahon*, ignoring the Supreme Court's correction in *Rodriguez*.<sup>243</sup>

Recall that *McMahon* gave a hypertechnical parsing to the language of section 29(a),<sup>244</sup> which voids "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder."<sup>245</sup> *McMahon* stressed that section 29(a) invalidates contracts that waive "compliance" with a provision of the 1934 Act,<sup>246</sup> thereby focusing attention on whether the provision in question imposes a duty to comply.<sup>247</sup> Applying this approach to an arbitration clause, the Court found no conflict with section 29(a). The provision purportedly waived was the grant of federal subject matter jurisdiction, which did not impose any "duty with which persons trading in securities must 'comply'."<sup>248</sup>

Recall further that the Court took an altogether different approach in *Rodriguez*,<sup>249</sup> which was a replay of *McMahon* under section 14 of the 1933 Act,<sup>250</sup> the counterpart to section 29(a) of the 1934 Act.<sup>251</sup> The Court no longer focused on whether there had been a waiver of a duty to comply. Instead, the focus shifted to whether the investor had given up something necessary to "place buyers of securities on an equal footing with sellers."<sup>252</sup> The Court concluded that the surrender of the right to litigate did not waive a right essential to buyers.<sup>253</sup> The reason was that, thanks

243. Several pre-*McMahon* cases spotted a conflict between merger clauses and § 29(a). See *Rogen v. Ilikon Corp.*, 361 F.2d 260, 268 (1st Cir. 1966); *Esposito v. Sweeney*, No. 80-C-2861 (N.D. Ill. May 13, 1982) (LEXIS, Genfed library, Dist file); *Lanza v. Drexel & Co.*, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,826, at 90,101 n.14 (S.D.N.Y. Oct. 9, 1970), *aff'd*, 479 F.2d 1277 (2d Cir. 1973).

244. See *supra* notes 86-92 and accompanying text.

245. 15 U.S.C. § 78cc(a) (1988).

246. See *supra* note 90 and accompanying text.

247. See *supra* note 91 and accompanying text.

248. *Id.*

249. *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477 (1989).

250. See *supra* note 80 (providing text of § 14).

251. See *supra* text accompanying note 78 (providing text of § 29(a)).

252. *Rodriguez*, 490 U.S. at 481, see *supra* note 100 and accompanying text.

253. See *supra* note 101 and accompanying text.

largely to the SEC's expanded oversight of arbitration procedures,<sup>254</sup> arbitration accords investors adequate protection.<sup>255</sup>

Considered alone, *McMahon* pointed towards voiding the merger clause if construed as a waiver of the defendant's duty under section 10(b) and rule 10b-5 not to engage in oral fraud.<sup>256</sup> But a court could instead have construed the merger clause as a waiver of the plaintiff's right to sue for oral fraud. Seen in this light, the merger clause could be analogized to the *McMahons'* waiver of their right to litigate—a waiver that the *McMahon* Court upheld.<sup>257</sup> Admittedly, this analogy is somewhat strained: the merger clause would deprive the plaintiff of all fora in which to pursue his oral fraud claim, whereas an arbitration clause eliminates one forum (judicial) but preserves another (arbitral). Yet *McMahon* provided no policy reason for use in discounting strained analogies, or, more generally, to guide the choice between pro-investor and anti-investor constructions.

Now consider the impact of *Rodriguez*. The analogy between a merger clause and an arbitration clause is no longer tenable because the merger clause's preclusion of all fora is significantly more anti-buyer than the arbitration clause's preclusion of the judicial forum alone. Moreover, after *Rodriguez* nothing turns upon whether the merger clause is seen as a waiver of the defendant's statutory duty or of the plaintiff's right to sue. Viewed either way, enforcement of the clause significantly compromises the "equal footing" of buyers and sellers.

Nor is it arguable that a merger clause defense is appropriate at least in the situation where the investor knew at the time he signed the contract that the merger clause would preclude an oral fraud lawsuit. The *McMahon* Court disposed of this argument when it held that once an agreement is invalid under section 29(a), "[t]he voluntariness of the agreement is irrelevant."<sup>258</sup>

The courts must reject the merger clause defense to rule 10b-5 actions. Efficiency arguments on behalf of this defense are inadequate in the wake of

---

254. *See supra* note 102 and accompanying text.

255. *See supra* note 103 and accompanying text.

256. *Cf. Shearson/Am. Express, Inc. v McMahon*, 482 U.S. 220, 253 n.9 (1987) (Blackmun, J., concurring in part and dissenting in part) (observing that majority "implies that the literal language of § 29(a) does not apply to an investor's waiver of his own action").

257. *Id.* at 238.

258. *Id.* at 230.

*Musick*.<sup>259</sup> Moreover, merger clause enforcement cannot be reconciled with section 29(a) of the 1934 Act.<sup>260</sup>

#### *IV Contract Devices and Rule 10b-5. Attorneys' Fees Clauses*

Investors' contracts with sellers and brokers commonly include a clause obligating the investor to pay any attorneys' fees that the seller or broker incurs in connection with the sale or account.<sup>261</sup> These clauses typically do not contain any reciprocal obligation on the part of the seller or broker to pay the attorneys' fees of the investor.<sup>262</sup> When these clauses entitle a seller or broker sued under rule 10b-5 to file a counterclaim for attorneys' fees, significant consequences follow. To see why, first consider the allocation of attorneys' fees in the absence of an attorneys' fees clause. Because the 1934 Act is silent concerning attorneys' fees under section 10(b),<sup>263</sup> federal common law rules applicable to federal claims in federal court control this matter.<sup>264</sup> Under these rules, the losing party pays only his own fees unless the court determines that he acted in bad faith.<sup>265</sup> Now consider the allocation of attorneys' fees when an enforceable attorneys' fees clause is present: in that instance, an investor who loses must pay the defendant's fees even when he sued in good faith.<sup>266</sup> To be sure, no court has yet addressed whether an attorneys' fees clause is

259. *Musick, Peeler & Garrett v Employers Ins. of Wausau*, 113 S. Ct. 2085, 2089 (1993) (rejecting efficiency considerations in determining whether right of contribution exists among joint tortfeasors in rule 10b-5 private damages actions).

260. *See supra* notes 242-58 and accompanying text.

261. *See supra* note 29 and accompanying text.

262. *See id.*

263. In 1934, Congress had no reason to address attorneys' fees under § 10(b) because private actions under that section were not contemplated. *See supra* note 137 and accompanying text.

264. *See generally* *Alyeska Pipeline Serv. Co. v Wilderness Soc'y*, 421 U.S. 240, 257-59 (1975). These rules do not apply to diversity cases. *See id.* at 259 n.31.

265. *See id.*, LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 1045 (2d ed. 1988).

266. An investor who loses his case cannot be assumed to have acted in bad faith. Indeed, defeat at trial—or even before trial—hardly establishes that an action should never have been brought.

enforceable against an investor who wins her case.<sup>267</sup> But because an investor cannot know in advance that she will win, the presence of an attorneys' fees clause threatens a penalty that makes it more likely that she will withdraw the lawsuit prior to judgment or, alternatively, not file it at all.<sup>268</sup> If the investor nonetheless perseveres, the attorneys' fees clause will operate as a penalty if she loses.<sup>269</sup>

Rule 10b-5 case law involving attorneys' fees clauses is moving towards consensus, and once again in the wake of *McMahon*.<sup>270</sup> Pre-*McMahon* cases generated a wide variety of results.<sup>271</sup> Post-*McMahon* cases are more consistent. Almost all perceive the validity of fees clauses as simply a matter of contract law, with the 1934 Act as either irrelevant<sup>272</sup> or as satisfied by a clause that gives specific notice of its reach.<sup>273</sup> Judicial tolerance of these clauses is not prompted primarily by state law. While attorneys' fees clauses are enforceable under the law of

---

267 Cf. *Layman v Combs*, 981 F.2d 1093, 1101-02 (9th Cir. 1992) (regarding it as ludicrous to enforce clause under such circumstances); *Barnebey v E.F. Hutton & Co.*, 715 F. Supp. 1512, 1521 (M.D. Fla. 1989) (noting that defendants seek enforcement of attorneys' fees clause only if plaintiffs lose).

268. Some courts attempt to rebut this argument by maintaining that if an attorneys' fees clause truly deterred litigation, the action then being adjudicated would never have been filed. See, e.g., *Barnebey v E.F. Hutton & Co.*, 715 F. Supp. 1512, 1522 (M.D. Fla. 1989). But this contention does not dispose of the possibility that other actions that might otherwise have been filed were instead deterred.

269. See, e.g., *Samuels v Wilder*, 871 F.2d 1346, 1352 (7th Cir. 1989) (holding clause enforceable and rejecting public policy objection to enforcement on ground that "the loss (litigation expenses) resulted from a successful defense of a suit brought by plaintiffs"); *Tartell v Chelsea Nat'l Bank*, 351 F. Supp. 1071, 1079 (S.D.N.Y. 1972) (holding clause enforceable and noting that plaintiff "must be charged with realization of the covenant language and awareness that his claims might be found wanting on the merits"), *aff'd per curiam*, 470 F.2d 994 (2d Cir. 1972). Sometimes the threat hangs over the trial. See, e.g., *McCain v Phoenix Resources, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,834 at 94,531 (S.D.N.Y. Nov. 16, 1989) (deferring until trial question of whether attorneys' fees clause was specific enough to be enforceable); *Barnebey v E.F. Hutton & Co.*, 715 F. Supp. 1512, 1522 (M.D. Fla. 1989) (denying plaintiff's motion to strike counterclaim to enforce attorneys' fees clause).

270. *Shearson/Am. Express, Inc. v McMahon*, 482 U.S. 220 (1987). For a discussion of *McMahon*, see *supra* notes 86-94 and accompanying text.

271. See cases cited *supra* note 30.

272. See *supra* note 31 and accompanying text.

273. See *supra* note 32 and accompanying text.

most states,<sup>274</sup> this is so only in the absence of a countervailing statute.<sup>275</sup> In all likelihood, the rule 10b-5 case law tolerates attorneys' fees clauses as the result of the influence of the law-and-economics movement and the emphasis the movement places on the enforcement of private choices.<sup>276</sup>

#### A. Treating the 1934 Act As Irrelevant

In a 1989 rule 10b-5 case, Judge Manion observed on behalf of the Seventh Circuit that if the plaintiff had "any reservations about the scope of the [attorneys' fees clause] he should have insisted upon other language."<sup>277</sup> Judge Manion effectively treated the 1934 Act as irrelevant.

Judge Manion's view is mistaken. The validity of attorneys' fees clauses must be controlled by federal law because these clauses pose a threat to rule 10b-5's enforcement. The controlling role of federal law follows from the Supreme Court's 1985 decision in *Bateman Eichler, Hill Richards, Inc. v Berner*.<sup>278</sup> At issue in *Eichler* was the availability in a private rule 10b-5 action of the common law defense of *in pari delicto*.<sup>279</sup> Stressing that private actions are "a necessary supplement to Commission action,"<sup>280</sup> the Court subordinated the *in pari delicto* defense to enforcement considerations.<sup>281</sup> To this end, it established a two-pronged test that permits the defense only when rule 10b-5's enforcement will not be compromised thereby.<sup>282</sup> A privately negotiated contract clause with the capacity to thwart the enforcement of rule 10b-5<sup>283</sup> must likewise be governed by federal principles.

274. See 2 STUART M. SPEISER, ATTORNEYS' FEES § 15:3 (1973 & Supp. 1988).

275. See *id.* § 15:7

276. See *supra* notes 41-43, 73 and accompanying text.

277. *Samuels v Wilder*, 871 F.2d 1346, 1352 (7th Cir. 1989); see *McGuire v Miller*, 1 F.3d 1306, 1313 (2d Cir. 1993) (recovery under attorneys' fees clause in rule 10b-5 action depends on whether "the contract is valid under applicable state law").

278. 472 U.S. 299 (1985).

279. *Bateman Eichler, Hill Richards, Inc. v Berner*, 472 U.S. 299, 301 (1985).

280. *Id.* at 310 (quoting *J.I. Case Co. v Borak*, 377 U.S. 426, 432 (1964)).

281. *Id.* at 310-11.

282. *Id.*, see *Sachs*, *supra* note 3, at 133-34 (discussing two-prong test).

283. See *supra* notes 268-69 and accompanying text.

*B. Accommodating the 1934 Act Through Enhanced Notice*

Some current rule 10b-5 decisions concede that the validity of an attorneys' fees clause is not simply a matter of state contract law. According to these decisions, the 1934 Act can be accommodated by a clause that provides clear notice of its coverage of attorneys' fees in rule 10b-5 litigation.<sup>284</sup> The cases that impose an enhanced notice requirement are quite uninformative about precisely what aspect of the 1934 Act the notice accommodates. Most of the cases simply duck the question.<sup>285</sup> The cases are vaguer still about how an enhanced notice requirement resolves these largely unspecified conflicts with the 1934 Act.<sup>286</sup> Presumably, the idea is that an investor who signs a contract that contains a crystal-clear attorneys' fees clause can be assumed to have acted freely and voluntarily, and hence it seems fair, not to mention efficient, to enforce the clause against him. Thus, the decisions that accommodate the 1934 Act through enhanced notice are grounded ultimately in contract principles. No serious consideration is given to the practical impact of these clauses—whether they operate as an incentive not to sue, as pressure to terminate actions early, or as a penalty for investors who sue and lose.<sup>287</sup>

Grounded in contract principles, these decisions fail to come to terms with the fact that freedom of contract cannot overcome section 29(a).<sup>288</sup> Indeed, attorneys' fees clauses and section 29(a) are irreconcilable. With an attorneys' fees clause, the investor gives up an important protection—not having to pay her opponent's attorneys' fees unless the court first determines that she acted in bad faith.<sup>289</sup> To be sure, section 29(a) refers to the waiver of a 1934 Act "provision,"<sup>290</sup> and the surrendered protection stems from federal common law that comes into play through the 1934 Act's silence.<sup>291</sup> This does not make section 29(a) irrelevant, however.

---

284. See cases cited *supra* note 32.

285. One case made reference, bereft of citation or elaboration, to "preserv[ing] the power of securities purchasers to enforce their rights." See *Stratmore v Combs*, 723 F Supp. 458, 461 (N.D. Cal. 1989).

286. See cases cited *supra* note 32.

287. See *id.*

288. See *id.* For the text of § 29(a), see text accompanying note 78.

289. See *supra* notes 263-65 and accompanying text.

290. See *supra* text accompanying note 78 (providing text of § 29(a)).

291. See *supra* notes 263-64 and accompanying text.



In its *Rodriguez* decision, the Court eschewed literalism in the construction of section 29(a) and its 1933 Act counterpart.<sup>292</sup> It is thus fair to read section 29(a) as encompassing a waiver not only of a 1934 Act "provision" but also of a protection that arises as the result of statutory silence.

*Rodriguez*, of course, held that section 29(a) voids waivers of matters necessary to "place buyers of securities on an equal footing with sellers."<sup>293</sup> Judicial oversight of fee-shifting is clearly a matter of this sort. Indeed, Congress has made clear its view that this oversight is crucial. Each of the fee-shifting provisions in the express fraud provisions of the 1933 and 1934 Acts<sup>294</sup> is designed so that the losing party is not responsible for his opponent's fees unless his bad faith is established to the court's satisfaction.<sup>295</sup> Congress evidently judged that to shift fees to losing litigants as a matter of course would discourage private enforcement.

In short, attorneys' fees clauses under rule 10b-5 should not be enforced. These clauses waive rights necessary to investor protection in violation of section 29(a).

### V Cumulative Consequences

Significant cumulative consequences of incorporating contract devices into rule 10b-5 emerge upon categorizing the cases. The fifty-six cases involving the statute of frauds, merger clauses, and attorneys' fees clauses are not a random assortment.<sup>296</sup> A full 80% involved transfer of close

292. See *supra* notes 95-103 and accompanying text.

293. *Rodriguez de Quijas v Shearson/Am. Express, Inc.*, 490 U.S. 477, 481 (1989); see *supra* note 100 and accompanying text.

294. The three provisions are contained in § 9(e) of the 1934 Act, 15 U.S.C. § 78i(e) (1988) [hereinafter § 9(e)], § 18(a) of the 1934 Act, 15 U.S.C. § 78r(a) (1988) [hereinafter § 18(a)], and § 11(e) of the 1933 Act, 15 U.S.C. § 77k(e) (1988) [hereinafter § 11(e)]. The fee-shifting aspect of § 11 was enacted by the 1934 Congress as an amendment to the 1933 Act. See Pub. L. No. 291, 48 Stat. 881 (1934), reprinted in 4 LEGISLATIVE HISTORY, *supra* note 38, item 1, at 908; see also *Blue Chip Stamps v Manor Drug Stores*, 421 U.S. 723, 753-54 (1975).

295. For a discussion of fee-shifting in §§ 11(e), 9(e) and 18(a), see LOSS, *supra* note 265, at 1046-47

296. No distinction is made here as to whether the statute of frauds, merger clause, or attorneys' fees clause arose by way of holding, dictum, or merely as an issue that the court spotted but did not pursue. Two cases were counted twice because two of the devices came up in each: *Pommer v Medtest Corp.*, 961 F.2d 620, 625 (7th Cir. 1992) (statute of frauds and merger clause) and *Doody v E.F. Hutton & Co.*, 587 F. Supp. 829, 832-33 (D. Minn.

corporation stock (30%),<sup>297</sup> private-placements (34%),<sup>298</sup> or customer-

1984) (merger clause and attorneys' fees clause).

297 The following cases involved the transfer of close corporation stock and the statute of frauds: *Pommer v. Medtest Corp.*, 961 F.2d 620 (7th Cir. 1992); *Kagan v. Edison Bros. Stores, Inc.*, 907 F.2d 690 (7th Cir. 1990); *Threadgill v. Black*, 730 F.2d 810 (D.C. Cir. 1984) (finding an oral contract to suffice for standing, but without specifically mentioning the statute of frauds); *Reprosystem, B.V. v. SCM Corp.*, 727 F.2d 257 (2d Cir. 1984); *Fogarty v. Security Trust Co.*, 532 F.2d 1029 (5th Cir. 1976); *Chariot Group, Inc. v. American Acquisition Partners, L.P.*, 751 F. Supp. 1144 (S.D.N.Y. 1990), *aff'd mem.*, 932 F.2d 956 (2d Cir. 1991); *Geeting v. Prizant*, 664 F. Supp. 343 (N.D. Ill. 1987); *Markovich v. Vasad Corp.*, 617 F. Supp. 142 (E.D. Pa. 1985); *Southeastern Waste Treatment, Inc. v. Chem-Nuclear Sys., Inc.*, 506 F. Supp. 944 (N.D. Ga. 1980); *Omega Executive Servs., Inc. v. Grant*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,889 (S.D.N.Y. May 25, 1979); *Desser v. Ashton*, 408 F. Supp. 1174 (S.D.N.Y. 1975), *aff'd mem.*, 573 F.2d 1289 (2d Cir. 1977); *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967).

The following cases involved the transfer of close corporation stock and a merger clause: *Pommer v. Medtest Corp.*, 961 F.2d 620 (7th Cir. 1992); *Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp.*, 910 F.2d 1540 (7th Cir. 1990); *One-O-One Enters., Inc. v. Caruso*, 848 F.2d 1283 (D.C. Cir. 1988); *Braunstein v. Berman*, No. 89-5344, 1990 WL 192547 (D.N.J. Sept. 12, 1990); *Taylor v. Door to Door Transp. Servs., Inc.*, 691 F. Supp. 27 (S.D. Ohio 1988).

Thus, 17 of the 56 cases, or 30%, involved the transfer of close corporation stock.

298. The following cases involved private placements and the statute of frauds: *Northland Capital Corp. v. Silver*, 735 F.2d 1421 (D.C. Cir. 1984); *Bartels v. Algonquin Properties, Ltd.*, 471 F. Supp. 1132 (D. Vt. 1979); *Kingstone v. Oceanography Dev. Corp.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,387 (S.D.N.Y. April 11, 1978).

The following cases involved private placements and a merger clause: *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511 (10th Cir. 1983); *Becherer v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 799 F. Supp. 755 (E.D. Mich. 1992); *Miltland Raleigh-Durham v. Myers*, 807 F. Supp. 1025 (S.D.N.Y. 1992); *Davidson v. Wilson*, 763 F. Supp. 1465 (D. Minn. 1990), *aff'd*, 973 F.2d 1391, 1401 (8th Cir. 1992); *Caliber Partners, Ltd. v. Affeld*, 583 F. Supp. 1308 (N.D. Ill. 1984); *Esposito v. Sweeney*, No. 80-C-2861 (N.D. Ill. May 13, 1982) (LEXIS, Genfed library, Dist file); *NBI Mortgage Inv. Corp. v. Chemical Bank*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,066 (S.D.N.Y. May 24, 1977).

The following cases involved private placements and an attorneys' fees clause: *Layman v. Combs*, 981 F.2d 1093 (9th Cir. 1992); *Samuels v. Wilder*, 871 F.2d 1346 (7th Cir. 1989); *Zissu v. Bear, Stearns & Co.*, 805 F.2d 75 (2d Cir. 1986); *Hill v. Equitable Bank*, No. 82-220-CMW, 1991 WL 169371 (D. Del. Aug. 28, 1991); *Fulco v. Continental Cablevision, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,345 (D. Mass. June 19, 1990); *McCam v. Phoenix Resources, Inc.*, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,834 (S.D.N.Y. Nov 16, 1989); *Stratmore v. Combs*, 723 F. Supp. 458 (N.D. Cal. 1989); *Barnebey v. E.F. Hutton & Co.*, 715 F. Supp. 1512 (M.D. Fla. 1989); *Tartell v. Chelsea Nat'l Bank*, 351 F. Supp. 1071 (S.D.N.Y.), *aff'd*, 470 F.2d 994 (2d Cir. 1972).

Thus, 19 of the 56 cases, or 34%, involved private placements.

broker disputes (16%).<sup>299</sup> The remainder either fell into other categories or could not be classified on the basis of the information given.<sup>300</sup>

This distribution is not surprising. Private placements and transfers of close corporation stock occur off the public securities markets, and hence are more likely than transactions on those markets to be the result of face-to-face negotiations. Moreover, an investor typically negotiates with her broker the terms of their ongoing relationship. Indeed, other contract issues—such as the formation of an agreement<sup>301</sup> or the validity of a release<sup>302</sup> or choice of law clause<sup>303</sup>—are apt to reflect a similar distribution.

299. The following cases involved a customer-broker dispute and the statute of frauds: *Pelletier v Stuart-James Co.*, 863 F.2d 1550 (11th Cir. 1989); *Horst v W.T. Cabe & Co.*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,213 (S.D.N.Y. Oct. 31, 1977).

The following cases involved a customer-broker dispute and a merger clause: *Connor v First of Mich. Corp.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,350 (W.D. Mich. May 31, 1990); *Platsis v E.F. Hutton & Co.*, 642 F Supp. 1277 (W.D. Mich. 1986); *Doody v E.F. Hutton & Co.*, 587 F Supp. 829 (D. Minn. 1984).

The following cases involved a customer-broker dispute and an attorneys' fees clause: *Chee v Marine Midland Bank, N.A.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,806 (E.D.N.Y. Jan. 29, 1991); *Doody v E.F. Hutton & Co.*, 587 F Supp. 829 (D. Minn. 1984); *Ging v Parker-Hunter, Inc.*, 544 F Supp. 49 (W.D. Pa. 1982); *Maryville Academy v Loeb Rhoades & Co.*, 530 F Supp. 1061 (N.D. Ill. 1981).

Thus, 9 of the 56 cases, or 16%, involved customer-broker disputes.

300. See *McGuire v Miller*, 1 F.3d 1306 (2d Cir. 1993) (merger agreement); *Jackvony v RIHT Fin. Corp.*, 873 F.2d 411 (1st Cir. 1989) (not clear whether corporation is publicly held); *Jackson v Oppenheim*, 533 F.2d 826 (2d Cir. 1976) (privately negotiated sale of publicly held stock); *Rogen v Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966) (same); *Jankovich v Bowen*, 844 F Supp. 743 (S.D. Fla. 1994) (company in the process of going public); *Branch-Hess Vending Servs. Employees' Pension Trust v Guebert*, 751 F Supp. 1333 (C.D. Ill. 1990) (not clear whether corporation is publicly held); *Arrizza v Jefferson Guar. Bank*, 696 F Supp. 204 (E.D. La. 1988) (same); *Rowe v Maremont Corp.*, 650 F Supp. 1091, 1106 (N.D. Ill. 1986) (privately negotiated sale of publicly held stock), *aff'd*, 850 F.2d 1226, 1234 (7th Cir. 1988); *Allen Organ Co. v North Am. Rockwell Corp.*, 363 F Supp. 1117 (E.D. Pa. 1973) (not clear whether corporation is publicly held); *Colonial Realty Corp. v Brunswick Corp.*, 337 F Supp. 546 (S.D.N.Y. 1971) (public offering); *Lanza v Drexel & Co.*, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,826 (S.D.N.Y. Oct. 9, 1970) (exchange of close corporation stock for public stock), *aff'd*, 479 F.2d 1277 (2d Cir. 1973).

301. For illustrative rule 10b-5 cases on the formation of an agreement, see *supra* note 11.

302. For an illustrative rule 10b-5 case on releases, see *supra* note 10.

303. For illustrative rule 10b-5 cases on choice of law clauses, see *supra* note 9.

The distribution is cause for concern. The reason is that rule 10b-5 actions involving close corporations, private placements, and customer-broker disputes perform unique functions, and the derailment of these actions jeopardizes those functions.<sup>304</sup>

*A. Private Placements and Transfers of  
Close Corporation Stock*

The 1933 and 1934 Acts extend beyond the public markets to reach privately negotiated transactions.<sup>305</sup> While such transactions are typically exempt from the registration requirements,<sup>306</sup> they are nonetheless subject to the fraud provisions. Indeed, section 10(b) and its 1933 Act counterpart, section 17(a),<sup>307</sup> extend by their terms to all securities transactions, on and off the public markets.<sup>308</sup>

The Supreme Court has been vigilant in upholding the applicability of the fraud provisions to transactions off the public markets. The Court's decision in *Landreth Timber Co. v Landreth*<sup>309</sup> is illustrative. The Court held that section 10(b) extends to a privately negotiated sale of the stock of a close corporation.<sup>310</sup> It flatly rejected the argument that the "[1933 and 1934] Acts were intended to cover only 'passive investors' and not privately negotiated transactions involving the transfer of control to 'entrepreneurs.'"<sup>311</sup> While acknowledging that such transactions were exempt from registration,<sup>312</sup> the Court stressed that "there is no compara-

304. See *infra* notes 305-21 and accompanying text.

305. See *infra* notes 308-15 and accompanying text.

306. Registration of the initial offering under the 1933 Act can be avoided on the basis of the private offering exemption, § 4(2) of the 1933 Act, 15 U.S.C. § 77(d)(2) (1988), or Regulation D, 17 C.F.R. § 230.501-08 (1994). Registration under the 1934 Act is likewise inapposite, since it pertains only to securities that are publicly traded. See generally 1 HAZEN, *supra* note 52, § 9.2.

307. 15 U.S.C. § 77q(a) (1988) [hereinafter § 17(a)].

308. See *supra* note 1 (providing text of § 10(b)). Section 17(c) specifically makes the registration exemptions inapplicable to § 17(a). See 15 U.S.C. § 77q(c) (1988).

309. 471 U.S. 681 (1985).

310. *Landreth Timber Co. v Landreth*, 471 U.S. 681, 692 (1985).

311. *Id.*

312. *Id.*

ble exemption from the anti-fraud provisions."<sup>313</sup> Similarly, in its decision in *Superintendent of Insurance v Bankers' Life & Casualty Co.*,<sup>314</sup> the Court held that section 10(b) reaches fraud "whether conducted in the organized markets or face to face."<sup>315</sup>

When it comes to transactions off the public markets, the Supreme Court's longstanding refrain that private rule 10b-5 actions serve as "a supplement to Commission action"<sup>316</sup> holds especially true. The SEC concentrates on the public markets not only because of limited resources but also because in general it lacks, with respect to transactions exempt from registration, both oversight of and access to the materials distributed to investors concerning which a charge of fraud might conceivably be directed. Contract law derailment of private actions involving these transactions therefore moves in the direction of conferring on them the fraud exemption that Congress so painstakingly withheld.

### B. Customer-Broker Disputes

The mandatory arbitration clauses declared enforceable in *McMahon*<sup>317</sup> are currently found in close to 40% of cash accounts with brokerage houses as well as in essentially all margin and option accounts.<sup>318</sup> *McMahon* thus reduced the number of litigated cases against brokers, and hence the number of judicial decisions addressing customer-broker disputes. This reduced body of case precedent creates cause for concern that arbitrators will have only limited guidance<sup>319</sup> for their decisions.<sup>320</sup> Professor Lipton explains:

---

313. *Id.*

314. 404 U.S. 6 (1971).

315. *Superintendent of Ins. v Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971).

316. *Bateman Eichler, Hill Richards, Inc. v Berner*, 472 U.S. 299, 310 (1985) (citations omitted).

317. *Shearson/Am. Express, Inc. v McMahon*, 482 U.S. 220 (1987).

318. LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 428 (2d ed. Supp. 1993).

319. Judicial review of arbitrators' decisions focuses on whether there was "manifest disregard of the law." *See, e.g.*, *French v Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 784 F.2d 902, 906 (9th Cir. 1986).

320. *E.g.*, JAMES D. COX ET AL., *SECURITIES REGULATION* 1252 (1991); LOSS & SELIGMAN, *supra* note 318, at 429; *see also infra* note 321.

[W]ithout the benefit of guidelines derived from case-generated precedent, arbitration decisions will definitely lack a uniform response to issues and this lack of predictability can impact on the integrity of the system. Perhaps most importantly, the case law may stagnate and lose its ability to respond dynamically to changes in the world of securities.<sup>321</sup>

Rule 10b-5's development in this area will be only further imperiled if contract law succeeds in derailing those cases against brokers that still remain in the federal courts.

Thus, the functioning of the federal securities laws is impaired when rule 10b-5 actions involving the statute of frauds, merger clauses, and attorneys' fees clauses are derailed. This consequence compounds the inappropriateness of incorporating these contract devices into rule 10b-5.

### *Conclusion*

Courts today frequently derail private rule 10b-5 actions by using traditional contract devices such as the statute of frauds, merger clauses, and attorneys' fees clauses. Yet remarkably, these courts give scant heed to the real world in which investors function. Thus, no consideration is given to whether a statute of frauds requirement is practical for securities transactions, despite the fact that the American Law Institute at present has slated this requirement for elimination from Article 8 of the UCC specifically because of its impracticality. Nor do courts question the reasonableness of expecting an investor to ferret out a merger clause from a voluminous offering document of considerable complexity. Finally, no serious assessment is made regarding whether the enforcement of attorneys' fees clauses carries deleterious practical consequences, such as the discouragement of lawsuits or the penalizing of investors who sue and lose.

Moreover, importing contract devices into rule 10b-5 involves jurisprudential difficulties as well. A contract device is entitled to a place in rule 10b-5 only if it has a firm anchor in the language, history, or policies of the federal securities laws. Yet when importing the statute of frauds, merger clauses, and attorneys' fees clauses into rule 10b-5, courts rely on efficiency rationales and disregard the statutory text.

---

321. David A. Lipton, *Generating Precedent in Securities Industry Arbitration*, 19 SEC. REG. L.J. 26, 40-41 (1991).

The federal securities laws were necessary in the first place because those who dealt with investors abused the freedom that they enjoyed under the common law. Courts should resist allowing them to resurrect that freedom under the auspices of law-and-economics.