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Ii. Rule 10B-5

approach to the definition of a security, perhaps through legislation, is preferable to the current case by case approach in the courts which necessarily yields conflicting conclusions due to the subjective nature of judicial analysis.

JEAN L. BYASSEE

II. RULE 10b-5

A. *Purchaser-Seller Requirement*

The Supreme Court's 1975 decision in *Blue Chip Stamps v. Manor Drug Stores*[1] firmly established the purchaser-seller requirement as a limitation on the class of plaintiffs entitled to sue under Rule 10b-5.[2] The purchaser-seller requirement, or *Birnbaum* Rule,[3]

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intra-corporation fiduciary duties traditionally governed by state law); Piper v. Chris-Craft Indus., Inc., 97 S. Ct. 926 (1977) (no implied private right of action for damages to tender offeror under § 14(e), '34 Act); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (cause of action Rule 10b-5 does not lie for mere negligence); United Housing Foundation v. Forman, 421 U.S. 837 (1975) (definition of "securities" under the securities acts does not include units in private housing cooperative); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (standing for rule 10b-5 private action limited to actual purchasers or sellers of securities).

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[1] 421 U.S. 723 (1975).

[2] SEC Rule 10b-5 was promulgated pursuant to § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1970). Section 10(b) makes it:

> unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . 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.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1976) 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 light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

[3] The purchaser-seller requirement was first formulated in Birnbaum v. Newport

requires that the plaintiff allege fraud in connection with the purchase or sale of a security to have standing under Rule 10b-5.[4] Prior to the *Blue Chip* decision courts had not uniformly applied the *Birnbaum* Rule, and a number of exceptions to the strict purchaser-seller requirements arose.[5] In upholding the *Birnbaum* Rule the Court

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Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952).

[4] The *Birnbaum* Rule has been sharply criticized as unnecessarily limiting the useful potential of Rule 10b-5. *See, e.g.,* A. JACOBS, THE IMPACT OF RULE 10b-5 (1976) § 38.01[d] [hereinafter cited as A. JACOBS]; Lowenfels, *The Demise of the* Birnbaum *Doctrine: A New Era For Rule 10b-5,* 54 VA. L. REV. 268 (1968). Application of the requirement prior to *Blue Chip* ranged from rigid to extremely flexible. *Compare* Landy v. FDIC, 486 F.2d 139, 156-57 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974) (purchaser-seller requirement held an absolute prerequisite for Rule 10b-5 standing) *with* Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir. 1973), *cert. denied,* 416 U.S. 960 (1974) (purchaser-seller rule held not a prerequisite in the Seventh Circuit).

[5] Five principal exceptions to the *Birnbaum* Rule had developed prior to *Blue Chip.* These were the injunctive relief exception, *see, e.g.,* Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967); the forced seller exception, *see, e.g.,* Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied,* 389 U.S. 970 (1967); the derivative action exception, *see, e.g.,* Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); the aborted transaction exception, *see, e.g.,* Walling v. Beverly Enterprises, 476 F.2d 393 (9th Cir. 1973); and the de facto seller exception, *see, e.g.,* James v. Gerber Prods. Co., 483 F.2d 944 (6th Cir. 1973).

The injunctive relief exception applied when the plaintiff sought to enjoin future or ongoing Rule 10b-5 violations rather than seeking equitable relief or damages for past violations. The rationale for this exception was that the problems of proof of damage which in part motivated the *Birnbaum* Rule were not present in an action for injunctive relief and that less rigorous standards should be applied in order to effectuate the remedial aims of Rule 10b-5. The continued validity of this exception after *Blue Chip* is unsettled. *Blue Chip* expressly imposed a purchaser-seller requirement only in actions for damages. The Court's fear of vexatious litigation stemmed largely from the *in terrorum* potential of "strike" suits with settlement values dwarfing actual damages. *See* note 9 *infra.* However, the thrust of *Blue Chip* is clearly an effort to stem the flood of Rule 10b-5 litigation by limiting the class of plaintiffs, and courts may therefore view claims for injunctive relief as an effort to evade the Supreme Court's intended result. *Compare* Wright v. Heizer Corp., 411 F. Supp. 23 (N.D. Ill. 1975) (rejecting injunctive relief exception in light of *Blue Chip) with* Davis v. Davis, 526 F.2d 1286 (5th Cir. 1976) (upholding continued validity of injunctive relief exception). *See* Bauman, *The Future of Rule 10b-5: A Comment on Jacobs, The Impact of Rule 10b-5,* 4 SEC. REG. L.J. 332, 338-39 (1976) [hereinafter cited as Bauman]; *Rule 10b-5, 1975-1976 Securities Law Developments,* 33 WASH. & LEE L. REV. 935, 953-56 (1976) [hereinafter cited as *1975-1976 Developments*]. *But cf.* Jacobs, *Standing to Sue Under 10b-5 After Blue Chip Stamps,* 3 SEC. REG. L.J. 387, 401-03 (1976) [hereinafter cited as Jacobs]; Note, *Blue Chip Stamps v. Manor Drug Stores: Failure to Solve the Purchaser-Seller Problem,* 70 NW. U. L. REV. 965, 986-87 (1976) [hereinafter cited as *Failure to Solve*] (injunctive relief exception remains valid after *Blue Chip*).

The forced seller exception applied when transactions such as a short form merger in *Blue Chip* failed to state whether the various exceptions to that Rule remained valid.[6] The *Blue Chip* Court posed three principal justifications for sustaining the *Birnbaum* Rule; the longstanding judicial acceptance of the Rule,[7] the conformity of a purchaser-seller limitation on the plaintiff class under Rule 10b-5 with the statutory language and legislative history of the Securities Exchange Act of 1934 ('34 Act),[8] and the danger of "strike" suits and vexatious litigation if the *Birnbaum* limitation were removed.[9] Courts applied the

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or corporate liquidation converted the plaintiff's ownership interest into a claim for cash. Although no actual sale by the plaintiff had occurred, courts applying this doctrine reasoned that, since the plaintiff would shortly be forced to accept cash for his shares, requiring an actual sale as a condition for Rule 10b-5 standing was a "needless formality." Vine v. Beneficial Fin. Co., 374 F.2d 627, 634 (2d Cir. 1967). For a discussion of the continued validity of the forced seller doctrine after *Blue Chip* see text accompanying notes 69-79 *infra*. *See also* Jacobs, *supra* at 400.

The derivative action exception allowed a plaintiff who was not a purchaser or seller to bring a derivative action, when the corporation had purchased or sold shares. The validity of this exception does not appear to have been significantly affected by *Blue Chip.* 421 U.S. at 737-38. The rationale for the affirmance of the *Birnbaum* Rule is not disturbed by the continued existence of the derivative relief exception because the remedy sought runs to the corporation, not to the individual shareholder who caused the suit to be filed. *See 1975-76 Developments, supra* at 952-53.

The aborted transaction exception actually amounted to little more than recognition that plaintiffs claiming under contracts to purchase or sell securities fell within the statutory definitions of purchase and sale §§ 3(a)(13) and 3(a)(14) '34 Act, 15 U.S.C. §§ 78c(a)(13) and (14) (1970). *See* A. T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967). After *Blue Chip* the exception has been strictly limited to such a contractual context. *See 1975-76 Developments supra* at 956-57 n.114. *See* text accompanying notes 43-65 *infra.*

The de facto seller exception applied when the plaintiff was the beneficial owner of shares bought or sold. *See, e.g.,* James v. Gerber Prods. Co., 483 F.2d 944 (6th Cir. 1973). The continued validity of this exception after *Blue Chip* is open to doubt. *See* text accompanying notes 80-93 *infra.*

[6] 421 U.S. at 31-55.

[7] *Id.* at 731-33. The Court characterized the *Birnbaum* Rule as having been upheld by virtually all of the hundreds of reported cases considering *Birnbaum* in the quarter century since that decision. In addition, the Court cited the failure of the SEC to persuade Congress to alter the language of § 10(b) to bar fraud "in connection with the purchase or sale of, *or any attempt to purchase or sell,* any security" (Court's emphasis). *Id.* at 732, *citing Hearings on S.1178-82 before a Subcomm. of the Senate Comm. on Banking & Currency,* 86th Cong., 1st Sess. 367-68 (1959).

[8] 421 U.S. at 733-36. The Court emphasized that several provisions of the securities acts provide express private remedies for non-purchasers/sellers. *Id.* at 733, *citing* § 17(a) of the Securities Act of 1933 ('33 Act), 15 U.S.C. § 77q (1970); § 5 of the '33 Act, 15 U.S.C. § 77e (1970) and § 16(b) of the '34 Act, 15 U.S.C. § 78p(b) (1970). Had Congress wished to provide a remedy to non-purchaser/sellers under § 10(b), the Court reasoned, such an express provision could have been made.

[9] 421 U.S. at 737-49. The Court conceded that the statutory language and long-

mandate of *Blue Chip* during the past year when considering what sorts of transactions constituted purchases or sales of securities,[10] the status of plaintiffs claiming contractual rights to purchase or sell securities,[11] and the effect of *Blue Chip* on various of the pre-existing exceptions to the *Birnbaum* Rule.[12]

The *Blue Chip* Court relied in part on the statutory language of the '34 Act to justify its limitation on the availability of a Rule 10b-5 cause of action.[13] However, the terms "purchase" and "sale" are not defined in the '34 Act,[14] and *Blue Chip* provided no general guidelines for the definition of these terms.[15] Thus, whether a given transaction constitutes the purchase or sale of securities continues to be settled on a case-by-case basis[16] in view of the language of the '34 Act and the policy thrust of *Blue Chip.*[17] Two decisions in the last year have contributed to this case-by-case definition of a purchase or sale of securities.

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standing judicial acceptance of the *Birnbaum* Rule would not by themselves, justify the result in *Blue Chip.* However, the opinion posed a number of policy justifications for the maintenance of the *Birnbaum* Rule which were viewed as determinative. *Id.* These policy justifications were: (1) the potential for vexatious "strike" suits arising out of the fact that a Rule 10b-5 action may have a settlement value to the plaintiff completely out of proportion to its chances for success on the merits and may thus disrupt normal business activity absent limits which allow for dismissal; (2) the possibilities for abuse of discovery rules in such strike suits; (3) the fact that, without the *Birnbaum* Rule's imposition of the requirements of a sale transaction—an "objectively demonstrable fact"—triers of fact in Rule 10b-5 cases would be left to rule on "many rather hazy issues of historical fact" with no guidance other than the plaintiff's oral testimony as to what he *would have done* in the absence of the fraud alleged.

[10] *See* text accompanying notes 13-42 *infra.*

[11] *See* text accompanying notes 43-65 *infra.*

[12] *See* text accompanying notes 66-92 *infra.*

[13] *See* note 8 *supra.*

[14] The appropriate definitional provisions of the '34 Act, §§ 3(a)(13) and (14), 15 U.S.C. §§ 78c(a)(13) and (14) (1970) provide only that the terms "buy" and "purchase" shall include contracts to acquire, and that the terms "sale" and "sell" shall include contracts to dispose of securities. The definitions of purchase and sell are treated by the '34 Act as matters of common knowledge.

[15] *Blue Chip* involved an offer to sell securities made pursuant to an antitrust consent decree. 421 U.S. at 725-27. The plaintiff alleged that the prospectus which accompanied this offer had been fraudulently pessimistic and that it had been induced not to accept the offer by this unduly pessimistic prospectus. The Court's holding was limited to a finding that, on those facts, the plaintiff did not meet the purchaser-seller requirement. *Id.* at 731.

[16] The need to give substantive content to the terms "purchase" and "sale" did not begin with *Blue Chip.* The existence of the *Birnbaum* Rule required courts to struggle with the question of what is a purchase or sale of securities for more than twenty years prior to *Blue Chip. See* A. JACOBS, *supra* note 4, at § 38.02[b].

[17] *See* notes 7-9 *supra.*

In *Mallis v. FDIC,*[18] the Second Circuit held that a pledge of stock as collateral for a loan is a sale of securities[19] and that fraud in connection with such a pledge gives rise to a cause of action under Rule 10b-5.[20] The plaintiffs in *Mallis* had taken a pledge of stock as security for a loan.[21] At the time of the pledge, the stock was held by defendant Bankers Trust and was subject to an escrow agreement.[22] Plaintiffs sued after default on the loan, alleging that the defendant had violated Rule 10b-5 by knowingly misrepresenting that the stock was no longer subject to the escrow agreement.[23] The district court held that the plaintiffs lacked standing to bring an action under Rule 10b-5 because no sale had occurred.[24]

The Second Circuit reversed,[25] stating that a pledgee takes an investment risk identical to that taken by an investor[26] and that the

[18] [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,823 (2d Cir. Jan. 3, 1977), *cert. granted,* 45 U.S.L.W. 3761 (U.S. May 24, 1977) (No. 76-1359).

[19] *Id.* at 90, 958.

[20] *Id.* at 90,961-62.

[21] *Id.* at 90,959.

[22] *Id.* Plaintiff's loan was made to two investors, Arnold and Fowler to enable them to purchase certain shares of Equity National Industries, Inc. Title to these shares was in Jerome and Judith Kates. However, the shares were in the possession of Banker's Trust pursuant to a prior pledge by the Kates'. In addition, the shares were subject to an escrow agreement which required that they be returned to Equity National for cancellation or reissue depending on whether the corporation met specified earnings conditions. The shares had already been called for cancellation at the time of the pledge by Arnold and Fowler and the subsequent transactions which resulted in the release of the shares by Banker's Trust and their transfer to Arnold and Fowler and thence to plaintiff.

[23] *Id.*

[24] 407 F. Supp. 7 (S.D.N.Y. 1975). The district court relied on McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied,* 420 U.S. 930 (1975), which held that a pledgor of securities might be liable under Rule 10b-5 after his default and a consequent sale of the securities by the pledgee, but that the pledge itself did not constitute a sale.

[25] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,823 (2d Cir. Jan. 3, 1977). The *Mallis* court saw the holding in United States v. Gentile, 530 F.2d 461 (2d Cir.), *cert. denied,* 96 S.Ct. 2651 (1976), as dispositive. *Gentile* held that a pledge of stock was a sale in the context of a criminal prosecution under § 17(a) of the '33 Act, 15 U.S.C. § 77q(a) (1970). The *Mallis* court saw no basis for treating the term "sale" differently for purposes of a § 10(b) action. [1976- 1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,823 at 90,961. *See generally* A. JACOBS, *supra* note 4, at § 38.02[a] & [b].

[26] The court wrote:

> In effect, the pledgee assumes a very real investment risk that the pledged securities will have continuing value, a risk that is identical in nature to the risk taken by investors which serves as the indisputable basis for statutory regulation of securities transactions. We there-

policy objectives of *Blue Chip* would not be undermined by granting standing to plaintiffs.[27] The court of appeals saw no reason to expect that its holding would lead to an increase in vexatious litigation based solely on oral testimony—the prime fear of the *Blue Chip* Court.[28] In support of this holding, the court stated that a "pledge which occurs pursuant to a loan is just as concrete a transaction as is a normal transfer of title"[29] and provides the "objectively demonstrable fact"[30] that *Blue Chip* required for Rule 10b-5 standing.

In another recent case examining the purchaser-seller requirement, the District Court for the Southern District of New York employed analysis similar to that used in *Mallis* and held that a corporate "wind down" did not involve a purchase or sale of securities.[31] The case, *Alpex Computer Corp. v. Pitney-Bowes, Inc.*,[32] involved an unsuccessful joint venture between Alpex and Pitney-Bowes.[33] The joint venture had been pursued by means of a separate corporation, PBA, Inc., which had issued all of its stock to the plaintiff and defendant.[34] When the venture showed no prospects of success after several years, Pitney-Bowes used its controlling position to bring about a wind down of PBA's corporate activities, leaving the joint venture dormant but still in existence.[35] Alpex claimed that this wind down

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> fore find no reason to treat the equivalent risks differently under the statute.

[1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,823 at 90,961, *quoting* United States v. Gentile, 530 F.2d 461, 467 (2d Cir. 1976).

[27] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,823 at 90,961.

[28] *See* 421 U.S. at 743-49; notes 8-9 *supra*.

[29] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,823 at 90,962.

[30] 421 U.S. at 746-47.

[31] *See* Alpex Computer Corp. v. Pitney-Bowes, Inc., 417 F. Supp. 328, 330 (S.D.N.Y. 1976). "Wind down" is an indefinite term, and the *Alpex* court provided no definition. The term was used there to describe an action that causes a corporation to cease operations but maintain its corporate existence. Thus, the term as used in *Alpex* is analogous to a partial liquidation prior to dissolution. *See* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES (2d Ed.) (1970) § 381 at 814-15.

[32] 417 F. Supp. 328 (S.D.N.Y. 1976).

[33] The two companies formed the joint venture to develop and market a computerized retail store cash register known as the SPICE system. Initially, Pitney-Bowes and Alpex each owned a fifty per cent interest in PBA, Inc., the joint venture. However, the initial agreement between the parties provided that Alpex would have operating control of PBA. This agreement was revised as Pitney-Bowes provided the increasing sums needed to shore up the venture, and Pitney-Bowes eventually attained complete control and a sixty-four per cent ownership interest. *Id.* at 329.

[34] *Id.*

[35] *Id.* at 330. The wind down resolution directed PBA's officers to take appropriate action, to the extent permitted by the company's resources, to conclude arrangements

constituted a Rule 10b-5 violation which had damaged Alpex by converting its interest in a going concern to a worthless interest in a dormant corporation.[36] Alpex asserted that it had standing to make this claim under the "forced seller" exception to the *Birnbaum* Rule.[37]

While assuming the continued validity of the forced seller doctrine,[38] the court held it inapplicable to a wind down because there had been no termination of the plaintiff's interest, no liquidation of the joint venture, and no conversion of the plaintiff's ownership interest into a claim for cash.[39] Because these indicia of a forced sale situation were absent, the court held that no sale had occurred and that the plaintiffs consequently lacked standing to sue under Rule 10b-5. The *Alpex* court stated that such limitations were necessary in order to prevent a flood of claims based on changes in corporate operations involving no transfer of securities.[40] Reasoning that *Blue Chip* had established that Rule 10b-5 does not reach such mismanagement claims, the court granted summary judgment to Pitney Bowes.

The *Mallis* and *Alpex* decisions took a similar approach to defining a purchase or sale for Rule 10b-5 purposes. Both opinions first examined the transactions involved to determine their similarity to transactions already recognized as sales.[41] Next, both opinions sought guidance from the policy justifications offered by the *Blue Chip* Court for the imposition of firm standing requirements: to limit Rule 10b-5 to its intended reach[42] and to prevent a flood of vexatious litigation.[43]

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with customers, and to cancel, revise or fulfill any outstanding unfilled orders. After the wind down was complete, PBA terminated its business activity but not its existence. At the time of the Alpex decision, PBA still owned its principal asset, the SPICE system, and both parties still owned stock in PBA.

[36] *Id.* Alpex made two other claims under Rule 10b-5, involving alleged fraud in the issuance of PBA's shares and the acquisition of control by Pitney-Bowes. However, the court considered only plaintiff's third claim worthy of discussion.

[37] *See* note 5 *supra; see also* text accompanying notes 69-79 *infra.*

[38] 417 F. Supp. at 330. *But see* Gallagher, *10b-5 After Blue Chip Stamps: How Stands the Judicial Oak,* 80 DICK. L. REV. 1 36-37 (1975) [hereinafter cited as Gallagher].

[39] 417 F. Supp. at 330. *Accord,* Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973).

[40] 417 F. Supp. at 332. *Accord, In re* Penn Central Sec. Litigation, 494 F.2d 528, 534 (3d Cir. 1974), *noted at* 41 Mo. L. REV. 463 (1976).

[41] *See* text accompanying note 26 *supra;* 417 F. Supp. at 330-31.

[42] *See* notes 7-8 *supra.*

[43] *See* text accompanying notes 28-30 *supra;* 417 F. Supp. at 332; *see generally* R. JENNINGS & H. MARSH, SECURITIES REGULATION: CASES AND MATERIALS (4th Ed.) (1970) at 1034 [hereinafter cited as JENNINGS & MARSH].

This analysis appears well suited to achieve a definition of the purchaser-seller requirement consonant with *Blue Chip*. In the context of complex transactions, "purchase" and "sale" are necessarily indefinite terms. By considering both prior case law defining those terms in various settings and the policy objectives of *Blue Chip*, however, the *Mallis* and *Alpex* decisions point the way toward a workable purchaser-seller requirement.

Contractual Rights to Purchase and Sell Securities

An additional factor complicating the application of the purchaser-seller requirement is the fact that the '34 Act expressly provides that the terms "purchase" and "sale" shall include contracts for the purchase and sale of securities.[44] Thus, an allegation of fraud in connection with a contract to purchase or sell securities falls within the *Birnbaum* Rule and states a claim under Rule 10b-5.[45] However, the '34 Act does not define the exact nature of the contractual right required to meet the purchaser-seller requirement and thus confer standing under Rule 10b-5. Thus, courts faced with claims resting on allegations of fraud in connection with contracts to purchase or sell securities must look elsewhere for guidance as to whether a sufficient contractual right is present. State contract law provides a potential source for such guidance. Two recent cases reached conflicting results as to the applicability of state contract law to cases involving the purchaser-seller requirement.

Ohashi v. Verit Industries, Inc.[46] involved a contract for the sale of securities which remained executory by virtue of the defendant's failure to perform a covenant of good faith implied by state law. The Ninth Circuit held that fraud in connection with such a contract can support a Rule 10b-5 claim.[47] The plaintiff in *Ohashi* had purchased restricted shares of the defendant's stock. The contract under which the shares were purchased provided that the shares could not be transferred without the defendant's express consent and an opinion from its counsel that such transfer would not violate the securities laws.[48] The defendant fraudulently withheld the required consent and opinion as part of a scheme to keep the market price of defendant's

[44] 15 U.S.C. § 78c(a)(13) & (14) (1970) ('34 Act §§ 3(a)(13) and (14)).

[45] *See* A. JACOBS, *supra* note 4, at § 38.02[b].

[46] 536 F.2d 849 (9th Cir.), *cert. denied*, 46 U.S.L.W. 3411 (U.S. Dec. 7, 1976) (No. 76-254).

[47] 536 F.2d at 853-54.

[48] *Id.* at 852.

stock artificially high.[49]

The Ninth Circuit affirmed the district court's dismissal of the plaintiff's claims based on his inability to transfer the shares. The appellate court ruled that the *Birnbaum* Rule foreclosed recovery for claims founded on such "non-sales."[50] The contract under which the plaintiff had purchased the shares appeared to be fully performed, the transfer of the shares to the plaintiff and payment to the defendant having occurred.[51] However, the court ruled that performance of the stock sale contract was not completed by transfer of shares to the plaintiff.[52] The plaintiff could not get the full benefit of his bargain until the restrictions on the transfer of the shares were removed. The court, applying California law, held that the defendant had an implied duty to deal in good faith and thus could not take any action that would prevent full performance of the contract.[53] The defendant's fraudulent scheme breached this covenant, and the contract thus remained executory while the scheme was carried out.[54] The court then found that the misrepresentations that rendered the contract executory were tied to the market manipulations that caused the plaintiff's damages.[55] Thus, in the court's opinion, the plaintiff met the purchaser-seller requirement and stated a cause of action under Rule 10b-5.[56]

While the *Ohashi* court applied state contract law to determine whether a contract for the purchase or sale of securities was present

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[49] *Id.* Defendant in *Ohashi* allegedly used false assurances that it would perform its agreement to remove the restrictions on transfer of the shares to mollify the plaintiff, thereby preventing the plaintiff from taking independent action to secure removal of the restrictions. The plaintiff eventually secured a "no action" letter from the SEC and was able to get the transfer restrictions removed. However, by the time the plaintiff was able to transfer his shares the price had fallen from a high of $14 per share to $1.50 per share.

[50] *Id.* at 852-53.

[51] *Id.*

[52] *Id.* at 853.

[53] *Id., citing* Crail v. Blakely, 8 Cal. 3d 744, 749-50, 106 Cal. Rptr. 187, 191, 505 P.2d 1027 (1973); 1 B. WITKIN, SUMMARY OF CALIFORNIA LAW § 6 (8th ed. 1973). *But see* 1 WILLISTON ON CONTRACTS § 14 (3d ed. 1957).

[54] 536 F.2d at 853.

[55] *Id.* The court was careful to state that not every nonperformance of a contractual covenant in a contract for the purchase or sale of securities will support a Rule 10b-5 claim. Which breaches would support such claims, the court held, was to be determined using a facts and circumstances test. The facts alleged in *Ohashi,* involving breach of a contractual covenant as a means to further a scheme of market manipulations, clearly stated a Rule 10b-5 claim, *citing* 1 A. BROMBERG, SECURITIES LAW: FRAUD —SEC RULE 10b-5, § 4.6(230), at 82.1 (1975) [hereinafter cited as A. BROMBERG].

[56] 536 F.2d at 854.

to confer Rule 10b-5 standing, a contrasting application of state contract law was made in *Desser v. Ashton.*[57] The court in *Desser* declined to apply the state statute of frauds to bar a plaintiff claiming under an oral contract.[58] Citing the "broad remedial purposes"[59] of Rule 10b-5, the court held that the nonenforceability of a contract under state law was not determinative for purposes of assessing the sufficiency of the plaintiff's allegation of a Rule 10b-5 claim.

The contrast between the *Ohashi* and *Desser* courts' application of state law suggests the possibility that courts may still use their power to fashion remedies when exercising federal question jurisdiction[60] as a means of applying the purchaser-seller requirement as the equities of each case seem to dictate. Such a result is questionable in view of the policy position of *Blue Chip* which clearly defined limits to the class of potential Rule 10b-5 plaintiffs in order to avoid vexatious litigation.[61] Thus, while both the *Ohashi* and *Desser* courts recognized the plaintiffs' Rule 10b-5 claims, the analysis in *Ohashi* seems more tenable. The clear import of *Blue Chip* is that settled rules limiting the reach of Rule 10b-5 are necessary and that the pre-*Blue Chip* flexible approach to Rule 10b-5 was erroneous.[62] State

[57] 408 F. Supp. 1174 (S.D.N.Y. 1975), *noted at* 28 U. FLA. L. REV. 858 (1976). *Desser* was decided subsequent to the Supreme Court's decision in *Blue Chip* and appears less consistent with the thrust of that case than does *Ohashi. See* text accompanying notes 58-61 *infra.*

[58] 408 F. Supp. at 1176-77. The plaintiff in *Desser* claimed that he had surrendered confidential information in consideration for the defendant's oral promise to transfer securities to plaintiff, thereby allegedly creating a contract for the sale of securities. The parties stipulated that no transfer ever took place. The plaintiff alleged that the defendant entered into the contract with the intention of not performing, thereby violating Rule 10b-5. *See* 28 U. FLA. L. REV. 858, 859-60 (1976).

[59] 408 F. Supp. at 1176. The *Desser* court did not discuss the possibility that *Blue Chip* had altered the historically flexible construction of Rule 10b-5. *See* Bauman, *supra* note 4, at 340-42. The *Desser* court's only discussion of *Blue Chip* was an effort to distinguish the *Desser* plaintiff's obvious need to rely on oral testimony from the *Blue Chip* Court's strong rejection of the validity of claims based on such testimony under Rule 10b-5. The *Desser* court reasoned that *Blue Chip* was inapposite because the plaintiff could confirm his oral testimony with *additional* oral testimony. Given the Supreme Court's fundamental assertion that Rule 10b-5 claims must rest on at least one objectively demonstrable fact, *see* note 9 *supra,* the *Desser* court's reasoning is not persuasive. *See* 28 U. FLA. L. REV. 858, 864 (1976).

[60] *See* Illinois v. City of Milwaukee, 406 U.S. 91 (1972); Mishkin, *The Variousness of "Federal Law:" Competence and Discretion in the Choice of National and State Rules for Decision,* 105 U. PA. L. REV. 797, 802-03 (1957).

[61] *See* notes 7-9 *supra.*

[62] *See, e.g.,* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

contract law provides a settled body of precedent for guidance in determining the existence of necessary contractual rights for the purchase and sale of securities. The *Ohashi* court's application of this settled body of precedent is thus consistent with the *Blue Chip* policy of establishing clear limiting rules as to standing. By contrast, the *Desser* court's continued adherence to the pre-*Blue Chip* flexible view of rules limiting the availability of Rule 10b-5 remedies appears inconsistent with the Supreme Court's mandate in *Blue Chip.*

The problem of contractual rights and the purchaser-seller requirement also arose in *Camp v. Genesco, Inc.*[63] There, the court dealt with the question of whether fraud in connection with retained contractual rights, as opposed to fraud in connection with the creation of contractual rights,[64] can give rise to a Rule 10b-5 cause of action. The plaintiffs in *Camp* owned convertible securities of Genesco. They alleged that the defendant fraudulently induced them not to exercise their conversion rights and sued for damages under Rule 10b-5.[65] The court rejected defendant's argument that only plaintiffs who have been fraudulently induced to *enter into* contracts for the purchase or sale of securities have standing under the *Birnbaum* Rule. The court relied on the definitional provisions of the '34 Act and language in *Blue Chip* to hold that the plaintiffs had stated a claim under Rule 10b-5.[66] This analysis is consistent with the

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[63] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,679 (S.D.N.Y. Aug. 6, 1976).

[64] *See* text accompanying notes 48-58 *supra.*

[65] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,679 at 90,336.

[66] The *Camp* court stated,

> the holders of . . . options, and other contractual rights or duties to purchase or sell securities have been recognized as 'purchasers' or 'sellers' of securities for purposes of Rule 10b-5, not because of a judicial conclusion that they were similarly situated to 'purchasers' or 'sellers', but because the definitional provisions of the 1934 Act themselves grant them such a status.

[1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,679 at 90,337, *quoting* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 751 (1975).

The Third Circuit similarly focused on the existence of a contractual right as the central issue in determining whether the purchaser-seller requirement had been met in Tully v. Mott Supermarkets, Inc., 540 F.2d 187 (3d Cir. 1976). In *Tully,* the plaintiffs claimed that they had been fraudulently denied their contractual right of first refusal of shares of the defendant. The plaintiffs, Class A shareholders of defendant, sought injunctive relief claiming that defendant had offered Class A treasury shares to all classes of shareholders on an equal basis in breach of a restrictive stock agreement requiring that any such offer first be made to Class A shareholders. The offer was the result of machinations by Class C shareholders directed towards reducing the control exercised by Class A shareholders. All Class A shareholders were subject to a restrictive

Blue Chip Court's policy objectives and fidelity to statutory language. The '34 Act does not distinguish between retained contractual rights and the creation of contractual rights for purposes of defining a contract for the purchase or sale of securities. Further, a retained contractual right such as a put, call, option, or the conversion right involved in *Camp* provides the objectively demonstrable fact sought by the *Blue Chip* Court as a check on vexatious litigation.

Exceptions to the Purchaser-Seller Requirement

The continued validity of the various judicially created exceptions to the *Birnbaum* Rule was not discussed by the *Blue Chip* Court.[67] Courts in the past year, however, addressed and upheld two of these exceptions, the forced seller[68] and the de facto seller[69] doctrines.

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stock agreement that forbade transfer of any Class A shares unless they were first offered to the other Class A shareholders at book value or $100 per share, whichever was higher. However, the offer which gave rise to the *Tully* litigation was an offer of treasury shares held by the corporation and not by a Class A shareholder subject to the restrictive stock agreement. 540 F.2d at 192-93. Focusing on this act, the Third Circuit held that plaintiff's contractual right of first refusal did not extend to the shares at issue in *Tully*. Thus, unlike the plaintiffs in *Camp*, who had contractual conversion rights, the plaintiffs in *Tully* lacked any entitlement to purchase shares under the express terms of the agreement relied upon. Because the plaintiffs lacked a contractual right to purchase or sell securities, the Third Circuit held that they could not state a Rule 10b-5 claim. 540 F.2d at 193.

The analysis employed by the *Camp* and *Tully* courts is consistent with *Blue Chip* as well as with pre-*Blue Chip* decisions holding that plaintiffs claiming on the basis of contractual rights to purchase or sell securities meet the purchaser-seller requirement. *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 751 (1975); Fenstermacher v. Philadelphia Nat'l Bank, 493 F.2d 333, 336 n.4 (3d Cir. 1974); Walling v. Beverly Enterprises, 476 F.2d 393, 396 n.5 (9th Cir. 1973).

[67] *See* notes 6-8 *supra*. Likewise, the *Blue Chip* Court failed to deal expressly with the continued validity of the approach of those courts which had treated *Birnbaum* not as a rigid rule of standing but rather as a policy decision to limit antifraud litigation by limiting the class of potential plaintiffs. *See, e.g.*, James v. Gerber Prods. Co., 483 F.2d 944, 948 (6th Cir. 1973); Iroquois Indus., Inc. v. Syracuse China Corp., 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970); Heyman v. Heyman, 356 F. Supp. 958, 965 (S.D.N.Y. 1973). The clear implication of *Blue Chip's* affirmance of *Birnbaum*, however, was that a measure of rigidity had been added to the purchaser-seller requirement. Thus, the fate of the various judicially created exceptions to the *Birnbaum* Rule was open to doubt. *See* text accompanying notes 1-6 *supra*; *compare* Jacobs, *supra* note 5, *and Failure to Solve*, *supra* note 5, *with* Bauman, *supra* note 5; *and Rule 10b-5, Survey of 1974 Securities Law Developments*, 32 WASH. & LEE L. REV. 719, 742-50 (1975) [hereinafter cited as *1974 Developments*].

[68] *See* note 5 *supra*.

[69] *Id.*

The decision in *Singer v. Magnavox Company*[70] affirmed the vitality of the forced seller exception after *Blue Chip*. The plaintiffs in *Singer* alleged that the defendant had employed proxy materials which contained material misrepresentations and omissions to effectuate a two-step takeover of Magnavox.[71] Plaintiffs sought rescission or, in the alternative, damages.[72] The plaintiffs had not sold their shares in Magnavox but claimed that the effect of the imminent short form merger[73] would be to convert their ownership interest into a claim for a grossly inadequate amount of cash,[74] the gravamen of a claim under the forced seller doctrine.[75] The *Singer* court did not analyze the effect of *Blue Chip* on this claim, but merely cited several pre-*Blue Chip* cases for the proposition that the plaintiff had "clearly" stated a claim under Rule 10b-5.[76]

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[70] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,830 (D. Del. Jan. 4, 1977).

[71] The takeover in *Singer* was to be achieved by forming a Delaware shell corporation to make a tender offer for the shares of Magnavox. Control gained by means of the tender offer would then be used to authorize the creation of a wholly owned subsidiary, and a subsequent freeze out merger of Magnavox into the subsidiary would eliminate the rest of the shareholders. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,830 at 90,993-94. A freeze out merger, as the term applies to *Singer*, is a contrived merger with a shell corporation created solely for the purpose of the merger. The terms of such mergers commonly provide that the "frozen out" minority shareholders will receive senior securities or cash in exchange for their common stock. The effect is to terminate the ownership interest of the minority and give total control of the corporation to the insiders who effected the freeze out. *See generally* Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019, 1020-21 (1975); Note, *Going Private*, 84 YALE L.J. 903, 910-11 (1975).

[72] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,830 at 90,994. The plaintiffs in *Singer* placed primary reliance on the principle, first enunciated in Green v. Santa Fe Indus., Inc., 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 97 S.Ct. 1292 (1977) and Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir.), *vacated and remanded*, 97 S. Ct. 228 (1976), that a freeze out merger without a legitimate corporate purpose is a per se violation of Rule 10b-5. *See* Part E, *infra*. The *Singer* court expressly refrained from deciding this question, although it doubted the validity of the *Green-Marshel* rule. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,830 at 90,995.

[73] *See* note 70 *supra*. The freeze out merger in *Singer* was to have been carried out under the Delaware short form merger statute, DEL. CODE ANN. tit. 8, § 253 (1974 and Cum. Supp. 1976) (parent corporation owning at least 90% of subsidiary's stock may merge with subsidiary upon resolution of parent's board and shareholders; no notice to or consent of minority shareholders required).

[74] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,830 at 90,995-96.

[75] *See* note 5 *supra*.

[76] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,830 at 90,996. The court relied on Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967) (*see* note 5 *supra*) and Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369 (D. Del. 1965), which

A more complete analysis of the basis for the survival of the forced seller doctrine would have been desirable and arguably would have led to the same result. Granting standing to a forced seller does not undermine the policy objectives of *Blue Chip* and is not necessarily barred by the *Blue Chip* Court's careful attention to statutory definitions.[77] Indeed, the *Blue Chip* opinion cited a leading forced seller case, *Vine v. Beneficial Finance Co.*,[78] albeit for another proposition, but without suggesting that the holding in *Vine* was invalid.[79] The Court's benign treatment of the forced seller exception permits the inference that the exception remains valid.[80]

A second exception to the *Birnbaum* Rule was involved in *Klamberg v. Roth.*[81] In that case the court, citing pre-*Blue Chip* cases as authority,[82] upheld the de facto seller exception in denying a motion to dismiss a Rule 10b-5 claim by a beneficiary of a trust against the trustee.[83] The court relied on language in the *Blue Chip* opinion

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held that an allegation of a fraudulent scheme which results in a compelled sale of securities at an inadequate price states a Rule 10b-5 cause of action.

[77] The forced seller exception rests on the proposition that an actual sale by the plaintiff is, under the circumstances, a needless formality. *See* note 5 *supra*. The policy objectives of *Blue Chip* are not thwarted by giving standing to forced sellers. The imminent, inevitable sale by the plaintiff provides the "objectively demonstrable fact" required by *Blue Chip* and eliminates the danger of vexatious strike suits based on oral testimony about hypothetical situations that provided the major policy impetus for the *Blue Chip* Court's affirmance of *Birnbaum*. *See Failure to Solve*, *supra* note 5, at 987-89; *but see* Gallagher, *supra* note 38, at 36-37.

[78] 374 F.2d at 627 (2d Cir.), *cert. denied* 389 U.S. 970 (1967).

[79] 421 U.S. at 746-47 n.10. The *Blue Chip* Court cited *Vine* for the proposition that limitations on Rule 10b-5 actions proposed by the SEC were not adequate to deal with the adverse effects which would flow from the elimination of *Birnbaum*.

The weakness of the *Singer* court's analysis stems neither from its reliance on *Vine*, nor from its result, which is defensible in light of *Blue Chip*, but rather from the failure to discuss the impact of *Blue Chip* on the facts before it. No analysis of a purchaser-seller question which fails to discuss the policy thrust of *Blue Chip* can be considered an adequate treatment of the issues, regardless of the result.

[80] *See* Jacobs, *supra* note 5; *Failure to Solve*, *supra* note 5; *but see* Gallagher, *supra* note 38.

[81] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,747 (S.D.N.Y. Oct. 20, 1976).

[82] The *Klamberg* court relied in part on James v. Gerber Prods. Co., 483 F.2d 944 (6th Cir. 1973), the pre-*Blue Chip* case that established the de facto seller exception. As in *Singer*, the inadequacy of the *Klamberg* court's analysis is not its reliance on pre-*Blue Chip* cases per se, but rather its failure to reevaluate the adequacy of those cases as precedent in light of the policy objectives set forth in *Blue Chip*.

[83] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,747 at 90,629. The plaintiffs in *Klamberg* were employees of A. Sandler Co. and beneficiaries of its profit sharing retirement plan. The complaint alleged that Kayser-Roth Co., which had acquired A. Sandler Co. in 1969, had replaced the trustees of the retirement plan. The

which it argued supported the continuation of the policy of flexible interpretation of the *Birnbaum* Rule as the basis for justifying its continued adherence to the de facto seller doctrine.[84] Reasoning that the plaintiffs, while not the nominal sellers of the stock, were the parties most directly affected by the sale, the court held that a Rule 10b-5 cause of action had been stated.[85]

This result is difficult to support in light of the similarity of the plaintiff's position to that of the plaintiff in *Blue Chip*. In both cases the plaintiffs had not bought or sold any stock and lacked a contractual right to buy or sell stock.[86] The sale of stock by either plaintiff was neither imminent nor unavoidable and thus a needless formality as in a forced seller situation.[87] The *Klamberg* court's confidence that *Blue Chip* allowed a continuation of a flexible approach to the *Birnbaum* Rule is questionable given the tone of the *Blue Chip* opinion.[88] The *Blue Chip* Court paid careful attention to the statutory language of the '34 Act and emphasized the need to limit the reach of Rule 10b-5.[89] A de facto sale clearly does not fall within the statutory definitions of purchase and sale,[90] and there is no apparent justification for overriding these definitions in a de facto seller case.[91] The

new trustees, plaintiffs claimed, had placed 70% of the fund's assets in Kayser-Roth stock where they remained despite a steady decline in the market price of Kayser-Roth stock. The plaintiffs claimed that the value of the fund had decreased by 50% as a result of the trustees' action.

[84] The *Klamberg* court stated that, "[t]he *Blue Chip* Court recognized that 'the *Birnbaum* rule has been flexibly interpreted by lower federal courts', without commenting either pro or con on these decisions." [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,747 at 90,630 n.1., *quoting* 421 U.S. at 751.

[85] *Id.* at 90,631.

[86] *Compare* 421 U.S. at 726-27 *with* [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,747 at 90,629.

[87] *See* note 76 *supra.*

[88] *See* notes 7-9 *supra.* The entire *Blue Chip* opinion evinced a desire to limit the expansion of Rule 10b-5 litigation by elevating the purchaser-seller requirement to a strict rule of standing. Thus, the Supreme Court's failure to comment on the pre-*Blue Chip* pattern of flexible application of *Birnbaum, see* note 83 *supra,* hardly seems a conclusive justification for continuing that pattern unexamined.

[89] *See* notes 7-9 *supra.*

[90] A de facto seller has no contractual rights entitling him to purchase or sell securities and has not himself purchased or sold securities. *See* note 5 *supra.*

[91] A de facto seller has a state law remedy for breach of fiduciary duty. *See* note 92 *infra.* Thus, given the mandate of *Blue Chip* limiting the availability of a Rule 10b-5 cause of action, elimination of de facto seller standing under Rule 10b-5 appears justified. A contrary result would lead to what has been termed the anomaly of trying to "jigsaw" all manner of transactions into Rule 10b-5 because of the fortuitous, tangential involvement of a sale of securities. *See* Cary, *Federalism and Corporate Law:*

plaintiff in a de facto seller situation has recourse to the state courts for an action founded on the trustee's breach of his fiduciary obligation.[92] There is no reason to suspect that this is an inadequate remedy.[93] Given the lack of policy justifications for breaking with the *Blue Chip* doctrine of strict adherence to the statutory language of the securities acts, the continued validity of the de facto seller exception seems doubtful.[94] Thus, the result in *Klamberg* is apparently an improper application of *Blue Chip* and a misstatement of the current status of the de facto seller exception.

B. *Reliance*

The reliance element of a private Rule 10b-5 cause of action serves to establish a causal link between the defendant's violation of the rule and the plaintiff's harm.[95] Courts have adopted varying approaches

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Reflections Upon Delaware, 83 YALE L.J. 663, 700 (1974) [hereinfater cited as Cary]. *But see* Gallagher, *supra* note 38. Professor Gallagher argues that de facto seller standing should continue to be allowed because *a* sale of securities which can be established by documentary proof has occurred and because the plaintiff has a sufficient economic interest to eliminate the possibility of vexatious litigation from an indeterminate class of plaintiffs. Analysis focusing on what is being attacked in a de facto seller situation provides the answer to this contention. A Rule 10b-5 plaintiff claiming purchaser-seller status under the de facto seller exception has been harmed by a breach of fiduciary duty by the trustee, not by manipulation in the sale of stock. To allow a federal cause of action because securities are tangentially involved is to confuse categories. The transaction should be attacked in a state court action for breach of a fiduciary duty because of its unfairness, not in a Rule 10b-5 action because the fiduciary's wrongdoing happened to be accomplished by means of a securities transaction. This position is consistent with the Supreme Court's recent emphasis on removing matters "traditionally relegated to state law" from the class of permissible claims under the securities laws. *See* Santa Fe Indus., Inc. v. Green, 97 S.Ct. 1292 (1977) (breach of majority shareholders' fiduciary duty to minority); Piper v. Chris-Craft Indus., Inc., 97 S.Ct. 926 (1977) (no implied private right of action for damages to tender offeror under § 14(e), '34 Act, in part because claim traditionally available under state law).

[92] Because of the availability of a well developed state law remedy based upon the law of fiduciary obligations, application of the limiting policy of *Blue Chip* to the class of de facto sellers is appropriate. Plaintiffs in this class will not be deprived of a remedy and needless complication of the Rule 10b-5 area will be avoided.

[93] The alleged inadequacy of appropriate state remedies provided part of the justification for recent decisions by the Second Circuit expanding the reach of Rule 10b-5 in the area of going private transactions. *See, e.g.,* Green v. Santa Fe Indus., Inc., 533 F.2d 1283 (2d Cir. 1976), *rev'd,* 97 S.Ct. 1292 (1977). However, the remedies available to de facto sellers in state courts do not suffer from the defects which the Second Circuit saw in state appraisal actions available to shareholders "frozen out" in going private transactions. *See* Part E *infra.*

[94] *See 1974 Developments, supra* note 671, at 745.

[95] *See generally* 2 A. BROMBERG, *supra* note 55, at §§ 8.6, 8.7; 5 A. JACOBS, *supra*

to the concepts of "causation" and "reliance," often either using the terms interchangeably[96] or implying that they represent distinct elements of the plaintiff's case.[97] This confusion in terminology has obscured the essential question addressed by both "reliance" and "causation"—whether the defendant's violation is causally linked to the plaintiff's harm.[98]

This difficulty has its origins in the development of a judicially implied private right of action under Rule 10b-5.[99] The courts naturally attempted to define the scope and elements of private Rule 10b-5 actions by looking for guidance to analogous common law actions.[100] Given the use of terms such as "fraud" and "misrepresentation" in Rule 10b-5, courts adopted the common law torts of deceit and misrepresentation as appropriate analogs.[101] The elements of those torts required a showing of justifiable reliance by the plaintiff as the means of establishing causation in fact.[102] Thus, courts faced with private Rule 10b-5 actions tended to frame their discussion of causation in terms of the plaintiff's "reliance" upon the misrepresentation or

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note 4, at §§ 64.01, 64.02; Note, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 COLUM. L. REV. 562 (1972); Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975) [hereinafter cited as *Reliance Requirement*].

[96] *See, e.g.*, Harnett v. Ryan Homes, Inc., 496 F.2d 832, 836 n.12 (3d Cir. 1974); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2d Cir. 1969); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

[97] *See, e.g.*, Titan Group, Inc. v. Faggen, 513 F.2d 234, 238-39 (2d Cir. 1975), *cert. denied*, 423 U.S. 840 (1976); Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 517-18 (10th Cir.) (en banc) (per curiam), *cert. denied*, 414 U.S. 874 (1973); Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D.N.Y. 1965).

[98] *See* JENNINGS & MARSH, *supra* note 43, at 1064.

[99] Neither section 10(b) nor Rule 10b-5 expressly provide for a private right of action. The legislative history is also silent on this subject. *See* Bromberg, *Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 167, 167 (1974). However, such a right was implied in Kardon v. National Gypsum Co., 73 F. Supp. 798, 802-03 (E.D. Pa. 1947). The Supreme Court affirmed the existence of a private right of action under Rule 10b-5 in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

[100] *See* 3 L. LOSS, SECURITIES REGULATION, at 1430-34 (2d ed. 1961).

[101] *See* Note, *The Nature and Scope of the Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 24 CASE W. RES. L. REV. 363, 366-70 (1973) [hereinafter cited as *Private Actions*].

[102] The elements of a prima facie case of common law deceit are: (1) a false representation by the defendant, (2) knowledge or belief on the part of the defendant that the representation is false, (3) an intention by the defendant to induce the plaintiff to act or refrain from acting in reliance on the representation, (4) justifiable reliance by the plaintiff, (5) damage to the plaintiff caused by such reliance. W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 685-86 (4th ed. 1971) [hereinafter cited as PROSSER].

omission involved.[103] Courts have not, however, merely treated Rule 10b-5 as a codification of common law deceit, despite their occasionally confusing adherence to the terminology of the common law. Rather, recognition of the broad corrective and preventative aims of the Rule has led courts to abandon a strict adherence to common law doctrine in defining the nature of the causal link required to state a Rule 10b-5 claim.[104]

The leading example of this judicial modification of the common law in delineating the causation requirement in Rule 10b-5 actions is the Supreme Court's decision in *Affiliated Ute Citizens v. United States.*[105] In that case, the defendant withheld material information from plaintiffs in a face-to-face securities transaction.[106] Reversing a lower court decision which had found the plaintiff's failure to demonstrate reliance determinative,[107] the Court held that the plaintiffs need only demonstrate that the information was material in order to state a Rule 10b-5 claim.[108] The Court stated that the abrogation of the requirement of positively demonstrating reliance was necessary where the fraud alleged involves "primarily failure to disclose."[109] By

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[103] *See, e.g.,* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972); Kohn v. American Metal Climax, Inc., 458 F.2d 255, 288-91 (3d Cir.), *cert. denied,* 409 U.S. 874 (1972); City Nat'l Bank v. Vanderboom. 422 F.2d 221, 231 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970); List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965).

[104] Courts are not bound by the common law when implying private rights of action from federal regulatory statutes. *See Reliance Requirement, supra* note 95, at 585. Thus, the case law defining the scope of private actions under Rule 10b-5 has gone beyond its origins in the common law of deceit. *See Private Actions, supra* note 101, at 366-88.

[105] 406 U.S. 128 (1972).

[106] Plaintiffs in *Affiliated Ute* were unsophisticated Ute Indians. The defendants were sophisticated investors easily capable of taking advantage of the "not-so-knowledgeable" plaintiffs. 3 A. BROMBERG, *supra* note 55, at § 8.6 (New Matter). The plaintiffs alleged that the defendants has purchased securities from them without disclosing that defendants were engaged in selling those shares at substantially higher prices in a secondary market. 406 U.S. at 144-47.

[107] Reyos v. United States, 431 F.2d 1337, 1348 (10th Cir. 1970), *rev'd sub nom.* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

[108] 406 U.S. at 153-54.

[109] *Id.* at 153. The common law had some difficulty with the concept of even finding liability for deceit based on nondisclosures largely because of the old tort rule that nonfeasance will not support liability. *See, e.g.,* Swinton v. Whitinsville. Sav. Bank, 311 Mass. 677, 42 N.E. 2d 808 (1942). This rule was judicially altered, however, to require a defendant who made some representation to disclose sufficient information to prevent his representation from being misleading. Thus, an action for deceit based on nondisclosure would generally lie at common law. However, the common law has never inferred the reliance element of a deceit cause of action from the materiality of

this, the Court recognized the virtually insurmountable proof problems imposed upon a plaintiff if he is required to prove that he *would have* relied on undisclosed information had he known it.[110] The Court avoided this difficulty by defining material information as information upon which a reasonable investor would rely[111] and held that the plaintiff need only demonstrate that the information he was denied was of this nature.

While *Affiliated Ute* greatly eased the burden of plaintiffs claiming under Rule 10b-5,[112] a number of questions as to its applicability in variant factual situations remain unanswered. Specifically, the impact of the opinion on open market as opposed to face-to-face securities transactions was not clear.[113] Further, the *Affiliated Ute* Court did not treat the question of whether the defendant could rebut the presumption of reliance raised by a showing of material nondisclosures.[114]

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the undisclosed information as did *Affiliated Ute.* PROSSER, *supra* note 102, § 106 at 695-99.

[110] *See* 406 U.S. at 153-54, Titan Group, Inc. v. Faggen, 513 F.2d 234, 239 (2d Cir. 1975). A. BROMBERG, *supra* note 55, § 8.6 at 212; 29 VAND. L. REV. 287, 291 (1976).

[111] 406 U.S. at 153-54. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

[112] *See* Stoll, *Reliance as an Element in 10b-5 Actions,* 53 ORE. L. REV. 169, 174-77 (1974); *Reliance Requirement, supra* note 95, at 586-87. *Cf.* Mills v. Electric Auto-Lite, Inc., 396 U.S. 375, 384-85 (1970) (plaintiff not required to show a substantial effect on voting where proxy statements contained material omissions and misrepresentations).

[113] The chain of causation linking the defendant's conduct and the plaintiff's harm in an open market situation bears no relation to the plaintiff's own reliance. Rather, his damage is caused by the effect that the deception has on the market during the period in which the plaintiff trades. A. BROMBERG, *supra* note 55, § 8.6 at 212. This is the so-called "fraud on the market" theory of causation. *See* A. BROMBERG, *supra* § 8.7(2), at 217-18. Additionally, the definition of the applicable trading period in determining the class of potential plaintiffs presents some difficulties. *See* text accompanying notes 157-67 *infra.* Assuming that these difficulties can be overcome, where the plaintiff establishes that the information in question was material, the logical inference is that the defendant's conduct would affect a sufficient number of reasonable investors to produce a market impact causing the plaintiff's harm. However, courts have reached inconsistent results on this question. *Compare* Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied,* 97 S.Ct. 57 (1976) (proof of reliance unnecessary), *noted at* 29 VAND. L. REV. 287 (1976), *with* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 517-21 (10th Cir. 1973) (en banc) (per curiam) (reliance must be shown in open market transaction; *Affiliated Ute* not discussed) *and* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 337 F. Supp. 1128, 1139 (S.D.N.Y. 1971), *rev'd,* 480 F.2d 341 (2d Cir.), *cert. denied,* 414 U.S. 910 *and id.* at 924 (1973) (plaintiff must objectively demonstrate that some actual investors relied).

[114] *See, e.g.,* Chelsea Assoc. v. Rapanos, 527 F.2d 1266, 1271-72 (6th Cir. 1975);

The first of these unsettled issues, the application of *Affiliated Ute* to open market transactions, raises a number of difficult problems. If the effect of *Affiliated Ute* is to allow a showing of materiality to raise a rebuttable presumption of reliance[115] and therefore causation,[116] it is difficult to determine how a defendant would rebut the presumption in an open market setting.[117] Further, if *Affiliated Ute* extends to open market transactions and thus allows any investor who traded in a stock without the benefit of full or accurate information to make use of the reliance presumption, the potential exists for very large damage awards, due to the number of potential plaintiffs.[118]

The Second Circuit faced these issues in its 1974 decision in

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Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975); Rochez Bros. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1974) (presumption of reliance held to be rebuttable). One difficulty raised by terming the *Affiliated Ute* presumption rebuttable is that where the plaintiff's claim is based on omissions, a defendant seeking to rebut the presumption would face the same proof problems that justified the *Affiliated Ute* rule in the first place. *See* text accompanying note 110 *supra.*

An additional question left open by the *Affiliated Ute* Court was whether the Court had eliminated the requirement of proving reliance only for plaintiffs alleging material omissions. 406 U.S. at 153-54. The general rule that has emerged in cases subsequent to *Affiliated Ute* is that the presumption of reliance from a showing of materiality is applicable only in nondisclosure as opposed to misrepresentation cases. *Reliance Requirement, supra* note 95, at 606.

Some courts have stated, however, that the effect of *Affiliated Ute* is to abolish the reliance requirement in all Rule 10b-5 actions. Allen Organ Co. v. North Am. Rockwell Corp., 363 F. Supp. 1117, 1127 (E.D. Pa. 1973). Cases within the last year have exhibited a continued uncertainty on this issue. *Compare* McClean v. Alexander, 420 F. Supp. 1057, 1076 (D. Del. 1976) (presumption of reliance extends only to nondisclosure) *with* Adams v. Standard Knitting Mills, Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,683 at 90,367 (E.D. Tenn. May 19, 1976) (dictum) (*Affiliated Ute* applicable to both misrepresentations and omissions).

[115] *See* 29 VAND. L. REV. 287, 290 (1976) (presumption established by *Affiliated Ute* is rebuttable by an affirmative showing of lack of causation).

[116] *See* text accompanying note 114 *supra.*

[117] The defendant in an open market Rule 10b-5 case is faced with a large number of potential plaintiffs. Because of the nature of the causal chain in an open market case, *see* note 113 *supra,* the defendant would have to present objective evidence that an insufficient number of investors relied on any alleged misrepresentation to affect the market, normally an impossible burden.

[118] *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (1968) (Friendly, C.J., concurring), *cert. denied,* 394 U.S. 976 (1969). Recent cases limiting the use of class actions have reduced the potential liability somewhat. *See, e.g.,* Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974); Zahn v. International Paper Co., 414 U.S. 291 (1973). However, the sheer number of potential plaintiffs involved means that even a series of individual actions could result in very large cumulative liability for Rule 10b-5 defendants.

Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.[119] The *Shapiro* court held that the *Affiliated Ute* rule was applicable to a case involving trading on a national securities exchange.[120] The violation alleged in *Shapiro* was that Merrill Lynch, as underwriters of a new stock issue, had come into possession of material adverse earnings information about the issuer.[121] Merrill Lynch had not traded in the stock of the issuer but had allegedly failed to make the information public, while at the same time "tipping" certain of its customers.[122] The "tippee" customers had taken advantage of the information by selling their shares of the issuer before the earnings estimates became public and damaged the value of the stock.[123] The plaintiffs[124] had purchased the stock while the earnings information was still secret and had subsequently seen the value of the stock decline considerably after publication of the earnings information.[125]

The court, rejecting defendant's contention that *Affiliated Ute* was applicable only in face-to-face transactions, held that the nature of the transaction is not determinative.[126] Rather, given the aim of the securities laws to protect the integrity of securities markets by insuring that all investors trade on the basis of equal information,[127] the

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[119] 495 F.2d 228 (2d Cir. 1974).

[120] *Id.* at 234. Far more securities are traded on securities exchanges and in the over-the-counter market than are exchanged in face-to-face transactions. A. BROMBERG, *supra* note 55, § 8.7(2) at 217. Thus, the *Shapiro* court's extension of *Affiliated Ute* brought large numbers of plaintiffs within the class entitled to use the *Affiliated Ute* reliance presumption in private Rule 10b-5 actions.

[121] The information involved in *Shapiro* was that the earnings per share estimate of the issuer, Douglas Aircraft, was to be revised sharply downward in the company's annual report, to be issued approximately one month after Merrill Lynch learned of the revised estimate. 495 F.2d at 231-32. The revised figures showed that Douglas would earn virtually no profit for the year. *Id.*

[122] *Id.* at 232.

[123] *Id.*

[124] The plaintiffs in *Shapiro* were individual investors who had purchased Douglas stock while the earnings information was still secret. They sought to have the action maintained as a class action. The court denied this motion, holding that it was impossible to determine the parameters of the class. *Id.* at 233-34.

[125] *Id.* at 233 n.8.

[126] *Id.* at 240. The court stated that "defendants were under a duty . . . not to trade in, or recommend trading in Douglas stock without publicly disclosing the revised earnings information. . . . They breached that duty. Causation in fact therefore has been established." *Id.*

[127] *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968); Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1378-85 (1965) [hereinafter cited as Painter].

defendant's breach of its duty to disclose material inside information was held dispositive.[128] The court applied the *Affiliated Ute* rule and held that the plaintiff could establish the requisite causal link between the violation and the harm alleged by merely demonstrating the materiality of the undisclosed information.[129]

Shapiro subjected the non-trading, tipper defendant (Merrill Lynch) and the trading, tippee defendants (Merrill Lynch's customers) to potential liability to anyone who had purchased the stock in question while the earnings information remained undisclosed.[130] The potential damage liability of the defendants was obviously quite large, a fact expressly recognized by the court.[131]

The very large potential damage recovery resulting from an application of *Shapiro*[132] led the Sixth Circuit to apply a somewhat different test in a recent case factually analogous to *Shapiro*. The case, *Fridrich v. Bradford*,[133] involved insiders trading for their own benefit.[134] The defendants[135] had advance knowledge of an impending merger that would enhance the value of the stock involved in the case.[136] They bought shares of the company, which rose substantially

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[128] 495 F.2d at 240.

[129] The *Shapiro* opinion is not clear as to whether the materiality of the undisclosed information supports an inference that the *plaintiffs*, as reasonable investors, would have relied on it or rather an inference that sufficient numbers of other reasonable investors would have relied so that the integrity of the market price was impaired by its nondisclosure. *Id.* Logical consistency dictates the latter view because the plaintiffs demonstrated the damage element of their cause of action by showing the fall in the market price after the earnings information became public. *Id.* at 233 n.8. *See* note 113 *supra*.

[130] 495 F.2d at 241.

[131] *Id.* at 240-41. Recognizing that it had defined a very large class of potential plaintiffs and that the defendants' total liability might thus be enormous, the Second Circuit remanded to the district court for determination of the proper measure of damages.

[132] *See* text accompanying note 117 *supra*.

[133] 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 45 U.S.L.W. 3460 (U.S. Jan. 11, 1977) (No. 76-605).

[134] There was no allegation of tipping in *Fridrich*. Judge Celebrezze saw the presence of tipping in *Shapiro* and its absence in *Fridrich* as making it possible to view the two cases as consistent with each other. *See* text accompanying notes 158-165 *infra*.

[135] There were technically five defendants before the court; J.C. Bradford, J.C. Bradford, Jr. and three brokerage-related firms completely controlled by the two individual defendants. 542 F.2d at 309 n.4. The court's analysis of the causation issue, however, focuses almost entirely on the actions of the two individual defendants. The Sixth Circuit's discussion of the damages assessed by the lower court deals solely with the liability of defendant Bradford, Jr. *See* note 146 *infra*.

[136] Defendant Bradford, Sr. learned of the upcoming merger in *Fridrich* because of his status as controlling shareholder in one of the companies involved, Old Line Life

in value after the news of the upcoming merger became public several months later.[137] There was no allegation that defendants disclosed the information to any investors beyond their immediate families.[138]

In the ensuing private damage action, the district court held that any investor who sold the stock in question during the several months that the defendants' tortious conduct went undisclosed was entitled to recover damages from the defendants.[139] Echoing *Shapiro*, the district court in *Fridrich* held that plaintiffs fulfilled the requirement of

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Insurance (Old Line). He then informed defendant Bradford, Jr. of the impending merger. 542 F.2d at 309-10. In addition, defendant J.C. Bradford & Co., a brokerage firm controlled by the two individual defendants, was the principal market maker for the shares of Old Line. A market maker is a broker who offers and obligates himself to buy and sell a particular security at quoted prices. *Id.* at 309 n.5. In their various capacities as controlling shareholder, market marker, and officer of the market maker, the defendants not only learned of the upcoming merger but participated intimately in the negotiations that brought it to fruition. *Id.* at 310-11.

[137] Defendant Bradford, Sr. learned on April 21, 1972 that the merger was quite likely to occur and had as of that date an approximate knowledge of the merger terms. Between April 21 and April 27, Bradford purchased several thousand shares of Old Line for the account of his wife and that of a firm totally controlled by him. Bradford, Jr., after being informed of the probability of a merger, purchased 1225 shares of Old Line on April 27. Two of the plaintiffs purchased their shares of Old Line in May 1972 and sold them in mid-June. The other plaintiff was a long time Old Line shareholder who likewise chose to sell in mid-June.

A press release announcing the upcoming merger was issued on June 29, 1972. Bradford, Jr. sold his shares of Old Line on July 31, realizing a profit of $13,000. A portion of the shares which Bradford, Sr. had caused to be purchased were sold on August 24 at a profit of $103,000. The remainder of the shares purchased as a result of Bradford Sr.'s actions were not sold but had appreciated $74,000 in value as of the date the merger became effective. The facts of the defendant's tortious conduct became public on November 10, 1972, when the SEC filed an enforcement action against the five defendants. As a result of that action, the defendants were required to disgorge their profits, and Bradford, Sr. and Bradford, Jr. were suspended from any brokerage-related activity for periods of 60 and 20 days, respectively. 542 F.2d at 311-12.

[138] *Id.* at 309-12.

[139] [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,723 (M.D. Tenn. 1974). The district court's holding as to the relevant period of nondisclosure is a questionable application of *Shapiro*. The defendants violated Rule 10b-5 by trading in the shares of Old Line while *news of the upcoming merger* was undisclosed (a period of 60 days; April 21 to June 29). Yet the district court held that any investor who sold Old Line stock during the 148-day period while the *defendants' tortious conduct* was undisclosed was entitled to recover. This arguable extension of *Shapiro* was immaterial on the facts of *Fridrich* because all of the plaintiffs before the court had sold prior to the press release announcing the merger. However, the possibility that, under the district court's reasoning, a plaintiff who had sold Old Line stock while fully cognizant of the upcoming merger could recover from the defendants in a Rule 10b-5 action premised on defendants' trading prior to the press release disturbed the Sixth Circuit. 542 F.2d at 321 n.29.

proving causation by proving that defendants had breached their duty to disclose material information or refrain from trading in the stock.[140]

The Sixth Circuit reversed, holding that the lower court had overextended Rule 10b-5.[141] The court of appeals conceded that the defendant in *Fridrich* had breached Rule 10b-5 by trading on material inside information, but found that this breach was not causally connected to the plaintiff's harm.[142] The court rejected the causation rule set forth in *Affiliated Ute*, distinguishing that case on its facts. *Affiliated Ute* involved a deliberate scheme to defraud the investor-plaintiffs in a face-to-face transaction.[143] Applying *Affiliated Ute* to the facts of *Fridrich* would, the court stated, lead to an unjust and unworkable result.[144] The court distinguished face-to-face and open market transactions, stating that the natural limitations on damages present in the former are absent in the latter.[145] Noting the need to impose some such limits to avoid what it regarded as an unjust result,[146] the court adopted a very narrow view of the scope of private

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[140] [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) 94,723 at 96,404. The "disclose or refrain from trading" duty for insiders possessing material, nonpublic information originated in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). The defendants in *Fridrich* violated Rule 10b-5 by breaching this duty. However, the district court held that the defendants breached the duty not only by trading for their own personal gain, but also by continuing their normal market maker activities. [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,723 at 96,406. *See* note 136 *supra*.

[141] 542 F.2d at 309.

[142] *Id.* at 318-19.

[143] *Id. See* 406 U.S. at 145-48.

[144] 542 F.2d at 319-20.

[145] *Id.* at 321. The court noted that a strong policy consideration favoring some limits on open market Rule 10b-5 damages was that such judgments would often ultimately be paid by innocent stockholders for the benefit of speculators. *Id.* at n.28, *citing* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, C.J., concurring).

[146] The court illustrated the potential damage recovery under the district court's test in *Fridrich* by reference to the liability of defendant Bradford, Jr. He had made a profit of $13,000 from his inside dealings. *See* note 137 *supra*. The district court had found him liable for $361,000 in damages. The Sixth Circuit stated that if all persons who had sold their shares in the company during the three days when plaintiffs sold their shares were joined in a class action, Bradford, Jr.'s liability under the district court's test would have been approximately $800,000. If the period were extended to the date of publication of the news of the upcoming merger, Bradford, Jr.'s potential liability was $3,700,000. If the period were extended to the length the district court thought proper, until the disclosure of defendant's tortious activities, *see* note 139 *supra*, Bradford, Jr.'s liability in a class action would have totaled more than $7,000,000. 542 F.2d at 321 n.29.

Rule 10b-5 actions.[147] Under *Fridrich*, private damage liability must be based on a showing of "causation." However, the Sixth Circuit did not discuss how causation could be shown in an open market case.[148] On the facts before it, the *Fridrich* court held that the defendant's act of trading with third persons was not causally related to the plaintiff's harm.[149] The court's analysis in support of its holding is not particularly clear. Apparently the major factors considered in *Fridrich* were the "undisputed" fact that the defendants had not purchased any shares from the plaintiffs and that "defendant's act of trading in no way influenced plaintiffs' decision to sell."[150]

The *Fridrich* court's analysis seems questionable for several reasons. First, the court's holding is limited to a conclusory statement that the plaintiffs failed to establish causation,[151] but no techniques for analyzing future causation questions are provided. Further, the court's comments in attempting to justify its holding, focusing on the lack of contact between the plaintiffs and defendants and on the fact that defendants' trading was with third persons and not with the plaintiffs, evince an inaccurate view of the nature of the causal chain involved in open market Rule 10b-5 cases.[152] The factors discussed by the *Fridrich* court would have been appropriate in the analysis of reliance in a face-to-face transaction prior to *Affiliated Ute*.[153] However, these factors are inappropriate in a case involving anonymous open market transactions. In such transactions no single investor "trades" with any other investor in the sense that the Sixth Circuit used the term in *Fridrich*. Rather, all investors trade with reference to the market. Causation for Rule 10b-5 purposes stems from viola-

[147] Illustrative of the narrow view which the *Fridrich* appeals court took of private Rule 10b-5 actions is the fact that the court "seriously considered" basing its holding on the standing issue raised by the purchaser-seller requirement. 542 F.2d at 315 n.21, *citing* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). *See* Part A *supra*. The court saw the possibility of a decision based on *Blue Chip* by virtue of the fact that "none of the plaintiff's sold to the defendants, directly or indirectly." 542 F.2d at 315 n.21. The implications of such a doctrine are clear. If plaintiffs were required to establish that they had purchased or sold stock from or to a particular defendant, private Rule 10b-5 actions would be largely eliminated in open market cases by the insurmountable problems of proof which plaintiffs would face in meeting the purchaser-seller requirement.

[148] 542 F.2d at 318-19.

[149] *Id.*

[150] *Id.* at 318.

[151] *Id.* at 318-19.

[152] *See* note 113 *supra*.

[153] *See* text accompanying notes 99-104 *supra*.

tions which impair the integrity of the market.[154] By failing to recognize the "fraud on the market" variety of causation and looking instead to factors appropriate in the analysis of face-to-face transactions, *Fridrich* imposes undesirable limits on the reach of Rule 10b-5 actions in open market cases.[155]

Nonetheless, the general objective sought by the *Fridrich* court of limiting the class protected by Rule 10b-5 as a means of curbing the expansion of liability under the Rule is consistent with recent trends in the Rule 10b-5 area.[156] Judge Celebrezze's concurring opinion in *Fridrich* posed a possible reconciliation of *Fridrich* and *Shapiro* which treated the causation question more satisfactorily than did the majority opinion. Judge Celebrezze focused on the policy of the securities acts that all investors trading in an open market should possess equal information.[157] The objection to trading on inside information is that it creates an information imbalance, giving an improper advantage to the investor who possesses the information.[158] However, Judge Celebrezze stated that after the insider ceases his trading, the information imbalance equalizes, because no longer does any investor trading in the market possess superior information.[159] Applying this rationale to open market Rule 10b-5 cases, Judge Celebrezze reasoned that only those investors victimized by an information imbalance, that is,

[154] One commentator has stated the basis for the "fraud on the market" approach to causation as follows, "the market should not produce windfalls for some at the expense of others through control of information." 2 A. BROMBERG, *supra* note 55, § 8.7(2) at 217-18. *See* note 113 *supra*.

[155] The possible effect of *Fridrich* is to deny Rule 10b-5 plaintiffs in open market cases the presumption of causation from a showing of materiality laid down by *Affiliated Ute. But cf.* 542 F.2d at 323-27 (concurring opinion of Judge Celebrezze) (limits class of open market plaintiffs entitled to *Affiliated Ute* presumption in a case such as *Fridrich* where no "tipping" occurred to those investors who traded while integrity of market was impaired, plaintiffs in *Fridrich* stated not to fall within this class). The effect of such a doctrine would be to require plaintiffs to demonstrate causation. The *Fridrich* majority goes on to imply that plaintiffs must demonstrate that they traded with a particular defendant in order to demonstrate causation. 542 F.2d at 318-19. In an anonymous market, such a showing is virtually impossible. The effect is to eliminate Rule 10b-5 private actions in open market trading cases. Such a result is undesirable given the fact that the great bulk of securities transactions occur in open markets. *See* A. BROMBERG, *supra* note 55, § 8.7(2) at 217.

[156] *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[157] 542 F.2d at 324-25 (Celebrezze, J., concurring). Judge Celebrezze's emphasis on the policy of equal information for all investors is identical to the focus of the *Shapiro* court. *See* text accompanying note 127 *supra*.

[158] 542 F.2d at 326-27. *See* notes 113 & 154 *supra*.

[159] 542 F.2d at 326-27.

those who traded contemporaneously with an insider should be allowed to recover under Rule 10b-5.[160] Comparing *Shapiro* and *Fridrich,* Judge Celebrezze concluded that the holding in *Shapiro* had been dictated by the fact that Merrill Lynch's "tipping" of its customers[161] had served to perpetuate the information imbalance caused by the initial failure to disclose for as long as the information remained secret.[162] *Fridrich* on the other hand had not involved tipping, and thus by the time plaintiffs sold their shares the information imbalance in the market had equalized.[163] Thus, where no information imbalance existed, no purpose was served by extending the *Affiliated Ute* presumption of causation from material nondisclosure.

Judge Celebrezze's "information imbalance" analysis of the protected class of plaintiffs entitled to the benefit of the *Affiliated Ute* reliance presumption is a rational attempt to limit the reach of Rule 10b-5 in open market, insider trading cases while adhering to the policy of equality of information for all investors and the "fraud on the market" approach to causation in open market cases. However, his opinion appears deficient in certain respects. While the focus on the information imbalance caused by insider trading is analytically sound[164] and the notion that such imbalance dissipates after insider market activity ceases likewise seems unassailable, Judge Celebrezze does not define "contemporaneous" trading for the purpose of determining the protected class.[165] Similarly, the concurring opinion fails to discuss how long the market effect of insider trading endures and thus how long investors are victimized by the information imbalance—[166] a crucial determination for practical application of the test proposed by Judge Celebrezze.

Fridrich represents an effort to limit the massive damage liability made possible by the extension of *Affiliated Ute* to open market situations. Such an effort is consistent with recent trends in Rule 10b-5 decisions.[167] However, the *Fridrich* court fails to provide a satisfactory analytical basis for its holding limiting the reach of Rule 10b-5

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[160] However, Judge Celebrezze's concurrence in *Fridrich* provides inadequate guidelines for application. *See* text accompanying notes 164-166 *infra.*

[161] *See* text accompanying note 118 *supra.*

[162] 542 F.2d at 327.

[163] *Id.*

[164] *See* text accompanying note 154 *supra.*

[165] 542 F.2d at 326-27.

[166] *Id.*

[167] *See, e.g.,* Santa Fe Indus., Inc. v. Green, 97 S.Ct. 1292 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

and arguably adopts a view of the causation element inappropriate to open market transactions. Judge Celebrezze's concurring opinion, however, analyzes the facts of *Fridrich* and justifies the result in terms consistent with the accepted view of causation in open market Rule 10b-5 cases. Unfortunately, his theory lacks adequate guidelines for application of the proposed "information imbalance" test.

C. *Culpability Required for Rule 10b-5 Liability*

The degree of culpability necessary to support liability under Rule 10b-5 was long the subject of much dispute.[168] The Supreme Court's 1976 decision in *Ernst & Ernst v. Hochfelder*[169] authoritatively resolved some but not all of the questions in this area.[170] *Ernst & Ernst* involved an allegation that an accounting firm had breached Rule 10b-5 by negligently conducting an audit in failing to discover and disclose an intra-office "mail rule"[171] used by the subject company's president to carry out a scheme to defraud investors.[172] The Supreme Court reversed a lower court decision for the plaintiffs and stated that an allegation of mere negligence does not state a claim under Rule 10b-5.[173] After analyzing the statutory language[174] and legislative his-

[168] *Compare* Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974), *rev'd*, 425 U.S. 185 (1976) (negligence standard) *with* Sargent v. Genesco, Inc. 492 F.2d 750, 761 (5th Cir. 1974) (recklessness standard) *and* White v. Abrams, 495 F.2d 724 (9th Cir. 1974), *noted at* 32 WASH. & LEE L. REV. 99 (1975) (flexible duty standard, degree of culpability required held dependent on facts and circumstances). No cases would accept only the highest degree of culpability, that of conscious intent to defraud, in order to impose Rule 10b-5 liability. *See* Campbell, *Elements of Recovery Under Rule 10b-5: Scienter, Reliance, and Plaintiff's Reasonable Conduct Requirement*, 26 S.C.L. REV. 653, 656 n.12 (1975). *See generally* Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U. L. REV. 562, 598-600 (1972) [hereinafter cited as Bucklo, *Scienter*]; *1975-1976 Developments* note 5 *supra*, at 937-44.

[169] 425 U.S. 185 (1976).

[170] *See* text accompanying notes 178-179 *infra*.

[171] The "mail rule" involved in Ernst & Ernst provided that mail addressed to the president of First Securities Company, the brokerage firm which was the subject of defendant's audit, was not to be opened even if it arrived in his absence. This mail rule enabled the president to keep secret a scheme whereby he induced customers to invest in spurious "escrow" accounts with promises of high rates of return and then converted their funds immediately upon receipt. *See* 25 EMORY L.J. 465, 465-66 (1976).

[172] 425 U.S. 188-90 (1976).

[173] *Id.* at 193. The Court also rejected as improperly raised a claim by plaintiffs that Ernst & Ernst had breached § 17(a) of the '34 Act, 15 U.S.C. § 78p (1970), and SEC Rule 17(a)-5, 17 C.F.R. § 240.17a-5 (1976). 425 U.S. at 194 n.13.

[174] The Court reasoned that the use of the words "manipulative," "device," and "contrivance" in § 10(b) indicated an unmistakeable intent to proscribe a type of conduct quite different from negligence. Rather, in the Court's opinion, the plain

tory[175] of the securities acts, the Court held that liability under Rule 10b-5 requires an allegation of intent to deceive, manipulate or defraud, which was denoted as "scienter."[176]

Ernst & Ernst ended the debate over whether Rule 10b-5 reached negligent misrepresentations in private damage actions.[177] However, the opinion did not treat the question of whether scienter would be required in SEC enforcement actions.[178] Further, while the Court

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meaning of the words in § 10(b) "connote intentional or willful conduct designed to defraud investors by controlling or artificially affecting the price of securities." 425 U.S. at 199. Once the Court adopted this view of the language of § 10(b), the conclusion that the SEC lacks the power to promulgate a rule which requires a lesser degree of culpability than the statute is inevitable. The Court thus reasoned that Rule 10b-5 could not be extended to encompass negligent conduct. 425 U.S. at 213-14. *See generally,* Loss, *Summary Remarks,* 30 BUS. LAW. 163, 165 (Special Issue March 1975).

The Court bolstered its "plain meaning" construction of the language of § 10(b) with an argument founded upon the statutory scheme set out in the securities laws, emphasizing the interrelated nature of the provisions of those laws. Reasoning that every provision in the securities laws which allowed private recovery for negligent conduct also imposed significant procedural restrictions, the Court concluded that to allow recovery for negligence under § 10(b), which did not contain such procedural safeguards, would violate congressional intent. 425 U.S. at 208-10.

[175] Although admitting that the legislative history of § 10(b) was "bereft" of any specific mention of the statute's intended reach, the Court focused on the statement of one draftsman of the Act that § 10(b) was a "catch-all" designed to enable the SEC to deal with "new manipulative devices." 425 U.S. at 202-03, *quoting Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce,* 73d Cong., 2d Sess. 115 (1934) (statement of Thomas G. Corcoran). The Court concluded that no lawyer, legislative draftsman or legislator would use such words "if the intent was to create liability for merely negligent acts or omissions." 425 U.S. at 203.

[176] 425 U.S. at 214. The substantive content of the term "scienter" has been the subject of much confusion and debate. *See, e.g.,* Bucklo, *Scienter, supra* note 168; Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch-Phrases of Negligence and Scienter,* 45 N.Y.U.L. REV. 1206 (1970). Despite the volume and vehemence of this debate only one substantive benchmark can be ascertained as to the practical effect of the statement that Rule 10b-5 liability must now be predicated on a showing of "scienter", namely that proof of negligence is insufficient. Beyond that, the term scienter is largely devoid of substantive content except for the truism that scienter is that degree of culpability which will support Rule 10b-5 liability. After *Ernst & Ernst* the issue with regard to culpability revolves around what sorts of conduct can be encompassed within the rubric of "scienter". For a discussion of the semantic difficulties surrounding the term scienter, both before and after *Ernst & Ernst, see* Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5;* Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213 (1977) [hereinafter cited as Bucklo, *Ernst & Ernst*]; Floor, *The Scienter Requirement Under Rule 10b-5 and Reliance on Advice of Counsel After* Hochfelder, 12 NEW ENGL. L. REV. 191 (1976) [hereinafter cited as Floor].

[177] *See* note 168 *supra.*

[178] *See* text accompanying notes 180-211 *infra.*

ruled out negligence as a basis for Rule 10b-5 liability, it expressly refrained from deciding whether a misrepresentation made with reckless disregard for the truth but without conscious intent to defraud would give rise to Rule 10b-5 liability.[179] Courts dealing with Rule 10b-5 cases during the past year have faced these questions in attempting to apply *Ernst & Ernst.*

SEC Enforcement Actions

Unlike private damage actions, SEC enforcement actions are brought to protect the investing public from violations of the securities laws rather than to compensate individual investors harmed by

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[179] 425 U.S. at 194 n.12. The Court stated, "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question of whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." *Id. See* text accompanying notes 212-234 *infra.*

An additional question left unresolved by the *Ernst & Ernst* Court was the impact of its holding on the standard of culpability required for secondary defendants in private Rule 10b-5 actions. The class of secondary defendants consists primarily of parties involved in securities transactions in a professional, advisory capacity. *See, e.g.,* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (accountant); SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973) (attorney); Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974) (broker); Crofoot v. Sperry Rand Corp., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,611 (E.D. Cal. March 3, 1976) (data processing company); Fisher v. New York Stock Exchange, 408 F. Supp. 745 (S.D.N.Y. 1976) (stock exchange). *See generally* Ruder, *Multiple Defendants In Securities Law Fraud Causes: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification, and Contribution,* 120 U. PA. L. REV. 597 (1972) [hereinafter cited as Ruder]. Secondary defendants in Rule 10b-5 actions can be held liable as aiders and abettors of those violations if they have knowledge of the violation and render substantial assistance to the primary wrongdoer. *See* Woodward v. Metro Bank, 522 F.2d 84 (5th Cir. 1975); Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973). Prior to *Ernst & Ernst* there was substantial debate as to whether this test should be applied so as to hold parties professionally involved in securities transactions to a negligence standard of culpability under Rule 10b-5. *See, e.g.,* SEC v. Spectrum Ltd., 489 F.2d 535 (2d Cir. 1973); Lowenfels, *Expanding Public Responsibilities of Securities Lawyers, An Analysis of the New Trend in Standard of Care and Priorities of Duties,* 74 COLUM. L. REV. 412 (1974).

However, the Supreme Court's clear statement in *Ernst & Ernst* that a showing of scienter is required for private Rule 10b-5 liability is not limited to primary defendants. Thus, the effect of *Ernst & Ernst* is to lessen the distinction between primary defendants and their professional advisors by imposing the same standard of culpability for all varieties of Rule 10b-5 violations. *See generally* Note, *Rule 10b-5; Liability For Aiding and Abetting After* Ernst & Ernst v. Hochfelder, 28 U. FLA. L. REV. 999 (1976) [hereinafter cited as *Aiding and Abetting*]; *1975-1976 Developments supra* note 5, at 944-50.

such violations.[180] Considering this variance in purpose, differing culpability standards may be appropriate in these two types of actions.[181] The consequences of an SEC injunction can be quite serious, however, particularly when the defendant is a professional, including disbarment from practice before the SEC or suspension from securities-related activities.[182] This gravity of potential consequences militates against a lower standard of culpability in enforcement actions than the scienter standard imposed in private damage actions by *Ernst & Ernst*. Further, the statutory language cited in *Ernst & Ernst* as dictating that negligence be eliminated as a basis for Rule 10b-5 liability[183] was written only with SEC actions in mind, well before a private right of action under Rule 10b-5 was judicially implied.[184] A division of authority developed in the last year as to which of these arguments was more persuasive and therefore as to what standard of culpability is proper in SEC enforcement actions following *Ernst & Ernst*.[185]

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[180] *See, e.g.*, SEC v. Management Dynamics, Inc., 515 F.2d 801, 808 (2d Cir. 1975); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1100 (2d Cir. 1972); Painter, *supra* note 127.

[181] Advocates of applying a lower standard of culpability in SEC enforcement actions than that applicable in private damage actions argue that the public need for protection against violations of Rule 10b-5 is the same regardless of the defendant's state of mind. Thus, the contention is that the SEC should be allowed to continue to seek injunctions against negligent violations of the Rule even after *Ernst & Ernst*. *See, e.g.*, *SEC General Counsel's Memorandum Regarding* Ernst & Ernst v. Hochfelder, SEC. REG. & L. REP. (BNA), No. 354 at F-1 - F-2 (May 26, 1976); Floor, *supra* note 176, at 208-13.

[182] Rule 2(e) of the SEC's Rules of Practice provides for disbarment from practice before the Commission of any attorney, accountant, engineer or other professional expert against whom an injunction has been entered. Such disbarment is at the Commission's discretion and requires no hearing. Other sanctions available to the SEC include the power to order enjoined defendants not to engage in securities-related activities for a given period of time. *See, e.g.*, Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976) (sixty- and twenty-day suspensions from association with a broker, dealer or investment advisor to two defendants); *In re* Seidman & Seidman, SEC Rel. No. 34-12,752 [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 72,218 (Sept. 1, 1976) (accounting firm ordered not to undertake any new audit contracts with publicly-held companies).

[183] 425 U.S. at 199-201.

[184] The legislative and administrative history of § 10(b) and Rule 10b-5 contain no indication that Congress or the SEC contemplated a private right of action under either of these enactments. *See* S. REP. No. 792, 73d Cong., 2d Sess., 5-6 (1934); SEC Rel. No. 3230 (May 21, 1942). A private right of action under Rule 10b-5 was judicially implied in Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947), and has never been seriously questioned. *See* note 99 *supra*.

[185] *See* text accompanying notes 191-207 *infra*.

In *SEC v. Bausch & Lomb, Inc.*,[186] the court held that *Ernst & Ernst* applied with equal force to both private damage actions and SEC enforcement actions and that a showing of scienter was consequently required for liability in an enforcement action.[187] The case involved an allegation by the SEC that the chairman of the board of defendant Bausch & Lomb had leaked confidential earnings estimates to securities analysts.[188] The facts surrounding the disclosure left little doubt that the leak was not part of any fraudulent scheme.[189]

The court consequently found no violation of Rule 10b-5 and denied the SEC injunctive relief.[190] Although the opinion expressly recognized that *Ernst & Ernst* was factually distinguishable from an SEC enforcement action,[191] the court found that the language of the securities acts and the thrust of *Ernst & Ernst* dictated that scienter be pleaded and proved regardless of whether the suit is brought by the SEC or a private litigant.[192] The court noted that policy consider-

[186] 420 F. Supp. 1226 (S.D.N.Y. 1976). *Accord,* SEC v. American Realty Trust, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,913, at 91,439-40 (E.D. Va. Feb. 24, 1977).

[187] 420 F. Supp. at 1240-44.

[188] The SEC alleged that a number of interviews and phone conversations were involved in the disclosures in *Bausch & Lomb.* 420 F. Supp. at 1237-38. *See* note 189 *infra.*

[189] The actions of Bausch & Lomb's chairman belie any fraudulent intent. The company had been in a slight earnings slump but expected an upturn because of new product introductions and improvements in existing products. During the course of an ordinary interview with a financial analyst the chairman provided no more than "links in a chain of analytical information." *Id.* at 1237, *quoting, In re* Investors Management Co., SEC Rel. No. 9267 [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,163, at 80,519 (1971).

The analyst reduced his earnings estimate as a result of the interview and cancelled "buy" recommendations on Bausch & Lomb stock. Attempting to correct what he regarded as an inaccurate estimate and to prevent the estimate from gaining wide credence, the board chairman telephoned the analyst and gave him an estimate based on internal, company calculations. He then immediately released the information to the financial press and to those callers who got through to him despite the "inundation" of Bausch & Lomb's switchboard. 420 F. Supp. at 1237-38.

[190] Issuance of an injunction under the securities laws requires a reasonable likelihood that defendants will violate the securities laws in the future. *See* SEC v. Management Dynamics, Inc., 515 F.2d 881, 887 (2d Cir. 1975). The *Bausch & Lomb* court stated that even if the requisite degree of culpability had been shown, the improbability of continuing violations would have justified denial of the SEC's prayer for injunctive relief. 420 F. Supp. at 1244-46.

[191] *Id.* at 1240, *citing Ernst & Ernst* at 194 n.12.

[192] 420 F. Supp. at 1240-41.

ations could be used to distinguish the two types of actions[193] but decided that if the language and history of section 10(b) were dispositive with regard to private litigants whose right of action was judicially created, the same was true of the SEC, whose actions were "creatures of the statute."[194] Given the results of its statutory construction, the court declined to examine policy considerations.[195]

The First Circuit focused on these policy considerations—the differing purposes served by SEC enforcement actions and private damage actions—and reached a contrary result in *SEC v. World Radio Mission, Inc.*[196] In *World Radio* the SEC sought an injunction against a religious organization[197] for violations of both Rule 10b-5 and section 17(a) of the Securities Act of 1933.[198] The defendant argued that no

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[193] *Id.* at 1241, *citing* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, C.J., concurring). *See* note 181 *supra.*

[194] 420 F. Supp. at 1241.

[195] *Id., quoting Ernst & Ernst* at 214 n.33. *But cf.* SEC v. Universal Major Indus. Corp., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,804 (2d Cir. Dec. 16, 1976) (policy considerations justify rejection of an argument based on *Ernst & Ernst;* allegation of negligence sufficient to support SEC enforcement acton under § 5 of the '33 Act, 15 U.S.C. § 77e (1970)). *Universal* involved an attorney charged with aiding and abetting a violation of § 5 of the '33 Act by issuing opinion letters which made possible the transfer of securities which were issued in violation of the registration requirements of the '33 Act. The court rejected defendant's contention that an allegation of scienter was required to state a cause of action for an SEC injunction under § 5 after *Ernst & Ernst.* The *Universal* court noted, however, that § 5 of the '33 Act expressly forbids the sale of unregistered stock directly or indirectly. The court's holding that an SEC action for an injunction against negligent violations of such a specific statutory provision would lie after *Ernst & Ernst* does not dispose of the question of the requisite degree of culpability in an SEC enforcement action under Rule 10b-5. But the court's extensive discussion of the differing purposes of SEC enforcement actions and private damage actions indicates a willingness to distinguish the two with regard to the requisite standard of culpability. Further, the court reasoned that if a showing of scienter were required, proof that the defendant acted with reckless disregard for the truth would constitute such a showing. [1976-1977 Transfer Binder] FED. SEC. L. REP. ¶ 95,804 at 90,916, *citing* Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973). The court did not address the question of the continued validity of imposing Rule 10b-5 liability for recklessness after *Ernst & Ernst. See* text accompanying notes 212-234 *infra.*

[196] 544 F.2d 535 (1st Cir. 1976).

[197] The defendant in *World Radio* raised funds through the sale of bonds which it characterized as "Christian Loan Plans." The organization urged investors to commit their funds to "God's economy" and represented its financial structure as "capable of paying investors and still produce ton upon ton of free Gospel literature." *Id.* at 539-40. In fact, the organization was able to avoid default only by borrowing funds fast enough to meet matured obligations, and treating these newly borrowed funds as "revenue." *Id.*

[198] 15 U.S.C. § 77q(a). Section 17(a) provides:

injunction could issue because the SEC had failed to demonstrate scienter as required by *Ernst & Ernst.*[199] The court rejected this argument, holding that scienter was irrelevant in a SEC enforcement action.[200] Although the First Circuit declined to place full reliance for its holding on its view of *Ernst & Ernst,*[201] the court clearly stated that a scienter standard of culpability was inappropriate in SEC enforcement actions.[202] The *World Radio* court placed primary emphasis on

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> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
> (1) to employ any device, scheme or artifice to defraud or
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

[199] 544 F.2d at 540.

[200] *Id.*

[201] The court declared that it was "implausible to suppose that Congress intended to provide a mechanism for the SEC to protect the public from the injurious schemes of those of evil intent and yet leave the public prey to the same conduct perpetrated by the careless or reckless." 544 F.2d at 541 n.10. However, the court went on to state that it need not reach this question to uphold the injunction sought in *World Radio* because § 17(a) clearly authorizes the issuance of an injunction without regard to the defendant's state of mind. *See* note 198 *supra*. The court rejected defendant's argument that, because the language of § 17(a) was virtually identical to that of Rule 10b-5 and because *Ernst & Ernst* held that scienter was thus required for liability under the latter, scienter was thus required for § 17(a) liability as well. Reading *Ernst & Ernst* carefully, the court reasoned correctly that the Supreme Court had *not* held in *Ernst & Ernst* that the language of Rule 10b-5 dictated scienter as the applicable standard of culpability. *See* note 174 *supra*. Rather, the *Ernst & Ernst* decision held that, given the statutory language of § 10(b) of the '34 Act, it was beyond the rule-making power of the SEC to promulgate a rule allowing liability for less than scienter. Section 17(a), as a congressional enactment, was not subject to this limitation and thus could be interpreted as allowing an SEC injunction against merely negligent violations of its terms. 544 F.2d at 541 n.10.

[202] 544 F.2d at 540. The *World Radio* court went on to state that an injunction would be appropriate even if a showing of scienter were required because "an injunction is issued only after an adjudication that defendant's proposed conduct prima facie violates the statute" and that "their demonstrated intent to continue evidences, at the least, an intent to do what they now know a federal court, as well as the SEC, has found deceptive." *Id.* at 541. One commentator has cited this language with approval and concluded that "the suit itself will place the defendant on notice with respect to the misleading nature of similar future conduct." 90 HARV. L. REV. 1018, 1025 (1977). This analysis is flawed, however, and underestimates the significance of *Ernst & Ernst* in

the differing purposes served by private actions and enforcement actions.[203] Because an injunction is "designed to protect the public against conduct, not to punish a state of mind"[204] the *World Radio* court viewed the defendant's alleged good faith as irrelevant.[205] *World Radio* failed to deal with the argument held determinative in *Bausch & Lomb*[206] that the *Ernst & Ernst* Court found the statutory language

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SEC injunction actions. Granting for purposes of argument as did the *World Radio* court, that a showing of scienter by the SEC is a prerequisite to the issuance of an injunction, that showing cannot be made simply by demonstrating that the defendant intends to continue his present conduct. A further showing that he intends to do so *with the requisite state of mind* is required. To supply this state of mind by reasoning that defendant has been shown likely to continue with conduct which has been "adjudged deceptive" is not logically consistent. The deceptiveness of the conduct is only established when the court determines that it is deceptive, thus only then does the defendant have the knowledge that provides the requisite state of mind for a Rule 10b-5 violation. His intention to continue with the conduct prior to acquiring this knowledge cannot constitute a Rule 10b-5 violation because he intended to continue conduct which he did not yet know or may not believe to be deceptive.

The *World Radio* court's position, stated accurately, amounts to holding the defendant liable because he has been shown likely to continue with conduct which *will be* adjudged deceptive some time after this intention was formed. The state of mind necessary to sustain Rule 10b-5 liability is supplied retroactively to the defendant's intention to continue his conduct. Such a result is not supportable after *Ernst & Ernst*. A defendant's demonstrable intent to continue his conduct after the commencement of an SEC injunctive action may well demonstrate only that he disagrees with the SEC's evaluation of the deceptiveness of his conduct. After *Ernst & Ernst* if the SEC is required to demonstrate scienter, it cannot do so simply by showing the defendant is likely to continue his conduct and that the conduct is deceptive. Rather it must show that the intention to continue the conduct was formed with the knowledge that the conduct was deceptive. Thus the defendant's good faith in his prior actions should, after *Ernst & Ernst*, bar an SEC injunction by preventing the Commission from establishing scienter.

[203] *See* text accompanying notes 180-181 *supra*.

[204] 544 F.2d at 541.

[205] *Id.* The *World Radio* court reasoned that courts which had required a showing of scienter for private liability under Rule 10b-5 prior to *Ernst & Ernst* had distinguished SEC enforcement actions and had not considered the defendant's state of mind relevant to determining liability in those actions, *citing*, SEC v. Shapiro, 494 F.2d 1301, 1308 (2d Cir. 1974).

[206] *See* text accompanying notes 186-195 *supra*. One commentator has stated that a distinction should be drawn between cases where the SEC seeks to enjoin ongoing conduct found likely to continue and cases where the Commission is seeking what amounts to a disciplinary injunction based on past conduct. In the former type of cases, negligence would be the standard of culpability because of the preeminent need to protect the public from injurious schemes, regardless of the perpetrator's state of mind. In the latter variety of cases, however, the need for public protection is less compelling because the conduct has ended and is not likely to recur. Thus, the higher scienter standard would be more appropriate. *See* Bauman, *supra* note 5, at 345.

to be controlling and that the same statutory language supports both varieties of Rule 10b-5 actions.[207]

The fundamental question is whether *Ernst & Ernst* permits lower courts to go beyond the statutory language and examine the arguments found persuasive by the *World Radio* court.[208] The answer is not clear. The recent trend in Supreme Court decisions in the securities area emphasizes careful examination of the statutory scheme and language, and has tended to restrict the expansion of the scope of

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Applying this reasoning to the contrasting results in *Bausch & Lomb* and *World Radio,* the two cases apparently can be reconciled on the basis of the likelihood of recurrence of the violations involved. The violations alleged in *Bausch & Lomb* were one time occurrences rather than a pattern of violations amounting to an ongoing scheme. While the SEC sought to enjoin future violations, the court properly recognized that the Commission was really seeking to punish past violations and based its holding on the lack of scienter. The court stated, alternatively, that if the action were treated as one to enjoin future violations, the unlikelihood of continuing violations would have justified the denial of an injunction. 420 F. Supp. at 1244-46.

In contrast, *World Radio* clearly involved a pattern of violations injurious to the public and likely to continue unless enjoined. Under those circumstances, the result in *World Radio* can be supported as upholding the strong public policy of investor protection.

This reconciliation of *Bausch & Lomb* and *World Radio* based on the facts of those two cases does not, however, meet the contention of the *Bausch & Lomb* court that *Ernst & Ernst* bars any consideration of policy questions in assessing the culpability required for Rule 10b-5 liability. *See* text accompanying note 211 *infra.* Further, this reconciliation rests on a questionable view of the permissible scope of the SEC's enforcement authority under the securities acts, § 20(b) of the '33 Act, 15 U.S.C. § 77t(b) (1970), and § 21(e) of the '34 Act, 15 U.S.C. § 78u(e) (1970). While the Commission's power to obtain ancillary forms of relief has recently extended beyond the precise language of these statutory provisions, whether this authority extends to the use of civil enforcement powers in circumstances amounting to punishment of past violations is doubtful. *See* Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits,* 89 HARV. L. REV. 1779, 1807-14 (1976); Treadway, *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief,* 32 WASH. & LEE L. REV. 637, 676-79 (1975).

[208] *See* 425 U.S. at 214 n.33. One commentator has stated that by failing to consider policy arguments regarding the reach of Rule 10b-5, the *Ernst & Ernst* analysis was inconsistent with the analysis employed in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), which relied heavily on policy arguments in support of the purchaser-seller requirement. *See Aiding and Abetting, supra* note 179, at 1004-05. This argument seems misconceived. Given the differing issues involved in *Ernst & Ernst* and *Blue Chip,* the Supreme Court's conclusion that the statutory language was dispositive in one case and not in the other should not be criticized solely on the basis of "inconsistent" modes of analysis. The conclusion that the language of § 10(b) is dispositive as to the appropriate standard of culpability in Rule 10b-5 cases and that policy arguments thus need not be considered is fully consistent with the conclusion of the *Blue Chip* Court. There the Court determined that the language of § 10(b) does not dispose of the question of whether a purchaser-seller requirement is appropriate and that the Court must thus look further to policy considerations.

private damage actions under Rule 10b-5.[209] However, the Court has in the past taken a different view of SEC actions.[210]

The *Bausch & Lomb* result, however, emphasizing the language of section 10(b), appears more consistent with the views of the present Court as expressed in *Ernst & Ernst* than does *World Radio.* If the *Bausch & Lomb* court correctly read *Ernst & Ernst* as barring any consideration of policy questions in assessing the culpability required for Rule 10b-5 liability, then the policy objectives sought by the First Circuit in *World Radio* can be achieved only by congressional action amending section 10(b) to allow the SEC to seek injunctions of ongoing, negligent violations. Absent such congressional action or Supreme Court direction to the contrary, courts should require a showing of scienter in SEC enforcement actions as well as private damage actions.[211]

Recklessness

While eliminating Rule 10b-5 liability for mere negligent conduct, *Ernst & Ernst* failed to resolve the question of the applicability of Rule 10b-5 to conduct falling between negligence and conscious intent to defraud—conduct commonly denoted as recklessness.[212] At common law, an action for fraud or deceit would lie if the plaintiff alleged that he had relied to his detriment upon a representation made with willful or reckless disregard for the truth.[213] Prior to *Ernst & Ernst,* courts analogized private actions under Rule 10b-5 to these

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[209] *See, e.g.,* Piper v. Chris-Craft Corp., 97 S. Ct. 926 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); United Housing Foundation v. Forman, 421 U.S. 837 (1975); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); *See generally* Note, *Judicial Retrenchment Under Rule 10b-5: An End to the Rule as Law?,* 1976 DUKE L.J. 789.

[210] *See, e.g.,* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (securities laws must be interpreted broadly and flexibly to effectuate their remedial aims). *But cf.* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971) (similarly broad view of private actions held by Supreme Court pre-*Ernst & Ernst*).

[211] *See* Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of* Hochfelder, 51 N.Y.U.L. REV. 769 (1976). *Contra,* Floor, *supra,* note 176, at 208-13.

[212] *See* A. BROMBERG, *supra* note 55, § 8.4 at 572.

[213] The seminal case defining the degree of culpability required to give rise to a common law fraud action is Derry v. Peek, [1889] 14 A.C. 337, 374, where the court held that to prove fraud the plaintiff must show that a false representation had been made "(1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false." *See generally* Haimoff, *Holmes Looks at Hochfelder and 10b-5,* 32 BUS. LAW. 147 (1976) [hereinafter cited as Haimoff].

common law actions[214] and allowed recovery where the defendant acted recklessly.[215] However, the *Ernst & Ernst* Court's emphasis on the need to show an intentional act to justify imposition of liability under Rule 10b-5 and its express refusal to decide the recklessness issue[216] challenged the continued validity of this doctrine.[217]

Two cases that have dealt with this question during the past year have concluded that *Ernst & Ernst* does not preclude Rule 10b-5 liability for recklessness. The Second Circuit in *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*[218] held that an accounting firm which exhibited reckless disregard for the truth in conducting an audit had demonstrated a sufficient degree of scienter to warrant Rule 10b-5 liability.[219] The firm's audit report disregarded fundamental accounting principles and gave immediate recognition as sales and profits to very contingent transactions which represented the largest undertakings in the history of the subject of the audit.[220] The court distinguished *Ernst & Ernst* on the ground that plaintiffs there had proceeded solely on a theory of negligence and that the Supreme Court's holding addressed only that question.[221] Defendants in *Herzfeld* were liable, the court stated, not for negligence in failing to discover some hidden fact as had been the case in *Ernst & Ernst,* but rather because of their active participation in the preparation of materially misleading financial reports upon which the plaintiff relied to his detriment.[222]

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[214] *See* text accompanying notes 99-104 *supra.*

[215] *See, e.g.,* SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied,* 420 U.S. 908 (1975); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973); Cohen v. Franchard Corp., 478 F.2d 115 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973).

[216] 425 U.S. at 194 n.11.

[217] *See* test accompanying notes 232-234 *infra.*

[218] 540 F.2d 27 (2d Cir. 1976).

[219] *Id.* at 37.

[220] The transactions involved were the purchase of nursing homes for approximately $13 million and their sale for approximately $15 million. All that had occurred prior to the closing day of the audit period however, was the payment of $5,000 toward the purchase of the nursing homes. No steps past an agreement in principle had been taken toward their sale. Further, substantial doubt existed as to whether the proposed purchaser had sufficient resources to go through with the purchase. The audit report disclosed none of these facts, but rather listed the proceeds of the sale as "deferred gross profit." In addition, the auditor "generated" journal entries and corporate minutes authorizing the transactions. The effect of the transactions on the financial picture presented was dramatic. Without the immediate recognition of the nursing home sales as profit the subject of the audit had a net income loss of $169,000 and earnings pre share of -$0.25. Defendants' accounting treatment caused the firm's statement to reflect net income of $66,000 and earnings per share of $1.10. *Id.* at 29-31.

[221] *Id.* at 37.

[222] *Id.*

A similar result was reached in another reckless audit case, *McClean v. Alexander.*[223] Exhibiting a lack of care similar to that involved in *Herzfeld,* the defendant in *McClean* accepted without investigation the audit subject's characterization of certain transactions as "sales" which were in fact consignments.[224] The audit report listed revenues from these spurious sales as receivables considered "fully collectible."[225] This accounting treatment resulted in the company showing a positive net income rather than a loss for the period of the audit.[226] Plaintiff, an individual investor who had relied on the audit report in making a decision to purchase the company, sued the auditor under Rule 10b-5.[227]

As in *Herzfeld,* the court distinguished *Ernst & Ernst* as holding only that negligence was an insufficient basis for Rule 10b-5 liability.[228] The defendant's conduct in *McClean* was far more than negligent, although it fell short of an actual preconceived intent to defraud.[229] Given its view of *Ernst & Ernst* as non-determinative, the *McClean* court looked to common law[230] and pre-*Ernst & Ernst* cases involving reckless conduct and held that a sufficient showing of scienter to support liability had been made.[231]

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[223] 420 F. Supp. 1057 (D. Del. 1976).

[224] The audit in *McClean* was conducted under inherently suspicious circumstances. The company was in desperate need of funds. The auditor knew this and knew that the audit report had to be done quickly and reflect a favorable outlook if the company was to remain solvent. The company manufactured and sold laser tools. The financial difficulties were largely the result of the low marketability of these tools and high incidence of product failure. Nonetheless, the auditor accepted the word of company salesmen that transactions which were in fact consignments were sales. The auditor made only minimal attempts to confirm these "sales" and received no reply from companies whose alleged purchases represented 90% of the "sales." *Id.* at 1061-67.

[225] *Id.* at 1074.

[226] *Id.*

[227] *Id.* at 1062-63.

[228] *Id.* at 1080.

[229] *Id.*

[230] *Id.* n.118. The court relied on Derry v. Peek [1889], 14 A.C. 337. *See* note 213 *supra,* and Ultramares v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931). *Ultramares* is normally cited for the proposition that an action for deceit founded on negligence would not lie at common law. *See* Haimoff, *supra* note 213, at 155. However, the *McClean* court relied on additional language in *Ultramares* stating that the "[fraud] includes the pretense of knowledge when knowledge there is none," 255 N.Y. at 179, 174 N.E. at 444, for the proposition that statements made in reckless disregard for the truth would sustain a common law deceit action.

[231] 420 F. Supp. at 1081-82, *citing* Thomas v. Duralite Co., 524 F.2d 577 (3d Cir. 1975); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

The *Herzfeld* and *McClean* decisions indicate that courts faced with Rule 10b-5 private damage actions will look increasingly to the common law of fraud and deceit to determine the standard of culpability appropriate to sustain liability.[232] This development is consonant with the mandate of *Ernst & Ernst.* The Supreme Court there evinced an intent to halt the loosening of Rule 10b-5 liability standards that was fully consistent with the common law.[233] However, to interpret *Ernst & Ernst* as eliminating Rule 10b-5 liability for reckless conduct would be to make the rule *less* protective than the common law. The effect would be to give those involved in securities transactions a disincentive to be diligent and seek out the truth.[234] The *Ernst & Ernst* Court probably did not intend this result, and the *Herzfeld* and *McClean* courts properly avoided developing such a doctrine absent express direction from the Supreme Court.

D. *Plaintiff's Duty of Due Care*

Private actions under Rule 10b-5 are a judicial creation.[235] In tailoring the scope of these actions, courts have emphasized definition of the affirmative elements of the plaintiff's case more than the assessment of the scope of possible defenses to Rule 10b-5 claims.[236] In recent years, however, the upsurge of litigation under Rule 10b-5[237]

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[232] *See* note 213 *supra.* An indication that courts after *Ernst & Ernst* will treat Rule 10b-5 actions as analogous to fraud actions is the recent tendency to require Rule 10b-5 plaintiffs to comply with the requirement of FED. R. CIV. P. Rule 9(b) that fraud be alleged with particularity. *See, e.g.,* Weinberger v. Kendrick, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,853 (S.D.N.Y. Jan. 24, 1977) (sufficient allegation of scienter); Schmeidler v. Lazard Freres & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,834 (S.D.N.Y. Jan. 5, 1977) (insufficient particularity in alleging scienter).

[233] *See* Ultramares v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931); Haimoff, *supra* note 213; note 230 *supra.*

[234] *See* Haimoff, *supra* note 213, at 156; *1975-1976 Developments, supra* note 5, at 942-43.

[235] *See* text accompanying notes 95-97 *supra.*

[236] *See, e.g.,* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, (1976) (materiality standard); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (culpability standard); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (protected class); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (causation standard); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947) (private right of action implied). *See generally* Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense To An Implied Remedy,* 70 NW. U.L. REV. 561, 561-63 (1975) [hereinafter cited as Wheeler].

[237] *See* A. BROMBERG, *supra* note 55 § 2.5(b), stating that, "10b-5 is generating almost as much litigation as all the other antifraud provisions together, and several times as much as the express liabilities."

has given rise to a corresponding development of options for Rule 10b-5 defendants.[238] Various courts have allowed proof of laches,[239] waiver,[240] estoppel,[241] ratification,[242] *in pari delicto*,[243] and collateral estoppel[244] to bar recovery under Rule 10b-5.

A more recent development favorable to Rule 10b-5 defendants has been the judicial imposition of a duty of due care upon investors

[238] *See generally* Bromberg, *Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 167 (Special Issue March 1974); Jacobs, *Affirmative Defenses To Securities Exchange Act Rule 10b-5 Actions*, 61 CORNELL L. REV. 857 (1976) [hereinafter cited as Jacobs, *Defenses*]; Ruder & Cross, *Limitations on Civil Liability Under Rule 10b-5*, 1972 DUKE L.J. 1125; Wheeler, note 236 *supra*.

[239] *See, e.g.*, Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1207-08 (9th Cir. 1970), *modifying*, 283 F. Supp. 417, 428-29 (N.D. Cal. 1968); Myzel v. Fields, 386 F.2d 718, 740-41 n.15 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). Laches is a defense only to equitable claims. The court in *Hecht* set out the elements of laches as "(1) lack of diligence by the party against whom the defense is asserted, and (2) prejudice to the party asserting the defense." 430 F.2d at 1208.

[240] *See, e.g.*, Royal Air Properties, Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1964). The *Royal Air* court defined waiver as the voluntary relinquishment of a known right. *Royal Air* involved alleged misrepresentations in a face to face sale of stock. The defense of waiver was held to be unavailable because the plaintiff had not learned the facts regarding the claimed misrepresentation until after the act alleged to have constituted a waiver. *Id.*

[241] *See, e.g.*, Fey v. Walston & Co., 493 F.2d 1036, 1049 (7th Cir. 1974); Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1207-08 (9th Cir. 1970) (estoppel for Rule 10b-5 purposes defined in common law terms; party with knowledge of facts estopped to deny that knowledge when he acts with intent to influence party asserting estoppel to rely detrimentally upon those actions).

[242] *See, e.g.*, Ferguson v. Francis I. duPont & Co., 369 F. Supp. 1099, 1101 (N.D. Tex. 1974) (ratification validates a prior act). In *Ferguson*, a brokerage customer continued to do business with the brokerage firm even after receiving confirmation slips that revealed the defendant's violations of the securities laws.

[243] *See, e.g.*, James v. DuBreuil, 500 F.2d 155, 158 (5th Cir. 1974). *But see* Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50 (S.D.N.Y. 1971). *See generally* Bell, *How to Bar an Uninnocent Investor—The Validity of Common Law Defenses to Private Actions Under the Securities Exchange Act of 1934*, 23 U. FLA. L. REV. 1 (1970); Ruder, *supra* note 179.

[244] *See, e.g.*, Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806, 810 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971). Unlike collateral estoppel however, res judicata is normally not considered a defense in Rule 10b-5 cases. State courts lack jurisdiction to decide Rule 10b-5 claims, and common law actions arising out of facts which give rise to a Rule 10b-5 action are considered separate causes of action. *See, e.g.*, Clark v. Watchie, 513 F.2d 994, 997 (9th Cir.), *cert. denied*, 423 U.S. 841 (1975); Abramson v. Pennwood Inv. Corp., 392 F.2d 759, 762 (2d Cir. 1968). *Contra*, Connelly v. Balkwill, 174 F. Supp. 49, 55-60 (N.D. Ohio 1959), *aff'd per curiam*, 279 F.2d 685 (6th Cir. 1960) (state common law claim and Rule 10b-5 claim held same cause of action; therefore, res judicata defense appropriate). *See generally* Jacobs, *Defenses*, *supra* note 238, at 905-08.

claiming under Rule 10b-5.[245] Courts which have imposed this duty have not reached uniform conclusions as to the proper role for the plaintiff's duty of due care in Rule 10b-5 actions.[246] Some courts have treated this duty as a separate element of the plaintiff's prima facie case under Rule 10b-5.[247] The most common treatment of the plaintiff's duty of due care, however, has been as an affirmative defense analogous to contributory negligence.[248] Viewed in this manner, the continued validity of the defense is questionable given the Supreme Court's decision in *Ernst & Ernst v. Hochfelder.*[249] Because negligence is no longer an adequate basis for recovery under Rule 10b-5,[250] apparently contributory negligence likewise can no longer bar recovery.[251] This view is supported by the degree to which a breach of Rule 10b-5 after *Ernst & Ernst* resembles common law fraud,[252] where the plain-

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[245] *See generally* Wheeler, *supra* note 236; Note, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5,* 1975 DUKE L.J. 753 [hereinafter cited as *Due Diligence*]. There is no uniformity in the cases or the literature as to the name to give to this implied defense based on the plaintiff's conduct. Due diligence, contributory negligence and duty of due care have all been employed. Possibly the "duty of due care" terminology should be used because of its relative freedom from prior content and connotations—a useful attribute for a doctrine which remains ambiguous, pending further judicial analysis. Wheeler, *supra* note 236, at 563 n.7.

[246] *Compare* Arber v. Essex Wire Corp., 490 F.2d 414, 420 (6th Cir. 1974) (plaintiff's duty of care incorporated into scope of defendant's duty to disclose—no duty to disclose readily available information) *with* Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 103 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971) (plaintiff's duty of due care treated as an affirmative defense—expressly analogized to contributory negligence); *and* City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970) (duty of due care incorporated into plaintiff's prima facie case—plaintiff carries the burden of proving reasonable investigation).

[247] *See* City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 n.10 (8th Cir. 1970) (Rule 10b-5 protects only "conscientious buyers and sellers in good faith"). The effect of the *Vanderboom* court's analysis is to treat the question of whether the defendant has violated Rule 10b-5 in terms of the plaintiff's conduct. Wheeler, *supra* note 236 at 589-90.

[248] One commentator has argued that the plaintiff's duty of due care should be treated as an affirmative defense because the defendant's violation of Rule 10b-5 is independent of any particular plaintiff's right to recovery, thus the defendant remains liable in a public action. This analysis avoids confusing the questions of whether plaintiff *did* rely and whether he *should have* relied on the defendant's representations. Wheeler, *supra* note 236, at 591-96.

[249] 425 U.S. 185 (1976), *see* text accompanying notes 171-177 *supra.*

[250] 425 U.S. 185 (1976).

[251] *See* A. BROMBERG, *supra* note 55, at § 8.4 (652) (duty of due care imposed on plaintiff primarily by courts which have held defendant to a negligence standard). A. FLEISCHER, R. MUNDHEIM, & B. VANDEGRIFT (eds.), EIGHTH ANNUAL INSTITUTE ON SECURITIES REGULATION (1976) at 257-58.

[252] Assuming that *Ernst & Ernst* does not bar Rule 10b-5 liability for a statement

tiff's negligence was irrelevant.[253] One important countervailing argument, however, is that imposition of a duty of due care upon investors serves to encourage investor caution.[254] Thus, the *Ernst & Ernst* decision should not necessarily eliminate the plaintiff's duty of due care as a factor in Rule 10b-5 actions. Two courts have recently considered the question of whether actions under Rule 10b-5 are now so closely analogous to common law fraud as to preclude a defense founded on the plaintiff's lack of due care or whether such a defense could still be justified on other grounds despite apparent inconsistency with the common law.[255]

In *Holdsworth v. Strong*[256] *(Holdsworth II)* the Tenth Circuit on rehearing en banc reversed a pre-*Ernst & Ernst* panel decision[257] *(Holdsworth I)* which had upheld the duty of due care as a required element of the plaintiff's case, despite terming the defendant's conduct "primarily intentional."[258] *Holdsworth* involved a business ven-

made in reckless disregard for the truth, *see* text accompanying notes 212-234, *supra*, the scope of Rule 10b-5 liability after *Ernst & Ernst* is largely parallel to the scope of common law deceit. In common law actions factually analogous to *Ernst & Ernst*, negligent misrepresentations or omissions would not support liability. *See* PROSSER, *supra* note 102, § 107 at 704-10. Reckless misrepresentations or omissions however, would provide the basis for liability at common law. A defendant who spoke with reckless disregard for the truth or with no belief in the truth of his assertions was liable at common law and would apparently also be liable in a post-*Ernst & Ernst* Rule 10b-5 action. *See* Haimoff, *supra* note 213 at 162; 25 EMORY L.J. 465, 472 (1976).

[253] A plaintiff was barred from recovering in a common law fraud action only if the statement on which he relied was "so patently ridiculous as to be unbelievable"—a far higher standard than negligence or a duty of due care. PROSSER, *supra* note 102, § 108 at 717.

[254] *See* Wheeler, *supra* note 236 at 600-01.

[255] Straub v. Vaisman & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,623 (3d Cir. June 15, 1976); Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976) (en banc), *cert. denied*, 45 U.S.L.W. 3665 (U.S. April 5, 1977) (No. 76-1119). Because private actions under Rule 10b-5 are the result of judicial implication, courts are empowered to define the limits of those actions. Such a definition must effectuate legislative policy and is not bound by the definition of analogous common law actions. Thus, given that the fostering of investor caution is a legitimate avenue toward effectuating legislative intent, courts are free to impose a duty of due care as a means to that end without regard to the limits of the common law. *See Due Diligence, supra* note 245 at 760-61.

[256] 545 F.2d 687 (10th Cir. 1976).

[257] [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,465 (10th Cir. Feb. 27, 1976).

[258] *Id.* at 99,361-62. The panel decision in *Holdsworth (Holdsworth I)* rejected as clearly erroneous the trial court's finding that the plaintiff could not have ascertained the facts as to the undisclosed information. The court concluded that where the plaintiff had exercised "no diligence," the imposition of a duty of due care as a bar to recovery was appropriate. *Id.*

ture undertaken by three attorneys through the mechanism of a closely held corporation.[259] The defendant in *Holdsworth* was the controlling shareholder in the venture and carried on the business operations without significant involvement of or interference from the other shareholders. Plaintiff, who was both an accountant and an attorney, alleged that he was induced to sell his shares in the venture by the defendant's misrepresentations as to the future prospects of the venture.[260] The plaintiff further alleged that the defendant had appropriated corporate funds for personal use and had concealed these withdrawals with "expense" entries on the corporation's books.[261] The plaintiff in *Holdsworth* did virtually nothing to protect his own interests. Despite the fact that he was a director of the corporation, he never inspected the books and relied totally on the defendant's misrepresentations as to the venture's prospects.[262]

The *Holdsworth II* court rejected the defendant's contention that the plaintiff should be barred from Rule 10b-5 recovery because of his lack of due care.[263] Reasoning that it would be inequitable to require the plaintiff to prove scienter and yet allow his own negligence to bar recovery, the court held that only a gross lack of due care by the plaintiff, comparable to scienter on the part of the defendant, would bar recovery after *Ernst & Ernst*.[264] The court buttressed this analysis with a discussion of common law analogs to Rule 10b-5 actions, emphasizing the irrelevancy of the plaintiff's negligence in intentional

[259] The venture involved in *Holdsworth* was a closely held corporation formed to market a timekeeping system for law offices. Defendant allegedly concealed the venture's success by using his position as operator of the business to misappropriate funds and make concealing entries on the books. 545 F.2d at 689-91.

[260] *Id.* at 690. Defendant induced plaintiff to sell his shares in the venture by reporting that the corporation had invaded capital to pay its most recent dividend and that no dividends would be forthcoming in the foreseeable future. *Id.*

[261] *Id.* The plaintiff alleged that the defendant had appropriated the bulk of $96,000 in gross receipts and disbursed these to his family, his law firm and other business ventures. The spurious "expense" entries on the corporation's books concealed the fact that the venture was a thriving operation.

[262] *Id.* at 689-91.

[263] *Id.* at 693-94.

[264] *Id.* at 692-93. The court noted that the defense of lack of due care had been allowed prior to *Ernst & Ernst* primarily in cases involving negligent defendants. *Citing* White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974); Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968); 2 A. BROMBERG, *supra* note 55, § 8.4 (652). Given *Ernst & Ernst's* requirement that intentional conduct be proved in order to state a Rule 10b-5 claim, the *Holdsworth* court viewed as questionable a doctrine that would allow the defendant to avoid liability by claiming that the plaintiff would not have been cheated had he been careful. 545 F.2d at 693.

fraud cases.[265] The court did not, however, treat plaintiff's lack of due care as irrelevant. Rather, the Tenth Circuit viewed the due care issue as an element of the "justifiable reliance" which formed the causal link between the violation and the harm alleged.[266] After reaching this conclusion, however, the court failed to clarify the nature of the plaintiff's burden in demonstrating his due care as a part of the causation element of his claim.[267]

In *Straub v. Vaisman & Co., Inc.*[268] the Third Circuit employed a somewhat different analysis to reach a result similar to that in *Holdsworth II.* The defendant in *Straub* was a broker-dealer whose misrepresentations and omissions in connection with his recommendation that the plaintiff purchase a certain stock were sufficiently severe to "shock the conscience" of the court.[269] The defendant represented the recommended stock as a new issue when it was not. In addition, the defendant had inside information that bankruptcy was imminent for the recommended company. Further, the shares sold to the plaintiff were purchased from a company in which the defendant owned a controlling interest. Finally, the defendant concealed his status as a "market maker"[270] for the recommended stock. The plaintiff in *Straub* had accepted the defendant's recommendation without any independent investigation.[271] Thus the defendant argued that the plaintiff had breached his duty of due care and was consequently barred from recovering under Rule 10b-5.[272]

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[265] *Id.* at 693-94.

[266] *Id.* at 695-97. *See generally* Part B, *supra.*

[267] 545 F.2d at 697. The Tenth Circuit adopted the trial court's finding of reliance as reasonable and justifiable. The court stated that the friendship and trust between the plaintiff and defendant supported the trial court's finding of justifiable reliance and eliminated the "need for the *Holdsworths to show lack of contributory fault*" (emphasis added). *Id.* This implication that a showing of due care can be considered an element of a Rule 10b-5 plaintiff's prima facie case appears inconsistent with the court's earlier characterization of the plaintiff's due care as "irrelevant" after *Ernst & Ernst. See* text accompanying notes 281-283 *infra.*

[268] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,623 (3d Cir. June 15, 1976).

[269] *Id.* at 90,107. The defendant in *Straub* made his representations through a fiduciary in whom he knew plaintiff placed complete trust.

[270] *See* note 136, *supra.*

[271] The plaintiff in *Straub* was overseas at all times relevant to the litigation, and any investigation on his part was thus difficult. However, he took no steps toward any sort of investigation and failed even to request a prospectus. Rather, the plaintiff took the defendant's recommendations, made through the plaintiff's adviser, at face value. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,623 at 90,107-10.

[272] *Id.* at 90,109.

The *Straub* court recognized that such a claim of what amounted to contributory negligence would have had some validity as a bar to recovery prior to *Ernst & Ernst* but stated that since defendants could now be liable only for intentional conduct, the need for a contributory negligence defense was "less compelling."[273] The court nonetheless recognized that the policy of encouraging investor caution merited consideration even after *Ernst & Ernst.*[274] Balancing that policy against the common law analogs of Rule 10b-5 actions,[275] the Third Circuit applied a facts and circumstances test to evaluate the scope of the plaintiff's duty of due care.[276] Factors that the court considered significant in its evaluation included: the existence of a fiduciary relation between plaintiff and defendants, plaintiff's financial sophistication and opportunity to detect the fraud alleged, the existence of a longstanding business or personal relation between the parties, and the plaintiff's access to relevant information.[277] Applying this test to the facts of *Straub,* the Third Circuit held that the plaintiff's conduct would not bar his recovery under Rule 10b-5.[278] Nevertheless, the court made clear that the duty of due care was still

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[273] *Id.* at 90,110.

[274] *Id.* The court stated that

> [t]he analogy to the common law torts [of misrepresentation and deceit] indicates that since intent to defraud is a necessary element of a 10b-5 action, the due care defense should be narrowly circumscribed . . . . However, tort concepts must be balanced against the policies underlying the federal securities laws and the judicially created causes of action, where encouragement of watchfulness in the market place has obvious benefits.

[275] *Id.* The Third Circuit questioned treating the plaintiff's due care in a Rule 10b-5 action as totally irrelevant, *see* Carroll v. First Nat'l Bank, 413 F.2d 353 (7th Cir. 1969), *cert. denied,* 396 U.S. 1003 (1970), on the ground that such an approach fails to encourage investor caution. The *Straub* court, however, was similarly dissatisfied with the position that lack of due care should bar recovery, *see Holdsworth I,* [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,645 (10th Cir. Feb. 27, 1976), because that doctrine provides less protection for gullible investors than does the common law. The *Straub* court concluded that these two positions should be balanced, making the plaintiff's obligation of due care a flexible one, dependent on the facts and circumstances of each case. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,623 at 90,110. *See* text accompanying notes 276-278 *infra.*

[276] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,623 at 90,110.

[277] *Id.*

[278] The plaintiff in *Straub* was a sophisticated investor, a factor which weighed against him on the due care question. However, the fact that the plaintiff had no access to relevant information or opportunity to detect the fraud as well as the fact that the defendant made his fraudulent representations through a trusted, longstanding fiduciary of the plaintiff led the court to conclude that the plaintiff's lack of due care should not bar his recovery. *Id.* at 90,110-11.

available as an affirmative defense in the Third Circuit, provided the defendant could satisfy the court's facts and circumstances test.[279]

The *Straub* opinion represents a well reasoned attempt to balance the factors and policies involved in the plaintiff's duty of due care after *Ernst & Ernst.* The Third Circuit approached the issue clearly and provided needed guidelines for application lacking in *Holdsworth II.* The *Straub* court expressly set out the competing considerations involved in the plaintiff's duty of due care and provided a test to balance those considerations.[280] In contrast, the *Holdsworth II* court, though alluding to the "irrelevancy"[281] of the plaintiff's due care after *Ernst & Ernst,* nonetheless examined the duty as part of the justifiable reliance element of the plaintiff's case.[282] This analysis impliedly makes the need to show due care a part of the plaintiff's prima facie case.[283] In addition, the *Holdsworth II* court provides no guidelines for determining whether the plaintiff has made a sufficient showing of due care to fulfill the justifiable reliance element of his case. Further, the *Straub* opinion's treatment of the plaintiff's duty of due care as an affirmative defense is preferable to treating the issue as a part of the reliance element of the plaintiff's prima facie case.[284] The *Holdsworth II* court did not specify which party had the burden of proof on the issue of the plaintiff's diligence, but by treating the question solely in connection with the "justifiable" reliance element of the plaintiff's claim, the Tenth Circuit impliedly placed the burden on the plaintiff to demonstrate his due care, thereby proving that his reliance on the alleged misrepresentations was justified.[285] Therefore, although *Holdsworth II* contains broad language supporting the "irrelevancy" of the plaintiff's due care in an intentional fraud case,[286] the opinion arguably places a higher burden on a Rule 10b-5 plaintiff than does the *Straub* opinion, which expressly recognized the continued validity of the plaintiff's lack of due care as an affirmative defense. The degree to which *Holdsworth II* imposes such a burden remains unclear because of the opinion's lack of guidelines for application and its virtually wholesale adoption of the trial court's finding of reliance.

[279] *Id. Accord,* Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (3d Cir. 1974).

[280] *See* text accompanying notes 275-278 *supra.*

[281] *See* text accompanying notes 265-266 *supra.*

[282] *See* note 267 *supra.*

[283] *Id.*

[284] *See* notes 247-248 *supra.*

[285] *See* text accompanying notes 266-267 *supra.*

[286] 545 F.2d at 693-94. *See* text accompanying notes 265-266, *supra.*

After *Ernst & Ernst* however, it is difficult to justify the potential result of the *Holdsworth II* court's language which burdens the plaintiff with the requirement of demonstrating his due care. *Ernst & Ernst* requires the plaintiff to plead and prove scienter. It seems incongruous to allow a defendant with such a mental state embracing a "willful intent to defraud"[287] an opportunity to escape liability because a plaintiff fails to meet an ill-defined, additional burden of demonstrating due care in making the investment decision involved. The *Straub* court's approach of treating the issue as an affirmative defense evinces a recognition of this incongruity and places the burden of showing lack of due care on the defendant. This placement of the burden of proof together with guidelines drawn in light of *Ernst & Ernst* outlining the scope of that burden renders the *Straub* interpretation a more satisfactory attempt to balance the conflicting considerations present with regard to the plaintiff's duty of due care after *Ernst & Ernst;* that while conscious wrongdoers should not escape liability there is a need to foster investor caution.

E. *Rule 10b-5 and Internal Corporate Affairs*

Commentators have argued that the securities laws constitute, or should be interpreted to constitute, a body of substantive federal corporate law.[288] Yet, until very recently, courts have generally interpreted those laws as aiming solely at the prevention of securities fraud by compelling full and fair disclosure.[289] Under this view of the scope of the securities laws, the fiduciary obligations of corporate officers, directors, insiders and controlling persons have been considered state law concerns.[290] In *Santa Fe Industries, Inc. v. Green*[291] the

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[287] 425 U.S. at 193.

[288] Debate has been especially addressed to the scope of Rule 10b-5. *See, e.g.*, Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Mismanagement*, 59 CORNELL L. REV. 27 (1973); Painter, note 127 *supra;* Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007 (1973) [hereinafter cited as *Controlling Influence*]. This view of the reach of the securities laws has found some support outside the confines of academia. *See, e.g.*, Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961) (opinion of Commissioner Cary). *But cf.* Cary, note 91 *supra* (inappropriate to regulate all types of corporate transactions under the securities laws as presently written).

[289] *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Nathanson v. Weis, Voisin Cannon, Inc., 325 F. Supp. 50 (S.D.N.Y. 1971); 89 HARV. L. REV. 1917, 1918 (1976).

[290] *See* Bromberg, *Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 166, 168 (Special Issue March 1974); 89 HARV. L. REV. 1917, 1926 (1975). *But cf. Controlling Influence*, *supra* note 288, at 1009 (exertion of controlling insider influence to cause a corporation to enter an unfair securities transaction termed a Rule 10b-5 violation).

Supreme Court defined the proper role of Rule 10b-5 in the internal affairs of publicly held corporations. The Court held in *Santa Fe* that, absent a showing of deception or use of a manipulative device,[292] no action would lie under Rule 10b-5 for an alleged breach of an internal corporate fiduciary duty.[293] With this holding, the Court continued its recent pattern of restricting the growth of Rule 10b-5[294] and apparently repudiates the doctrine that the securities laws as presently written[295] provide the basis for a body of substantive federal corporate law.

Santa Fe involved a minority shareholder challenge to a "going private"[296] transaction. Majority shareholders sought to merge a pub-

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[291] 97 S. Ct. 1292 (1977).

[292] *See* text accompanying notes 305-314 *infra*.

[293] The Supreme Court's ruling in *Santa Fe* also implicitly reverses another recent Second Circuit decision, Marshel v. AFW Fabric Co., 533 F.2d 1277 (2d Cir.), *vacated and remanded for consideration of mootness*, 45 U.S.L.W. 3273 (U.S. Oct. 12, 1976), *noted at* 64 CALIF. L. REV. 1184 (1976); 89 HARV. L. REV. 1917 (1976). *Marshel* involved a conventional merger of Concord Fabrics, a publicly held company, into AFW Fabric Corp., a shell corporation created by Concord's controlling shareholders solely for the purpose of effectuating the merger. Under the terms of the merger agreement, minority shareholders of Concord would be forced to exchange their shares for cash. The proxy statements soliciting approval of the merger expressly stated that the sole reason for the merger was to convert Concord into a privately held company. Minority shareholders challenged the merger as a fraudulent transaction under Rule 10b-5. The Second Circuit reversed a lower court dismissal and held that the elimination of minority shareholders for no legitimate corporate purpose, accomplished through the purchase of securities, constituted a sufficient basis for a claim under Rule 10b-5. 533 F.2d at 1280-81. The court based its holding on the fact that the controlling shareholders had used corporate funds to finance a transaction that benefited only themselves. This misappropriation of corporate funds for private gain, combined with the fact that the purchase and sale of securities was at the heart of the transaction, was found sufficient to state a claim of fraud under Rule 10b-5 notwithstanding full disclosure. *Id.*

[294] *See, e.g.*, Piper v. Chris-Craft, Indus., Inc., 97 S. Ct. 926 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[295] *See* note 329 *infra*.

[296] A "going private" transaction is one whose ultimate goal is the elimination of public ownership of a corporation and the continuation of the corporation's activities as a closely held company. *See generally* Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019 (1975); Green, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); Note, *Going Private*, 84 YALE L.J. 903 (1975). Often the first step in the process of going private involves a cash tender offer or an offer to exchange a debt security for outstanding shares whereby minority shareholders are asked to relinquish voluntarily their corporate ownership. *See* Soloman, *Going Private: Business Practices, Legal Mechanics, Judicial Standards and Proposals for Reform*, 25 BUFFALO L. REV. 141, 148-49 (1976). The goal of such tender offers is to either reduce the number of stockholders, allowing a delisting of the corporation under the '34 Act,

licly held company into a privately held shell corporation by means of a Delaware short form merger.[297] Minority shareholders declined to assert their exclusive state remedy of appraisal[298] and instead chal-

§ 12(g)(4), 15 U.S.C. § 781(g)(4) (1970) (registration of any class of securities may be terminated if less than three hundred persons are holders of record) or to increase the majority's share of ownership, thereby facilitating going private through the use of state merger statutes. Merger statutes generally provide for mergers upon approval of a simple or two-thirds majority of all stockholders or, when a parent corporation owns a specified percentage of a subsidiary's outstanding stock, simply upon approval of the board of directors of the parent. *Compare* DEL. CODE ANN. tit. 8 § 251 (Cum. Supp. 1976) (simple majority approval required) *with* N.Y. BUS. CORP. LAW § 903 (1963) (McKinney) (two-thirds approval required) *and* NEB. REV. STAT. § 21-2074 (1974) (only parent board approval required if subsidiary 80% owned) *and* ILL. STAT. ANN. ch. 32, § 157.66a (Cum. Supp. 1976) (only parent board approval required if subsidiary 99% owned). Minority shareholders are forced from corporate ownership by the terms of the merger agreement which generally limit these unwanted shareholders to a cash settlement for their stock.

[297] DEL. CODE ANN. tit. 8 § 253 (1974) allows a parent corporation which owns at least 90% of the stock of a subsidiary to effect a merger with that subsidiary simply by filing a resolution of the parent's board of directors and shareholders. No premerger notice is required, nor does any provision of the statute require a business purpose for a short form merger. The statute provides that merger terms may provide for payment of the minority in cash, securities or other rights. The minority's sole remedy if dissatisfied with the terms of the proposed merger is to seek appraisal in state court. *See* note 298 *infra*.

The plaintiffs in *Santa Fe* were minority shareholders in Kirby Lumber Co., which was 95% controlled by Santa Fe Industries, Inc. Santa Fe sought to freeze out the minority by first forming a shell corporation, Forest Products, Inc. and transferring to it all of Santa Fe's Kirby stock in exchange for all of Forest Product's stock. Forest Products thereby became a "parent" of Kirby, and Santa Fe used its control of Forest Products to effect a short form merger of Kirby and Forest Products, requiring minority shareholders of Kirby to exchange their shares for cash.

[298] The plaintiffs in *Santa Fe* initially petitioned for appraisal, but withdrew that action almost immediately and instead sought relief under Rule 10b-5. 97 S. Ct. at 1297 n.4. The proxy materials in *Santa Fe* valued Kirby's stock at $125 per share. This appraisal, provided in an opinion by Morgan Stanley & Co., was supported by detailed historical and financial data estimating the fair market value of Kirby's assets. *See* Green v. Santa Fe Indus., Inc., 391 F. Supp. 849, 857 (S.D.N.Y. 1975). A challenge of such an offer in an appraisal proceeding is difficult. A dissatisfied shareholder must retain a comparable array of experts to contest the majority's figures. Further, Delaware law provides that an appraisal claim must demonstrate a "gross undervaluation . . . shocking to the court's conscience" in order to prevail. Stauffer v. Standard Brands, Inc., 178 A.2d 311, 314 (Del. Ch.), *aff'd*, 41 Del. Ch. 7, 187 A.2d 78 (Sup. Ct. 1962). In addition, the focus of the appraisal remedy is solely retrospective. A minority shareholder may recover only the amount by which he can demonstrate his shares were undervalued as of the time of the merger. A successful appraisal plaintiff does not participate in any gain anticipated from the merger. This limitation of the appraisal remedy has been widely criticized. *See* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1975); Rosenfeld, *An Essay in*

lenged the merger under Rule 10b-5 on the grounds that the merger terms undervalued their shares, that no advance disclosure of the merger had been made, and that the merger itself defrauded minority shareholders because it was performed without a legitimate corporate purpose.[299]

Reversing a district court dismissal of these claims,[300] the Second Circuit held that the lack of any legitimate corporate purpose for the short form merger was a sufficient basis for a Rule 10b-5 claim.[301] The court of appeals stressed the alleged breach of the majority shareholders' fiduciary obligation of fair dealing to the minority and characterized the consummation of a short term merger without a legitimate corporate purpose as a fraudulent scheme prohibited by Rule 10b-5.[302]

Support of the Second Circuit's Decisions in Marshel v. AFW Fabric Corp. and Green v. Santa Fe Industries, 5 HOFSTRA L. REV. 111, 124-26 (1976).

[299] 97 S. Ct. at 1297-99.

[300] Green v. Santa Fe Indus., Inc., 391 F. Supp. 849, 854 (S.D.N.Y. 1975). The district court dismissed the action because the plaintiff failed to allege any misrepresentation or omission in connection with the challenged transaction.

[301] 533 F.2d at 1291. By its terms, the Second Circuit's holding in *Santa Fe* reached only going private transactions effected by means of a short form merger. However, the Second Circuit clearly did not view such a transaction as the limit of the reach of Rule 10b-5 in internal corporate affairs. Five days before the Second Circuit decision in *Santa Fe*, another panel of the Second Circuit had applied a business purpose test to a going private transaction effected by means of a conventional merger. Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir. 1976). *See* note 293 *supra*. Further, while some courts have declined to extend *Santa Fe* and *Marshel* beyond the going private context, *see, e.g.*, Marsh v. Armada Corp., 533 F.2d 978 (6th Cir. 1976), *cert. denied*, 45 U.S.L.W. 3665 (U.S. April 5, 1977) (No. 76-5) (successful tender offeror held not to violate Rule 10b-5 by carrying out announced intention to reduce dividends, *Marshel* and *Santa Fe* held limited to going private transactions); Vernon J. Rockler v. Minneapolis Shareholders Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,857 (D. Minn. Jan. 13, 1977) (tender offer alleged to have no corporate purpose held not to violate Rule 10b-5; expansive view of *Marshel* and *Santa Fe* rejected), the Second Circuit's holding in *Santa Fe* clearly had implications beyond going private transactions. *See* Bailey v. Meister Brau, Inc., 535 F.2d 982 (7th Cir. 1976) (business purpose test applied to 10b-5 shareholder derivative action not involving going private). If, as the Second Circuit held, a breach of a fiduciary duty of fair dealing running from majority to minority shareholders also gives rise to a Rule 10b-5 claim, then the whole range of internal corporate fiduciary duties would also fall within the purview of Rule 10b-5. Thus, the Supreme Court's reversal of *Santa Fe* goes beyond the question of whether Rule 10b-5 reaches going private transactions and may effectively dispose of the contention that a body of substantive corporate law can be implied from § 10(b) and Rule 10b-5. *See* text accompanying notes 328-329 *infra*.

[302] 533 F.2d at 1289-91. *See generally* Note, *The Second Circuit Adopts a Business Purpose Test For Going Private:* Marshel v. AFW Fabric Corp. *and* Green v. Santa Fe Industries, Inc., 64 CALIF. L. REV. 1184, 1191-92 (1976) [hereinafter cited as *Business Purpose Test*].

The court stated that its holding that Rule 10b-5 imposed a business purpose test[303] on going private transactions demonstrated that neither misrepresentation nor nondisclosure was a necessary element of a Rule 10b-5 cause of action.[304]

In overturning the Second Circuit's decision the Supreme Court placed primary reliance on the language of section 10(b) of the '34 Act.[305] Stating that the language of section 10(b) must control the interpretation of Rule 10b-5[306] the court held that the statute contains no indication of any congressional intent to reach conduct not involving manipulation or deception.[307] Thus, the Court held that no fiduciary duty could be implied under Rule 10b-5 which prohibited conduct not manipulative or deceptive within the meaning of section 10(b).[308]

The Court then turned to the facts alleged in the plaintiffs' complaint to determine if the conduct involved was manipulative or deceptive.[309] The notice of the merger had, the Court found, fairly presented the plaintiffs with the choice of accepting the price offered for their shares or seeking appraisal in the Delaware courts, together with all the information necessary to make that choice.[310] Thus, the major-

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[303] The business purpose test of *Marshel* and *Santa Fe* was criticized as unworkable during the period between those decisions and the Supreme Court's reversal of *Santa Fe.* Virtually any corporate transaction may have numerous purposes, some legitimate, some less so. Recognizing the difficulty of balancing these purposes and determining the "dominant motivation" for a transaction, a panel of the Second Circuit different from the panels that decided *Marshel* and *Santa Fe* declined to apply the rationale of those cases to a transaction which it found did not present a "stark" example of the use of corporate funds for a "purely personal benefit." Merrit v. Libby, McNeill & Libby, 533 F.2d 1310 (2d Cir. 1976). Very few transactions would provide such a "stark" example, and even those that did could often be disguised with appropriately worded corporate minutes and memos. *See* 89 HARV. L. REV. 1917, 1930-32 (1976). Thus, even before the Supreme Court's decision in *Santa Fe,* the broad applicability and utility of the business purpose test had been questioned.

[304] 533 F.2d at 1287. The Second Circuit stated that it wished to remove any "lingering doubts" as to whether misrepresentation or nondisclosure were essential elements of a Rule 10b-5 claim. *Id.*

[305] 97 S. Ct. at 1299-1301.

[306] *See* note 174, *supra.*

[307] 97 S. Ct. at 1300-01. The *Santa Fe* Court relied heavily on the statutory analysis employed in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) *see* note 174 *supra.*

[308] 97 S. Ct. at 1301-02.

[309] *Id.*

[310] *Id.* The plaintiffs in *Santa Fe* also argued that the failure to give them advance notice of the merger was a material nondisclosure in violation of Rule 10b-5 even though no such disclosure was required by Delaware law. The majority summarily rejected this claim and held that no material non-disclosure had occurred. The Court supported this reasoning by noting that even had the prior notice been given, the

ity concluded that no deception was present in the transaction challenged in *Santa Fe.*[311] Addressing the further question of whether the conduct alleged was "manipulative" within the meaning of section 10(b), the Court focused on the technical construction given to that term in *Ernst & Ernst v. Hochfelder.*[312] The Court there held that "manipulative" is "virtually a term of art" as used in section 10(b) and solely encompasses conduct aimed at artificially affecting securities prices.[313] Based on this reading of the statutory language, the *Santa Fe* Court rejected the plaintiffs' contention that corporate mismanagement claims alleging unfair treatment of minority shareholders fall within the scope of section 10(b).[314]

In addition to the statutory language, the majority posed several further justifications for its holding in *Santa Fe.*[315] The Court first argued that because private actions under Rule 10b-5 are creatures of judicial implication,[316] the reach of these actions should be limited to the extent necessary to effectuate Congress' purpose in adopting the '34 Act. That purpose was to insure full and fair disclosure in securities transactions,[317] and the Court found that if full disclosure is made, the fairness of a transaction is "at most a tangential concern of the statute."[318] Thus, the Court declined to imply a private right

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plaintiffs' exclusive remedy under Delaware law would still have been appraisal. 97 S. Ct. at 1301 n.14, *citing* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976). *See* note 298 *supra.*

[311] 97 S. Ct. at 1301-02. The Court distinguished the cases relied upon by the plaintiffs including Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 9 (1971); and Schoenbaum v. Firstbrook, 405 F.2d 212, 220 (2d Cir. 1968), *cert. denied,* 395 U.S. 906 (1969), on the basis that each had involved some element of deception. 97 S. Ct. at 1301-02, n. 15.

[312] 425 U.S. 185 (1976). *See* Part C *supra.*

[313] 425 U.S. at 199-200.

[314] 97 S. Ct. at 1302. The Court stated that:

> [W]e do not think [Congress] would have chosen this "term of art" (manipulative) if it had meant to bring within the scope of § 10(b) instances of corporate mismanagement such as this, in which the essence of the compalint is that shareholders were treated unfairly by a fiduciary.

[315] *Id.* at 1302-04. Justices Blackmun and Stevens joined only in that portion of the Court's opinion which rested on the statutory language of § 10(b). *See* text accompanying notes 305-314 *supra.*

[316] *See* note 99 *supra.*

[317] 97 S. Ct. at 1302-03, *citing* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972), *quoting,* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

[318] 97 S. Ct. at 1303.

of action which reached beyond Congress' principal objective in adopting section 10(b).[319]

Finally, the Court noted that substantive corporate law has been traditionally a matter for state regulation as an additional argument for rejecting the implication of substantive intra-corporate fiduciary duties under Rule 10b-5.[320] The majority declined to create such a body of federal corporate law because of the danger of vexatious litigation arising from any expansion of the class of plaintiffs entitled to claim under Rule 10b-5.[321] Further, the *Santa Fe* Court was reluctant to override and interfere with state regulation of corporate affairs given the absence of any express congressional intent that the securities laws should be so extended.[322] The Court recognized the possibility that uniform federal fiduciary standards may be necessary to govern going private transactions,[323] but nevertheless held that Rule 10b-5 should not be extended to imply those standards.[324]

The Court's holding in *Santa Fe* is fully consonant with the recent trend in its decisions in securities cases. Given the preeminent status assigned to the statutory language of section 10(b) by *Ernst & Ernst* and the manner in which the Court's opinion in that case construed the terms "deceptive and manipulative," a fully disclosed short form merger in compliance with state law seems clearly beyond the pale of Rule 10b-5.[325] Further, the fear of "strike" suits and vexatious

[319] *Id. See* Cort v. Ash, 422 U.S. 66, 78-80 (1975).

[320] 97 S. Ct. at 1303, *citing*, Piper v. Chris-Craft Indus., Inc., 97 S. Ct. 926, 949 (1977).

[321] 97 S. Ct. at 1303. *See* text accompanying note 9 *supra*.

[322] 97 S. Ct. at 1303-04.

[323] *Id.* at 1304.

[324] *Id.* n.17, *quoting*, Cary, *supra* note 91, at 700, "it seems anomalous to jigsaw every kind of corporate dispute into the federal courts through the securities acts as they are presently written" (urging a "frontal attack" on the need for federal fudiciary standards by means of a Federal Corporate Minimum Standards Act). *See* note 329 *infra*.

[325] *But see* Haimoff, *supra* note 213, at 170-73. Haimoff contends that because a fiduciary relationship enables majority shareholders to misappropriate minority's shares without "overt fraud" would not absolve a fiduciary at common law, and that nothing in *Ernst & Ernst* is contrary to this result under Rule 10b-5. However, this argument is misconceived. *Ernst & Ernst* involved the language of § 10(b) on the question of the requisite standard of culpability in private actions under Rule 10b-5. The *Ernst & Ernst* Court concluded that because of the statutory language, no action would lie under Rule 10b-5 for a mere negligent violation of the Rule. This decision incidentally imposed a standard of culpability in Rule 10b-5 cases apparently identical to that imposed in common law deceit actions. *See* text accompanying notes 232-234 *supra*. This reasoning, however, merely assigns a pre-eminent status to the statutory language; it does not render Rule 10b-5 a codification of the common law of deceit.

litigation evinced in *Blue Chip Stamps v. Manor Drug Stores*[326] would likewise have been violated by the extension of Rule 10b-5 to encompass intracorporation fiduciary duties. Finally, the Court's solicitude for state corporate law, recently expressed in *Piper v. Chris Craft Industries, Inc.*[327] could not have been squared with the imposition of a supervening body of federal corporate law.

Santa Fe apparently represents the death knell for judicial implication of substantive federal corporate law from the language of the securities laws.[328] The Supreme Court's position is apparently that the creation of such a body of law is properly a subject for legislative and not judicial action. Thus, the rise of substantive federal corporate

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See text accompanying notes 102-104 *supra*. If the statutory language dictates a conclusion different from that reached in analogous common law actions, the mandate of *Ernst & Ernst* is that the statutory language must control, not that the common law has been codified. The common law of deceit is merely a useful analog and is not determinative as to the substantive rules governing Rule 10b-5 actions.

[326] 421 U.S. 723 (1975). *See* note 9 *supra* and accompanying text.

[327] 97 S. Ct. 926 (1977). *See generally* Tender Offers, *infra* Section IV, 943.

[328] *See* Note, *Judicial Retrenchment Under Rule 10b-5: An End to the Rule as Law?*, 1976 DUKE L.J. 789, 800-06, One possible argument for the proposition that the securities laws may still support a body of substantive corporate law even after *Santa Fe* is a contention that *Santa Fe* turned solely on the language of § 10(b) of the '34 Act.

The bulk of the *Santa Fe* opinion, concurred in by eight Justices, concerned the language of § 10(b) and the limitation of violations to "deceptive" or "manipulative" conduct. Justice White, writing for the Court, made it clear that this analysis alone was sufficient to support the result in *Santa Fe.*, 97 S. Ct. at 1302. Thus, Part IV of the *Santa Fe* opinion wherein the Court discusses the dangers of vexatious litigation arising out of a broadened class of potential Rule 10b-5 plaintiffs and the traditional state nature of substantive corporate law is arguably dictum. Reasoning from this conclusion, other provisions of the securities laws not limited to prohibiting deceptive or manipulative conduct could perhaps support the imposition of federal fiduciary duties. Provisions sometimes proposed as vehicles for the creation of such standards are Rule 14a-9, the antifraud provision of the proxy rules, and § 14(e) of the '34 Act governing proxies. *See* Bauman, *supra* note 5, at 351-52; Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 BUS. LAW. 991, 1013-19 (1976). Duties implied under these provisions would not have changed the result in *Santa Fe* which did not involve the use of proxies, but would affect a broad range of corporate transactions, albeit not so broad a range as § 10(b). An additional provision often posed as a means to create some federal intra-corporate fiduciary duties is § 17(a) of the '33 Act, which contains language almost identical to that of Rule 10b-5. *See* note 198 *supra*. An obstacle to the use of § 17(a) is the uncertainty as to whether a private right of action exists under that section. *Compare* Schaefer v. First Nat'l Bank, 509 F.2d 1287, 1293 n.6 (7th Cir. 1975), *cert. denied*, 425 U.S. 943 (1976) (issue still open); *with* Newman v. Prior, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,211 (4th Cir. 1975) (private right of action implied under § 17(a)) *and* Reid v. Mann, 381 F. Supp. 525 (N.D. Ill. 1974) (no private right of action under § 17(a)).

law must, under the doctrines presently espoused by the Supreme Court, await the action of Congress.[329] After *Santa Fe,* the reach of Rule 10b-5 will be limited to compelling full disclosure of securities transactions but will not extend to require fairness or a legitimate corporate purpose for a transaction involving the purchase or sale of securities.

E. TOWNES DUNCAN

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[329] There have been a number of proposals as to the form which this legislative federalization of corporate law should take. One proposal is the ALI's Federal Securities Code, which would codify many of the judicial developments under the present securities laws. *See* Loss, *Wrap Up,* 31 BUS. LAW. 1193, 1196-97 (1976). However the business purpose-fairness obligation implied under Rule 10b-5 by the Second Circuit in *Santa Fe* would not be codified in the ALI Code as it presently stands, although the Code would leave courts free to adopt the Second Circuit's approach. *Id.* at 1197. ALI FEDERAL SECURITIES CODE, Revised comments to § 1303, comment (5)(C) at 104-06 (Tent. Drafts Nos. 1-3, 1974). Section 1303 of the proposed Code was drafted prior to the lower court decision in *Santa Fe. See generally* Loss, *The American Law Institute's Federal Securities Code Project,* 25 BUS. LAW. 27 (1969). Another tactic, which has gained popular credence in recent years, is straightforward federal chartering of corporations above a given size. *See generally* R. NADER, M. GREEN & L. SELIGHMAN, CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR FEDERAL CHARTERING OF GIANT CORPORATIONS (1976); Schwartz, *A Case for Federal Chartering of Corporations,* 31 BUS. LAW. 1125 (1976). Finally, Professor Cary has proposed the adoption of a Federal Corporate Minimum Standards Act which would set basic federal requirements for state corporation law. *See* Cary, *A Proposed Federal Corporate Minimum Standards Act,* 29 BUS. LAW. 1101 (1974); Cary, *supra* note 91, at 696-705. Several of Professor Cary's proposed minimum standards would be significant in a situation such as that presented in *Santa Fe,* including federal fiduciary standards for directors and controlling shareholders and a provision prescribing fairness as a prerequisite for transactions involving interested directors or controlling shareholders. *See* Cary, *supra* note 91, at 702. *But see* Drexler, *Federalism and Corporate Law: A Misguided Missile,* 3 SEC. REG. L.J. 374 (1976) (present Delaware law provides adequate protection for all interests); Henning, *Federalism and Corporate Law: The Chaos Inherent in the Cary Proposal,* 3 SEC. REG. L.J. 362 (1976) (accepts some of Cary's criticisms, but poses a dual federal-state system of corporate chartering as a means better suited to deal with the problems). Absent congressional action, after *Santa Fe,* the regulation of intra-corporate fiduciary duties will apparently remain within the domain of state law. While some commentators have decried state law as providing inadequate protection for minority interests, *see* Cary, *supra* note 91, there are indications that state courts may now be inclined to provide closer scrutiny of majority actions in going private as well as other corporate transactions. *See, e.g.,* Singer v. Magnavox Co., SEC. REG. & L. REP. (BNA) No. 422 at E-1 (Del. Sup. Ct. Sept. 23, 1977); Tanzer Economic Assocs., Inc. v. Universal Food Specialties, Inc., 87 Misc.2d 167, 383 N.Y.S.2d 472 (Sup. Ct. N.Y. County 1976) (statutorily authorized merger still open to challenge on fairness grounds). *See generally* Note, *Going Private: Who Shall Provide the Remedies,* 51 ST. JOHNS L. REV. 131 (1977).