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RULE 10b-5 DEVELOPMENTS

A central purpose of the Security and Exchange Commission's (SEC) rule 10b-5[1] is protection of the securities investor form unfair treatment by persons possessing inside information of corporate affairs.[2] The use of inside information to trade for the personal benefit of the insider is a breach of fiduciary duty.[3] A breach of fiduciary duty alone, however, without deception or manipulation does not violate rule 10b-5.[4] Conversely, a misrepresentation or omission of fact, although deceptive, does not

[1] 17 C.F.R. § 240.10b-5 (1980). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (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.

The Securities and Exchange Commission (SEC) promulgated rule 10b-5 in 1942 under § 10(b) of the Securities Exchange Act of 1934 ('34 Act) which states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—.... (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1976).

[2] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 767 (1975) (Blackman, J., dissenting) (rule 10b-5 drafted to deal with situation in which corporate officer and director, possessing inside information not available to ordinary shareholders, purchases stock from shareholders at insufficient price); Note, *Suits For Breach of Fiduciary Duty Under Rule 10b-5 After* Santa Fe Industries v. Green, 91 HARV. L. REV. 1874, 1874 (1978) [hereinafter cited as *Suits for Breach*].

[3] *E.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

[4] Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1977). Manipulative conduct includes practices such as wash sales, matched orders, or rigged prices that are intended to stimulate trading and create an unnatural and unwarranted appearance of market activity. *E.g.*, Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 43 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976). Deceptive conduct includes fraudulent misstatements of fact, omissions and concealment of information indicating the misleading nature of a prior statement. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972) (bank employees made misstatements of material fact to purchase stock at less than fair value); Superintendent of Ins. v. Banker's Life & Cas. Co., 404 U.S. 6, 9-10 (1971) (seller duped into believing that it would receive proceeds); SEC v. National Bankers Life Ins. Co., 324 F. Supp. 189, 195 (N.D. Tex. 1971), *aff'd*, 448 F.2d 652 (5th Cir. 1971) (misleading statements or omissions are fraudulent acts under rule 10b-5).

violate the rule if there is not duty to disclose.[5] Further, no action lies unless the plaintiff is a purchaser or seller of securities.[6] In the past year, lower courts[7] have grappled with specific interpretations of rule 10b-5 in light of these broad demarcations.[8]

A. DUTY TO DISCLOSE

To effectuate the congressional goal of investor protection through full disclosure,[9] corporate insiders[10] generally have a duty to disclose material[11] nonpublic information or to refrain from using the information for personal benefit.[12] The duty to disclose arises, however, only when a fiduciary relationship exists between the parties.[13] Without a relationship of trust and confidence, insider trading is not a violation of rule

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[5] Chiarella v. United States, 445 U.S. 222, 227-28 (1980); RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976).

[6] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975).

[7] *E.g.*, Falls v. Fickling, 621 F.2d 1362 (5th Cir. 1980); Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980); Merritt v. Colonial Foods, Inc., 499 F. Supp. 910 (D. Del 1980); American General Insurance Co. v. Equitable General Corp., 493 F. Supp. 721 (E.D. Va. 1980).

[8] Recent Supreme Court decisions reversed a lower court trend of broadening a rule 10b-5 cause of action. *See, e.g.*, Sante Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977) (breach of fiduciary duty without deception not actionable under rule 10b-5); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (plaintiff in private damage action under rule 10b-5 must prove scienter); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738-39 (1975) (private plaintiff must be purchaser or seller of security for rule 10b-5 cause of action). *See generally* Lowenfels, *Recent Supreme Court Decisions Under Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891, 892 (1977); Note, *Judicial Retrenchment Under Rule 10b-5: An End to the Rule as Law*, 1976 DUKE L.J. 798, 790.

[9] Speed v. Transamerica Corp., 235 F.2d 369, 373 (3d Cir. 1956); Fratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953); 78 CONG. REC. 2770-71) (statement of Senator Fletcher) ('34 Act designed to insure full disclosure to investors).

[10] Insiders are those persons who have specific information regarding a company's securities that is unknown to otherwise knowledgeable investors. *See* Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 5 (1980) [hereinafter cited as Dooley]. Insiders include corporate officers, directors, and controlling stockholders, Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961), and those persons who have regular access to confidential information. *Id.* at 907. Friends and relatives who knowingly acquire information also may be insiders. *See* Dooley, *supra*, at 5.

[11] A fact is material if a substantial likelihood exists that a reasonable shareholder would consider the fact important in making an investment decision. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Although *Northway* involved an alleged violation of § 14(a), courts have used this materiality standard in § 10(b) cases. *E.g.*, Joyce v. Joyce Beverages, Inc., 571 F.2d 703, 707 n.6 (2d Cir.), *cert. denied*, 437 U.S. 905 (1978); Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1040 (7th Cir.) *cert. denied*, 434 U.S. 875 (1977).

[12] *See* RESTATEMENT (SECOND) OF AGENCY § 399, Comment c (1958); Dooley, *supra* note 10, at 21.

[13] Chiarella v. United States, 445 U.S. 222, 227-28 (1980); RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976).

10b-5.[14] In *American General Insurance Co. v. Equitable General Corp.*,[15] the federal district court for the Eastern District of Virginia considered whether corporate insiders who do not trade for their own account have a duty to disclose nonpublic information to minority shareholders.[16]

American General Insurance Company (American) is a sophisticated financial services corporation with a reputation for shrewdly acquiring smaller insurance companies.[17] In 1977, American purchased ten percent of the stock of Equitable General Corporation (Equitable), a small insurance company.[18] Because Equitable feared that American would attemp a hostile takeover,[19] Equitable sought to block American's acquisition efforts.[20] In addition, Equitable began to search actively for a merger partner which would negotiate with management.[21] To facilitate a potential merger, Equitable commissioned an actuarial appraisal of its financial condition, which indicated an "intrinsic" value of forty-five dollars per share of Equitable stock.[22] Without knowledge of Equitable's actuarial appraisal and search for a merger partner, and frustrated in its own acquisition efforts,[23] American decided to sell its Equitable stock.[24] American offered to sell the shares to Equitable for thirty-two dollars

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[14] Chiarella v. United States, 445 U.S. 222, 227-28 (1980); General Time Corp. v. Talley Indus., Inc., 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969). Not every instance of financial unfairness constitutes fraudulent activity under § 10(b). 445 U.S. at 232; *see* Sante Fe Indus., Inc. v. Green, 430 U.S. 462, 474-77 (1977) (mere breach of fiduciary duty without deception or manipulation not actionable under federal securities laws). *Chiarella* rejected the view that any informational disparity between traders is fraudulent under rule 10b-5. *See* Dooley, *supra* note 10, at 5 n.14.

[15] 493 F. Supp. 721 (E.D. Va. 1980).

[16] *Id.* at 743.

[17] *Id.* at 729.

[18] *Id.* at 730-31.

[19] *Id.* at 731. A hostile takeover is one in which the acquiring company eschews negotiations with management of the target company and deals directly with the shareholder. *Id.; see* note 21 *infra.*

[20] *Id.* at 731-32. Equitable contested American's efforts to gain approval of the Virginia Corporation Commission to allow American to acquire more than a 10% interest in Equitable. *Id.; see* VA. CODE § 38.1-178.1:2 (Supp. 1979) (Commission must approve any acquisition of control of a domestic insurer); VA. CODE § 38.1-178.1(2) (Supp. 1979) (control is presumed, *inter alia,* by holding 10% of voting securities).

[21] 493 F. Supp. at 732. Equitable wanted to find a "white knight," a merger partner who negotiates the merger terms with management of the target company. *Id.* at n.19. American, on the other hand, had a reputation as a "raider" who bypasses the incumbent management to deal directly with stockholders. *Id.* Management favors a white knight because the white knight woos management with offers of job security and other inducements, whereas a raider does not. *See generally* E. ARONOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 221 (1973) [hereinafter cited as ARANOW & EINHORN].

[22] 493 F. Supp. at 732. "Intrinsic" value reflects the value of the shares upon a complete sale of the company, not merely a 100-lot market price. *Id.; see generally* King v. United States, 292 F. Supp. 767, 776-77 (D. Colo. 1968).

[23] *See* note 19 *supra.*

[24] 493 F. Supp. at 733.

and fifty cents per share.[25] Meanwhile, Equitable had received two merger offers of thirty-three dollars per share.[26] Equitable accepted American's offer without disclosing the mature merger offers.[27] Before closing the transanction, Equitable issued a press release which appeared in the *Wall Street Journal.*[28] The press release mentioned that Equitable was engaged in "very preliminary and exploratory" merger talks.[29] American rigorously questioned a director of Equitable about Equitable's merger activities, but the director convinced American that Equitable was not merger prone, and that the press release was accurate.[30] Furthermore, the director offered a warranty which stated that Equitable had not reached any understanding with any company regarding merger.[31] American completed the sale upon the false assumption that Equitable's merger interests were merely "preliminary."[32] In fact, Equitable's merger negotiations were serious and substantive.[33] Six months later, Equitable merged with Gulf United Corporation and received fifty-one dollars per share.[34] American sued Equitable for violation of section 10(b) and rule 10b-5.[35]

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[25] *Id.* at 733. American's president offered the stock to Equitable's president as a courtesy to improve Equitable's attitude toward American in later dealings. *Id.* American offered to sell at $32.50 because American had received an offer for that amount from an investment banker. *Id.* Unknown to American, however, the banker represented Equitable. *Id.* Neither the banker nor Equitable disclosed that the actuarial appraisal of Equitable stock was $45.00. *Id.* American thought $32.50 was profitable since American purchased the stock for $26.25. *Id.* at n.21.

[26] *Id.* at 733-34.

[27] *Id.* at 735.

[28] *Id.* Equitable drafted the press release without notice to American and published it in the Southwestern Edition of the *Wall Street Journal* on the morning the sale was to be closed. *Id.* American's management read the announcement and quickly began to reconsider selling the stock to Equitable. *Id.* at 736.

[29] *Id.* at 735-36.

[30] *Id.* at 736. Although American requested detailed information from the director for two days, the director refused to enlarge upon the phrase "very preliminary and exploratory" to describe Equitable's merger prospects. *Id.*

[31] *Id.* at 728 n.5.

[32] *Id.* at 736.

[33] *Id.*

[34] *Id.* at 727.

[35] *Id.* at 728-29. American, incorporated in Texas, alleged that in addition to violating rule 10b-5, Equitable, a Virginia corporation, violated a Virginia common law fiduciary duty to shareholders, breached the terms of the warranty made by Equitable to American on the sale, and violated provisions of the Texas Securities Act. *Id.* at 72-79.

Directors owe a fiduciary duty to a corporation's shareholders under Virginia law. Wometco Enterprises, Inc. v. Norfolk Coco-Cola Bottling Works, Inc., 528 F.2d 1128, 1129 (4th Cir. 1979); Adelman v. Conotti Corp., 215 Va. 782, 213 S.E.2d 774 (1975). The district court found that the Virginia common law duty to shareholders did not encompass individual shareholders but arose only when directors dealt with shareholders as a class. 493 F. Supp. at 740-41 (citing Kors v. Carey, 39 Del. Ch. 47, 58, 158 A.2d 136, 140-43 (1960)). Although Equitable's purchase was disadvantageous to American, the transaction benefitted the shareholders as a class. 493 F. Supp. at 741 n.42. Since the nondisclosure did not

At trial, American alleged two separate theories to support its contention that Equitable violated rule 10b-5. First, American posited that Equitable and its directors breached a fiduciary duty to disclose material inside information before purchasing the stock from American.[36] Second, American asserted that Equitable not only made omissions of material fact but also incurred liability because of the affirmative misrepresentations made by Equitable's directors in the course of the sale.[37]

In addressing American's first theory, the court found that federal securities laws impose a fiduciary duty upon insiders, but that insiders breach the duty only when they trade for their own account.[38] Although the purchase of American's shares ultimately benefitted the majority shareholders, including the defendants, the district court found that the Equitable directors were not trading for their own account or with the expectation of individual personal benefit.[39] Since the directors did not trade on their own behalf, the defendants owed American no fiduciary duty, and the director's silence regarding the material merger information did not violate rule 10b-5.[40]

Although the directors had no affirmative duty to disclose material inside information, the *American General* court held the directors to a duty of avoiding affirmative misrepresentations and of disclosing any information necessary to make previous statements accurate.[41] In accept-

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harm all shareholders, Equitable had not violated any fiduciary duty under Virginia law. *Id.* at 741.

Upon learning that Equitable had begun merger negotiations, American sought an escalation agreement and an exemption from the Mutual Release of potential securities claims inlcuded in the sale terms. 493 F. Supp. at 736; *see* text accompanying notes 28-30 *supra.* The Equitable director who was to close the deal refused American's demands, but offered a warranty. *Id.* at 728 n.5; *see* text accompanying note 31, *supra.* The district court found that Equitable's directors knew that the warranty's affirmative representations were false and that Equitable therefore breached the warranty. *Id.* at 741; *see* text accompanying note 32 *supra.* The court held Equitable liable to American for breach of contract. 493 F. Supp. at 747.

The Texas Securities Act establishes that a buyer of securities who fails to disclose a material fact is civilly liable. TEX. CODE ANN. § 581-33(B) (Supp. 1978). The buyer may avoid liability, however, if he proves that the seller knew of the untruth or omissions. *Id.*; 493 F. Supp. at 748. The district court found both that Equitable knew of the falsehoods and that American was unaware of the truth. *Id.* at 750. Therefore, Equitable was liable under § 581-33(B). *Id.*

[36] 493 F. Supp. at 742.

[37] *Id.* at 744.

[38] *Id.* at 743.

[39] *Id.*

[40] *Id.* (citing Chiarella v. United States, 445 U.S. 222, 235 (1980) and SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968)).

[39] *Id.*

[40] *Id.* (citing Chiarella v. United States, 445 U.S. 222, 235 (1980) and SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968)).

[41] 493 F. Supp. at 744.

ing American's offer, Equitable's president affirmatively represented that Equitable was not engaged in merger negotiations and immediately issued press release omitting any reference to other merger bargaining.[42] The Equitable director at the closing of the sale made further affirmative misrepresentations of the material facts of Equitable's merger status.[43] The district court held that once Equitable disclosed information to American and the investing public, Equitable was under a duty to insure that its representations were accurate and that any inaccuracies were corrected immediately.[44] Because of the breach of this duty, the court found the defendant directors and Equitable liable for violation of rule 10b-5.[45]

Although the *American General* decision correctly interprets existing case law, a seeming incongruity results from the court's imposition of a duty to disclose accurate information after Equitable's misrepresentations, irrespective of the existence of an earlier duty to disclose arising from Equitable's silence. The compromise between effective antifraud protection and open-ended liability explains this apparent inconsistency. By its terms, rule 10b-5 does not state whether insider trading constitutes a manipulative or deceptive device.[46] To protect investors, courts have held those who trade on inside information liable for breach of rule 10b-5 but only if the insiders violated a fiduciary duty to disclose the material information.[47] Balanced against the concern for investor

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[42] *Id.; see* text accompanying notes 28-30 *supra* (press release).

[43] 493 F. Supp. at 744-45; *see* text accompanying notes 30-32 *supra* (defendant director's misrepresentations).

[44] 493 F. Supp. at 744-45.

[45] *Id.* at 747. The court awarded the plaintiff rescissional damages of $3,622,500.00. *Id.* at 766.

[46] *See* note 1 *supra* (rule 10b-5); Chiarella v. United States, 445 U.S. 222, 226 (1980) (section 10(b) does not state whether silence may be manipulative or deceptive device, but broad interpretations of rule 10b-5 have imposed liability for insider trading).

[47] *E.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972); Davis v. Davis, 526 F.2d 1286, 1289 (5th Cir. 1976); O'Neill v. Maytag, 399 F.2d 764, 768 (2d Cir. 1964); Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962); Note, *Omission and Nondisclosure Under SEC Rule 10b-5: A Distinction In Search of a Difference*, 7 FORDHAM URB. L.J. 423, 425 (1979) [hereinafter cited as *Omission and Nondisclosure*]. Liability can result from the total silence of a defendant insider, but only if the insider trades for his own account and has a duty to disclose. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 233 (1980) (no fraud under rule 10b-5 absent duty to speak); SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833, 848 (2d Cir. 1968) (insider trading for his own account and personal benefit violates rule 10b-5); Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961); Morrison, *Silence Is Golden: Trading on Nonpublic Market Information*, 8 SEC. REG. L.J. 211, 217 (1980) [hereinafter city as Morrision]. Unless a plaintiff alleges self-dealing and deception by a director, the director may approve a purchase sale of stock without disclosing that the purpose of the sale was to retain control of the corporation. *E.g.*, O'Neill v. Maytag, 339 F.2d 764, 767-68 (2d Cir. 1964); 5A JACOBS, THE IMPACT OF RULE 10b-5 5-89 (1980) [hereinafter cited as 5A JACOBS]. At common law, a director or officer owed no fiduciary duty to a shareholder in transactions of the corporation's stock absent fraud or misrepresentations. Cundick v. Broadbent, 383 F.2d 157, 164 (10th Cir. 1967), *cert. denied*, 390 U.S. 948 (1968); H. HENN,

protection, however, is the desire to circumscribe potentially limitless liability.[48] Neither party to an arm's-length transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relationship.[49] Absent a fiduciary relationship, a businessman has the right to capitalize on his experience and skill in securing and evaluating information.[50] Congress, in enacting section 10(b), never intended to adopt a parity-of-information rule.[51] A different situation arises, however, when one party makes affirmative representations. When a party makes misrepresentations, fraud replaces arm's-length competition. Therefore, rule 10b-5 draws the line of liability at the point where a nonfiduciary insider makes affirmative misstatements.[52]

Since the *American General* court explicitly found that the directors were not trading for their own account,[53] Equitable had no duty to break the silence to volunteer information to American.[54] The court correctly imposed liability upon Equitable for the affirmative misstatements regarding Equitable's merger status. When Equitable chose to communicate with American despite the absence of a legal duty to do so,

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HANDBOOK OF THE LAW OF CORPORATIONS § 239 (2d ed. 1979) [hereinafter cited as HENN]. On the other hand, directors have a fiduciary duty to minority shareholders if the directors' actions favor one group of shareholders over another. HENN, *supra*, at § 240. Directors may use corporate funds to acquire corporate stock to defeat an attempted control bid by a minority shareholder. Kors. v. Carey, 39 Del. Ch. 47, 58, 158 A.2d 136, 140-41 (1960); Note, *Buying Out Insurgent Shareholders With Corporate Funds*, 70 YALE L.J. 308, 309 (1960) [hereinafter cited as *Insurgent Shareholders*]. The directors must not trade merely to maintain their own control, but must believe that the purchase will benefit the corporation as a whole by removing an unsavory takeover threat. Martin v. American Potash & Chem. Co., 33 Del. Ch. 234, 92 A.2d 295, 302 (1952); *Insurgent Shareholder, supra*, at 309-10. Management may legitimately purchase shares of the corporation to avoid the cost of a proxy fight with minority shareholders in defending management policy. Kors v. Carey, 39 Del. Ch. 47, 58, 158 A.2d 136, 141 (1960); *Insurgent Shareholder, supra*, at 311. In fact, directors have a fiduciary duty to resist tender offers which, in the directors' judgment, are detrimental to the corporation's best interests. Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill 1969); ARANOW & EINHORN, *supra* note 21, at 222.

[48] *See generally* Chiarella v. United States, 445 U.S. 222 (1980).

[49] *See generally* Morrison, *supra* note 47, at 224.

[50] *Id.*

[51] Chiarella v. United States, 445 U.S. 222, 233 (1980).

[52] *See* note 1 *supra*. (Clauses two and three of rule 10b-5 prohibit misrepresentations and omissions of material facts in connection with the purchase or sale of a security). A party will be liable for a misrepresentation or omission in connection with a purchase or sale even if no fiduciary relationship exists between the parties to the sale. *See generally* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968). The misrepresentations and omissions must be of material information. *Id.; see* note 11 *supra* (standard of materiality). A misrepresentation is an untrue statement, while an omission is a deficiency arising from the failure to provide information to make a prior statement true. *See* note 11 *supra* (Rule 10b-5 definition); *Omissions and Nondisclosure, supra* note 47, at 424-25.

[53] 493 F. Supp. at 743; *see* text accompanying note 39 *supra*.

[54] *See* text accompanying notes 49-51 *supra*.

Equitable became liable for its untrue statements.[55] Further, once Equitable decided to release the information, it had an affirmative obligation to release accurate information promptly.[56] Equitable did not make an announcement which accurately reflected its merger status until three months after closing the sale with American.[57] The *American General* court found a valid distinction between silence and misrepresentations. American, as a sophisticated investor in an arm's-length transaction, had the responsibility to evaluate the situation, relying on its own expertise in light of Equitable's silence.[58] When Equitable volunteered false information, however, Equitable committed a fraud upon American and violated rule 10b-5.[59]

B. RELEASE OF LIABILITY

Although parties to securities transactions often agree to the predispute release of claims or to arbitration clauses,[60] courts strongly disfavor executory agreements requiring extra-judicial resolution of securities claims.[61] In response to the circumvention of early securities legislation by boilerplate releases,[62] section 14 of the Securities Act of 1933[63] and section 29(a) of the '34 Act[64] mandate that parties can release

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[55] *E.g.*, Kardon v. National Gypsum Co., 73 F. Supp. 798, 800-01 (E.D. Pa.) *modified*, 83 F. Supp. 613 (1947); 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD 70 (1979) [hereinafter cited as BROMBERG & LOWENFELS]; *Suits for Breach, supra* note 2, at 1882 n.44. In *Kardon*, a case similar to *American General*, defendants purchased all of plaintiff's stock in a corporation without revealing the existence of an agreement to sell the corporation's assets for a higher price. 73 F. Supp. at 800-01. At the closing of the sale, when the plaintiffs' attorney asked whether the defendants had made any agreement to sell the stock, the defendants answered "No." *Id.* at 801. The affirmative misrepresentation violated rule 10b-5. *Id.* at 800.

[56] *See* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 519 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973) ("undue delay not in good faith" violates rule 10b-5); SEC Comment on Timely Disclosure of Material Corporate Developments, Exchange Act Release No. 8995 (Oct. 15, 1970) (corporation "has an obligation to make a full and prompt announcement of material facts regarding the company's financial condition"); 5A JACOBS, *supra* note 50, at 4-3 to 4-4; *Suits for Breach, supra* note 2, at 1884.

[57] 493 F. Supp. at 736, 736 n.28.

[58] *See* text accompanying notes 49-51 *supra* (businessman must rely on his own skill unless fiduciary relationship exists).

[59] *See* note 55 *supra* (affirmative misrepresentation violates rule 10b-5).

[60] *See generally* Krause, *Securities Litigation: The Unsolved Problem of Predispute Arbitration Agreements for Pendant Claims*, 29 DEPAUL L. REV. 693, 718-19 (1980) [hereinafter cited as Krause] (predispute arbitration clauses are "compulsory prerequisite" for doing business in market).

[61] *E.g.*, Wilko v. Swan, 346 U.S. 427, 435 (1953); Fox v. Kane-Miller Corp., 398 F. Supp. 609, 624 (D. Md. 1975), *aff'd* 542 F.2d 915 (4th Cir. 1976).

[62] *See generally* Wilko v. Swan, 346 U.S. 427, 432, 435 (1953).

[63] 15 U.S.C. § 77n (1976). Section 14 provides: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." *Id.*

[64] 15 U.S.C. § 78cc(a) (1976).

only claims of which the parties have knowledge.[65] In *Wilko v. Swan*,[66] the Supreme Court considered whether an arbitration clause violated section 29(a) of the '34 Act.[67] In deciding that the clause was invalid, the Court emphasized that the statute does not bar a release or settlement of an existing mature claim, but only prohibits anticipatory waivers of compliance.[68] The circuits have adopted differing standards in assessing whether the claim underlying the release is mature or anticipatory.[69] The Ninth Circuit holds that only claims of which the parties are aware at the time of release is signed are sufficiently mature for the parties to waive.[70] By contrast, the Seventh Circuit takes a more liberal approach. That Circuit holds that a party may release not only known claims, but also claims that reasonable inquiry would disclose.[71]

At trial, Equitable asserted that American signed a release of all claims against Equitable and its directors, and that this release precluded any rule 10b-5 liability.[72] The *American General* court followed the Seventh Circuit and adopted a reasonable inquiry standard.[73] In adopting the reasonable inquiry standard, the *American General* court stated that the standard achieves the proper balance between the policies of the federal securities laws and the needs of judicial economy.[74] Further, the court found that the reasonable inquiry standard would provide an incentive for plaintiffs to investigate the possibility of claims before signing a release and, thus, would promote the informed signing

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[65] Wilko v. Swan, 346 U.S. 427, 435 (1953).

[66] 346 U.S. 427 (1953).

[67] *Id.* at 430-31; Krause, *supra* note 63, at 702.

[68] *E.g.*, Wilko v. Swan, 346 U.S. 427, 438 (1953). In *Wilko*, the Supreme Court held that a release of a claim *in futuro* is invalid because such a release contravenes Congress's policy of investor protection through full disclosure, *Id.* at 430-31; Krause, *supra* note 60, at 702. Congress intended to create a "special right" of protection of securities investors which cannot be waived. Wilko v. Swan, 346 U.S. at 430-31; Krause, *supra* note 60, at 702 (citing Securities Act of 1933, Pub. L. No. 73-22, Preamble, 48 Stat. 74 (1933); S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933)).

[69] *Compare* Goodman v. Epstein, 582 F.2d 388, 403-05 (7th Cir. 1975), *cert. denied*, 440 U.S. 939 (1979) (party may release not only known claims, but also claims that reasonable inquiry would disclose) *with* Hughes v. Dempsey-Tegeler & Co., 534 F.2d 156, 174-75 (9th Cir.), *cert. denied*, 429 U.S. 896 (1976) (only claims of which parties have knowledge at the time the release is signed are waivable).

[70] Hughes v. Dempsey-Tegeler & Co., 534 F.2d at 175; *see* Royal Air Properties, Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1964). In *Royal Air Properties*, the Ninth Circuit emphasized that waiver is the voluntary or intentional relinquishment of a known right. Therefore, for a waiver to be effective, the releasing party must have knowledge of his rights before he can relinquish them. *Id.*

[71] Goodman v. Epstein, 582 F.2d 388, 404 (7th Cir. 1978).

[72] 493 F. Supp. at 750.

[73] *Id.* at 750-51.

[74] 493 F. supp. at 750 n.57; *see* note 68 *supra* (Congress, in enacting § 10(b), intended to provide special protection of securities investors); Krause, *supra* note 60, at 694 (waiver or arbitration is in best interest of investors as effective and inexpensive extra-judicial method of dispute resolution).

of a waiver and encourage honest settlement attempts.[75] After adopting the reasonable inquiry standard, the court examined the circumstances surrounding the transaction to determine whether American could have discovered Equitable's misrepresentations.[76] The court found that American exercised due diligence by questioning an Equitable director immediately before the sale occurred.[77] Since American's due diligence indicated that the company had made a reasonable inquiry, the court determined that the release was ineffective to bar Equitable's rule 10b-5 liability.[78]

Although the Seventh and Ninth Circuits disagree on the applicable standard for determining the validity of a release,[79] both circuits state that their goal is to protect the innocent investor.[80] Thus, the standards of both circuits satsify the Supreme Court's interpretation of Congress' general policies in *Wilko v. Swan*.[81] The Seventh Circuit's reasonable inquiry standard, adopted in *American General*, probably protects investors better than the actual knowledge standard. By encouraing an investor to conduct some investigation of the other party's claims, the Seventh Circuit and *American General* diminish the possibility that a "willingly ingnorant" investor who blindly or careslessly speculates will then seek a remedy in court.[82]

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[75] 493 F. Supp. at 750 n.57; *see* Goodman v. Epstein, 582 F.2d 388, 404 (7th Cir. 1978); Mittendorf v. J.R. Williston & Beane, Inc., 372 F. Supp. 821, 835 (S.D.N.Y. 1974).

[76] 493 F. Supp. at 751. The Seventh Circuit only requires the plaintiff to prove that he acted with due diligence in establishing that a reasonable inquiry would not have revealed extant claims. Goodman v. Epstein, 582 F.2d 388, 404 (7th Cir. 1978). This is not the same as the proof of due diligence as an element of the substantive merits of a 10b-5 cause of action. *Id.* The Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1975) required a 10b-5 plaintiff to prove that the defendant acted with scienter in perpetrating the fraud. Courts have held that to require a plaintiff to prove both scienter and his due diligence to avoid the fraud in his case-in-chief would be too great a burden. *E.g.*, Goodman v. Epstein, 582 F.2d 388, 403 (7th Cir. 1978); Holdsworth v. Strong, 545 F.2d 687, 695 (10th Cir. 1976) (en banc), *cert. denied*, 430 U.S. 955 (1977). The Seventh Circuit distinguished between the proof of due diligence as a substantive element of the 10b-5 case and the requirement of proving due diligence in a reasonable inquiry when the plaintiff has affirmatively acted to release another party from any possible liability. Goodman v. Epstein, 582 F.2d at 404. The *Goodman* court stated that the mere fact that a party asks another to sign a release should put the second party on notice that a reasonable inquiry should be made. *Id.*

The requisite degree of due diligence varies among the circuits. *Compare* Dupuy v. Dupuy, 551 F.2d 1005, 1014-20 (5th Cir. 1977) (plaintiff may recover unless reckless in investigating risk that is obvious or highly probable that harm will result), *with* Holdsworth v. Strong, 545 F.2d 687, 693 (10th Cir. 1976) (plaintiff's acts must be "gross conduct" to establish lack of due diligence) *and* Straub v. Vaisman and Co., 540 F.2d 591, 598 (3d Cir. 1976) (plaintiff only required to act reasonably under circumstances).

[77] 493 F. Supp. at 751.

[78] *Id.*

[79] *See* text accompanying notes 69-71 *supra*.

[80] *E.g.*, Goodman v. Epstein, 582 F.2d 388, 404 (5th Cir. 1978); Hughes v. Dempsey-Tegeler & Co., Inc., 534 F.2d 156, 175 (9th Cir. 1976).

[81] *See* text accompanying notes 69-74 *supra*.

[82] *See* Goodman v. Epstein, 582 F.2d 388, 404 (7th Cir. 1978) (reasonable inquiry stan-

C. BREACH OF FIDUCIARY DUTY

Although mere breaches of fiduciary duty are not actionable under the federal securities laws,[83] shareholders may bring a derivative action under the antifraud provisions of the '34 Act when material deceptions or manipulations accompany corporate over-reaching.[84] Courts have had difficulty, however, in defining what conduct is manipulative or deceptive.[85] In *Merritt v. Colonial Foods, Inc.*,[86] the Delaware district court recently considered the disclosure requirements necessary to avoid rule 10b-5 liability in merger transactions.

Plaintiff Merritt was a shareholder in Colonial Foods, which merged with Jobemo, a corporation organized to acquire all outstanding Colonial shares.[87] The Opatut family owned three quarters of the Colonial shares and all of Jobemo's shares.[88] Merritt alleged that he refrained from taking action to enjoin the merger because of untrue statements of material fact contained in a tender document and a notice of the merger issued by

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dard precludes failure of waiver defense when party executing waiver "kept his eyes closed and therefore did not 'know.' ").

[83] Sante Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977); Superintendent of Ins. v. Banker's Life & Cas. Co., 404 U.S. 6, 12 (1971).

[84] *E.g.*, Goldberg v. Meridor, 567 F.2d 209, 221 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); Wright v. Heizer Corp., 560 F.2d 236, 249 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978). A shareholder derivative action permits a stockholder to assert a claim on the corporation's behalf. *See generally* FED. R. CIV. P. 23.1; 3B MOORE'S FEDERAL PRACTICE ¶¶ 23.1.16, 23.1.2. (3d rev. ed. 1979); Note, *Rule 10b-5: The Circuits Debate the Exclusivity of Remedies, the Purchaser Seller Requirement, and Constructive Deception*, 37 WASH. & LEE L. REV. 877, 896-907 (1980) [hereinafter cited as *Rule 10b-5] (discussing constructive deception)*. Constructive deception is a term of art which refers to deception of a corporation by its majority shareholders. *See generally* Klamberg v. Roth, 473 F. Supp. 544, 550-51 (S.D.N.Y. 1979) (memorandum); *Rule 10b-5*, *supra* at 898; *Suits for Breach*, *supra* note 2, at 1883. Since a corporation may act only through its shareholders, officers, or directors, deception of these persons acts as a fraud upon the entire corporation. *E.g.*, HENN, *supra* note 47, §§ 78-80; Sherrard, *Federal Judicial and Regulatory Responses to* Santa Fe Industries, Inc. v. Green, 35 WASH. & LEE L. REV. 695, 699 (1978). When these persons act in their own self-interest, however, the corporation's minority shareholders become the corporation's decision-making body by default. *E.g.*, Dasho v. Susquehanna Corp., 461 F.2d 11, 26 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972); Schoenbaum v. Firstbrook, 405 F.2d 215, 220 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969); *Suits for Breach*, *supra* note 2, at 1883. Therefore, any misrepresentation or omissions to the minority shareholders is a fraud upon the corporation. *E.g.*, Klamberg v. Roth, 473 F. Supp. 544, 551 (S.D.N.Y. 1979); *Suits for Breach*, *supra* note 2, at 1883.

[85] *See* note 1 *supra* (text of rule 10b-5). Manipulation involves intentional conduct designed to defraud investors by controlling or affecting the price of a security. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976). For the purposes of rule 10b-5, deceptive conduct includes affirmative misrepresentations, omissions, and concealment of information which would indicate that a prior statement was misleading. *E.g.* SEC v. National Banker's Life Ins. Co., 324 F. Supp. 189, 195 (N.D. Tex. 1971).

[86] 499 F. Supp. 910 (D. Del. 1980).

[87] *Id.* at 911.

[88] *Id.*

defendant majority shareholders.[89] The plaintiff claimed that the tender document contained nine misrepresentations and omissions, including a failure to state the successful conclusion of another derivative suit would result in a substantial increase in the book value of the corporation's shares, and a failure to include a statement of the financial repercussions of the merger of the corporation.[90] Merritt also alleged that the tender document contained no notice that the merger would result in a taxable event for shareholders, that the proposed merger lacked any business purpose, and that the merger was a scheme to benefit the majority shareholders.[91] The plaintiff further contended that the notice of merger contained misrepresentations and omissions that concealed the facts that, *inter alia*, the merger lacked a valid business purpose and that the price offered to the shareholders was "grossly" inadequate.[92]

The district court found that the plaintiff's allegations fell into two distinct categories.[93] The first category of allegations involved misrepresentations and omissions which essentially were a failure to confess corporate wrongdoing. The court held that statements of this kind were not deceptive or manipulative and, thus, were not actionable under federal securities laws.[94] The court found that the allegations that the merger lacked any valid business purpose, that the merger was a scheme to benefit the majority shareholders, and that the price offered to shareholders was inadequate failed to state a rule 10b-5 cause of action.[95] The second category of allegations concerned statements which might affect the shareholder's investment decision of whether to accept the offer or attempt to block the merger.[96] The court found that the failure to inform the shareholders of the possibility of a substantial increase in the book value of the shares from a successful conclusion of the other derivative suit, the failure to include a financial statement, and the failure to inform the shareholders of a possible tax liaiblity to the shareholders if the merger were successful were all misrepresentations and omissions which stated a cause of action under rule 10b-5.[97]

The Supreme Court has determined that Congress did not expressly or implicitly provide a cause of action for breach of fiduciary duty.[98] The Court reasoned that judicial creation of such a cause of action would exceed the congressional mandate and thrust federal courts into an area traditionally reserved to state law.[99] The district court in *Merritt*

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[89] *Id.* at 911-12.
[90] *Id.* at 912.
[91] *Id.*
[92] *Id.* at 913.
[93] *Id.* at 914.
[94] *Id.*
[95] *Id.*
[96] *Id.*
[97] *Id.*
[98] Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977).
[99] *Id.*

recognized that some of the plaintiff's claims merely alleged a failure to confess corporate wrongdoing, a claim actionable under state law, and therefore, did not state a federal cause of action.[100] The availability of a state injunctive remedy, however, does not preclude a federal claim.[101] A breach of fiduciary duty is actionable under section 10(b) and rule 10b-5 if deception, misrepresentation, or nondisclosure occurred.[102] The *Merritt* court, however, did not investigate whether the claims arose from deception, misrepresentation, or nondisclosure. The court assumed that these elements existed and focused its analysis on the materiality[103] of omissions and misrepresentations.[104] Finding that the second category of omissions included in the plaintiff's complaint had a direct bearing on the investment decisions of the shareholders, the court determined that the omissions were material and stated a federal claim.[105]

By determining a federal cause of action on the basis of materiality rather than deception, the *Merritt* court implicitly lowered the plaintiff's burden of proof of misrepresentation in contradiction of the Supreme Court's intent.[106] After *Merritt*, a plaintiff with a claim under state law could achieve standing to sue in federal court, not by proving that the defendant violated rule 10b-5 by his misrepresentations or omissions, but by a showing of materiality. The *Merritt* decision provides clarity, however, in constructive deception suits. The "confusion of cor-

[100] 499 F. Supp. at 914; *see* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (Congress did not intend § 10(b) to regulate internal corporate mismanagement).

[101] *E.g.*, Goldberg v. Meridor, 567 F.2d 209, 220-21 (2d Cir. 1977); Wright v. Heizer Corp., 560 F.2d 236, 249 (7th Cir. 1977).

[102] *E.g.*, Santa Fe Indus. Inc. v. Green 430 U.S. 462, 476 (1977).

[103] *See* note 11 *supra* (definition of materiality).

[104] 499 F. Supp. at 914.

[105] *Id.* Unlike other merger cases, the defendants in *Merritt* clearly committed fraud and deceit upon the plaintiff minority shareholders through their misrepresentations. *Compare* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474 (1977) *and* Beisenbach v. Guenther, 588 F.2d 400, 402 (3d Cir. 1978) *with* Healey v. Catylist Recovery of Pa., Inc., 616 F.2d 641, 646 (3d Cir. 1980) *and* Goldberg v. Meridor, 567 F.2d 209, 220-21 (2d Cir. 1977). In *Santa Fe*, the Supreme Court reviewed Delaware merger law to determine whether the defendant had omitted any requisite information. The Court determined that all relevant information was fairly represented by the defendant management. 430 U.S. 474. In *Beisenbach*, the defendant directors made loans to the corporation on terms which were 4% above the prime rate of interest and were to be repaid in shares of the corporation. 588 F.2d at 400. The Third Circuit declined to classify the directors' mistakes in calculating the interest rate and the directors' failure to confess the mistakes as deceptive conduct. *Id.* 402. In *Healey*, the defendants failed to provide the plaintiff with information concerning the acquiring company's future plans and the names of the acquirer's board members. 616 F.2d at 643. The Third Circuit found that misrepresentations and omissions were material and that the material misrepresentations deprived the minority of the opportunity to enjoin the merger under state law. *Id.* at 646-47. The Second Circuit in *Goldberg* found that a defendant parent company's undisclosed sale of overvalued assets for stock of a controlled subsidiary was a material misrepresentation or omissions. 567 F.2d at 220-21.

[106] *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474 (1977) (absent proof of deception, misrepresentation or nondisclosure, no federal cause of action stated).

porate wrong-doing" standard[107] furnishes a clear line of demarcation between actionable and nonactionable claimed under rule 10b-5.

D. CHURNING

Although section 15 of the '34 Act[108] grants the SEC power to regulate broker-dealers, the Commission has consistently used rule 10b-5 to augment its regulation.[109] The Commission justifies this use of rule 10b-5 by the "shingle theory."[110] A broker is a fiduciary to his customer,[111] and under the shingle theory, the broker must deal with his customers fairly and honestly.[112] By "hanging out his shingle" the broker impliedly represents that he will trade for a customer's account only to the extent of the customer's authorization.[113] Brokers and dealers may defraud their customers and violate the shingle theory by churning. Churning occurs when a broker-dealer engages in trading activity in a customer's account to generate commissions for the broker, and the activity is excessive in light of the customer's investment objectives and financial situation.[114]

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[107] *See* text accompanying notes 94-95, 100 *supra* (failure to confess corporate wrong-doing does not state rule 10b-5 cause of action).

[108] 15 U.S.C. § 78o(c)(1).

[109] *See generally* Investors Management Co., 44 S.E.C. 633 (1971); Cady, Roberts & Co., 40 S.E.C. 907 (1961); BROMBERG & LOWENFELS, *supra* note 5, at 2:33-2:34.

[110] *See generally* S. JAFFEE, BROKER-DEALERS AND SECURITIES MARKETS 307 (1977) [hereinafter cited as JAFFEE]; Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 870-71 (1967) [hereinafter cited as *Churning*].

[111] Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944); JAFFE, *supra* note 110, at 307.

[112] *See generally* JAFFEE, *supra* note 110, at 307; *Churning*, *supra* note 110, at 870-71.

[113] Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943); Duker & Duker, 6 S.E.C. 386, 388-89 (1939); N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS, ¶¶ 2.03, 2.11 (1977) [hereinafter cited as WOLFSON, PHILLIPS & RUSSO].

[114] *E.g.*, Dzentis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 168, 170-71 (10th Cir. 1974); Fey v. Walson & Co., 493 F.2d 1036, 1045 (7th Cir. 1974); WOLFSON, PHILLIPS & RUSSO, *supra* note 113, ¶ 2.11. Churning violates both rule 10b-5 and rule 15cl-2. *See* Charles Hughes & Co. v. SEC, 139 F.2d 434, 436 (2d Cir. 1943); JAFFE, *supra* note 110, at 127 & 137. Rule 15cl-2, 17 C.F.R. § 240.15cl-2 (1980), promulgated by the SEC under 15(c)(1) of the '34 Act, 15 U.S.C. § 78o(c)(1) (1976) prohibits:

> any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . . [and] any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.

17 C.F.R. § 240.15cl-2 (1980). For a comparison of rule 15cl-2 and rule 10b-5 antifraud provisions, see BROMBERG & LOWENFELS, *supra* note 55, §§ 2.1, 2.3; 5A JACOBS, *supra* note 47, § 3.02(f).

A related concept, the "suitability doctrine," holds that a customer may rely on his broker to invest only in those securities which are suitable to the degree of risk which the

In *Mihara v. Dean Witter & Co.*,[115] the Ninth Circuit recently considered the elements of proof in a churning action. Plaintiff Mihara, an aerospace engineer with ten years' investment experience, invested $30,000 by opening a margin account[116] with a branch of defendant Dean Witter.[117] Mihara claimed that because of his concern about his family's financial security and his daughers' education in light of the aerospace industry's layoff record, he wanted reliable financial expertise and safe investments.[118] Conversely, the defendant broker claimed that Mihara was not concerned about a layoff, that he was interested in growth, and that Mihara was knowlegeable about margin accounts and broker call rates.[119] The broker recommended that Mihara make purchases of stock in double-knit fabric companies.[120] Although the broker consulted Mihara prior to all purchases, Mihara's account made speculative investments, numerous purchases and sales, and lost a total of $46,464.[122] The broker received a cumulative total of $12,672 in commission.[123] After complaining to his broker, as well as Dean Witter's local and regional office managers, Mihara filed suit.[124] Following a jury trail, the court held the defendant liable for breach of fiduciary duty and violation of rule 10b-5.[125]

A plaintiff must prove several elements to establish a broker-dealer's liability for churning. First, the plaintiff must show that the broker induced activity in the plaintiff's account which, considering the character and financial situation of the account, was excessive in volume and frequency.[126] Second, the plaintiff must prove that the broker had control over the account.[127] Third, the broker must have

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customers are willing to assume. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 448-49 (1965). The doctrine is comparable to the implied warranty of fitness for a particular purpose imposed by § 2-315 of the Uniform Commercial Code. *Id.* at 452. A seller of goods warrants the goods if he has reason to know the particular purpose for which the goods are acquired and when the buyer relies on the seller's skill or judgment in selecting or furnishing goods which are suitable for that purpose. *Id.*

[115] 619 F.2d 814 (9th Cir. 1980).

[116] A margin account is a method by which brokers extend credit to customers to purchase securities. *See generally* JAFFE, *supra* note 110, at 327. An investor must pay a portion of the price upon ordering and remit the full price within seven business days from date of purchase. *Id.* at 328. Margin accounts are used principally for speculation. *See id.* at 327.

[117] 619 F.2d at 817.

[118] *Id.*

[119] *Id.*

[120] *Id.* at 817-18.

[121] *Id.* at 817.

[122] *Id.* at 817-18.

[123] *Id.* at 819.

[124] *Id.* at 818.

[125] *Id.* at 817. The jury awarded compensatory damages of $24,600 and assessed punitive damages of $66,666 against Dean Witter & Co. and $2,000 against the defendant broker. *Id.*

[126] E. H. Rollins and Sons, Inc., 18 S.E.C. 347, 380 (1945); JAFFE, *supra* note 110, at 308.

[127] Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1207 (9th Cir. 1970); JAFFE, *supra* note 110, at 308.

acted with the intent to defraud or in reckless disregard of the interests of the client.[128] The defendant may escape liability by proving waiver, laches or estoppel as defenses.[129]

Courts have developed several methods to determine whether the broker excessively traded in an account in order to obtain commissions rather than benefit the customer.[130] Because the sophistication, financial resources, and investment objectives of customers vary, courts must determine whether a broker churned an account on a case-by-case basis.[131] One factor which courts consider is the ratio of commissions to the size of the account.[132] Courts also use the "turnover rate" to determine excessive account activity.[133] The turnover rate, computed by dividing the cost of purchases in the account over a period by the average investment in the period, shows how many times in the period the customer's securities have been replaced by new securities.[134] Courts have established no minimum turnover rate or commissions-to-size ratio.[135] A third method in determining whether churning occurred examines individual purchases and sales in an account.[136] A fourth test examines the length of time individual securities are held in the account. A short length of time reflects poorly on the integrity of the broker's recommendation, raising an inference that if the broker's orginial judgement were sound he would not have traded so quickly.[137] A fifth test weighs the quality of the securities in the account against the customer's investment goals.[138]

In determining whether the broker had traded Mihara's account excessively, the court focused primarily on the turnover rate test.[139] Although testimony was available in the record to apply the other tests

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[128] Rolf v. Blythe, Eastman, Dillon & Co., 424 F. Supp. 1021, 1039-40 (S.D.N.Y. 1977), *aff'd*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); JAFFE, *supra* note 110, at 308.

[129] Hecht v. Harris Upham & Co., 430 F.2d 1202, 1208 (9th Cir. 1970); JAFFE, *supra* note 110, at 316.

[130] *See generally* JAFFE, *supra* note 110, at 308.

[131] *Id.*

[132] Looper & Co., 38 S.E.C. 294, 299 (1957).

[133] *Id.* at 297.

[134] *Id.*; JAFFE, *supra* note 110, at 309.

[135] JAFFE, *supra* note 110, at 309-10. Courts will weigh the turnover rate against the plaintiff's financial circumstances, *e.g.*, First Securities Corp., 40 S.E.C. 589, 591 (1961), and the customer's investment objectives, *e.g.*, Hecht v. Harris Upham & Co., 430 F.2d 1202, 1207 (9th Cir. 1970).

[136] *E.g.*, Walter S. Grubbs, 28 S.E.C. 323, 325 (1948). To achieve a high level of account activity to generate commissions, a broker must "switch" or sell securities already in the account to generate proceeds for new purchases. JAFFE, *supra* note 110, at 310-11.

[137] JAFFE, *supra* note 110, at 311.

[138] *Id.* The suitability doctrine requires that a broker invest only in those securities which are suitable to the degree of risk which the customer is willing to assume. *See* note 114, *supra*.

[139] *Id.* at 821; *see* text accompanying notes 133-35 *supra*.

of excessive trading,[140] the Ninth Circuit stated that a turnover rate of six reflects excessive trading, and mentioned the holding period test only in passing.[141] The court found that in the first year that Dean Witter handled the plaintiff's account, the broker turned over the average monthly investment more than nine times, and that the broker held over fifty per cent of the stock for fifteen days or less.[142]

When the customer is naive or unsophisticated, a court is more likely to find that the broker controlled the trading in the customer's account if the investor can prove reliance upon the expertise of the broker.[143] Even when the customer is relatively sophisticated and granted no formal discretionary authority to the broker, the court may find control if the customer regularly followed the broker's advice.[144] An experienced customer who regularly makes his own investment decisions, however, will have difficulty proving that the broker controlled the account.[145] Courts require the plaintiff to prove that the broker acted with scienter in perpetrating the fraud scheme.[146] Most courts consider reckless disregard of the injured party's rights sufficient to satisfy the scienter element.[147]

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[140] 619 F.2d at 819, *see* text accompanying notes 140-48, *supra*. For example, while the broker earned $12,672 in commissions, the average size of Mihara's account was approximately $39,000, 619 F.2d at 819, making the ratio of commissions to size of account almost 1:3. *See* text accompanying note 132, *supra*. The plaintiff's expert testified that the double-knit stocks recommended by the defendant were rated as high risk with below average financial strength. 619 F.2d at 819. These stocks would be unsuitable for an investor with conservative investment goals, as claimed by Mihara. *See* text accompanying notes 117 & 138 *supra*. No testimony was given to allow application of the individual purchases and sales examination.*See* text accompanying note 136, *supra*.

[141] 619 F.2d at 821.

[142] *Id.* at 819. Between January 1971 and July 1973, the broker turned over Mihara's average monthly investment of $36,653 approximately 14 times. *Id.* In 1971, Dean Witter turned over the plaintiff's average capital investment of $40,000 approximately 9.3 times. *Id.* Mihara's investment in 1972 was $39,800 and the broker turned that amount over 3.36 times. *Id.* In 1971, the holding periods of Mihara's stock were short. The broker held 50% of the securities for 15 days or less, 61% for 30 days or less, and 76% for 60 days or less. *Id.* From January 1971 to July 1973, Dean Witter held 81.6% of Mihara's securities for 180 days or less. *Id.*

[143] *E.g.*, Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 838-39 (E.D. Va. 1968); Shearson, Hammill & Co., 42 S.E.C. 811, 844-49 (1965); WOLFSON, PHILLIPS & RUSSO, *supra* note 113, ¶ 2.11.

[144] *E.g.*, Hecht v. Harris Upham & Co., 430 F.2d 1202, 1207 (9th Cir. 1970); WOLFSON, PHILLIPS & RUSSO, *supra* note 113, ¶ 2.11.

[145] *E.g.*, Powers v. Francis I. DuPont & Co., 344 F. Supp. 429, 432 (E.D. Pa. 1972); WOLFSON, PHILLIPS & ROSS, *supra* note 113, ¶ 2.11.

[146] *E.g.*, Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir. 1978); Carroll v. Bear, Stearns & Co., 416 F. Supp. 998, 1000 (S.D.N.Y. 1976). All plaintiffs proceeding under § 10(b) and rule 10b-5 must prove that the defendant acted with scienter. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976).

[147] *E.g.*, Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir. 1978); Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1046 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

The *Mihara* court found that the broker exercised control over the account, noting that Mihara routinely followed the broker's recommendations.[148] The court viewed the broker's conduct as indicating reckless disregard for the client's investment concerns, thus fulfilling the scienter requirement.[149] The defendant argued that the plaintiff must prove an intent to defraud on each trade made by the broker.[150] The court disagreed and held that since churning was a scheme to defraud, a plaintiff need only prove that the broker generally had scienter throughout the churning scheme.[151]

Churning usually occurs over a period of one to several years.[152] During this time, the broker must send the customer purchase and sale confirmations for each transaction.[153] An issue thus arises of whether the plaintiff, by failing to object to the broker's conduct, has waived any rights, created an estoppel, or by laches barred himself from recovery.[154] The defenses are easier to plead than to establish.[155] If the customer is unsophisticated the defenses are unavailable.[156]

Although Mihara regularly received confirmation slips from his broker, the Ninth Circuit affirmed the jury's rejection of the defenses of waiver, estoppel, and laches.[157] The court reasoned that even though the confirmation slips informed Mihara of the specific transactions made, the slips were not sufficient to put the plaintiff on notice that the trading his account was excessive.[158] The confirmation slips indicated only the suitability of the stocks purchased.[159] Further, the *Mihara* court found that the plaintiff's repeated complaints to Dean Witter management about the handling of his account provided ample evidence to block the defenses.[160]

The fact that the *Mihara* jury found the broker guilty of churning despite evidence that Mihara had been interested in growth stocks and was knowledgeable about the stock market[161] illustrates that a court must be subjective in a churning case. The need for flexible interpretations of fact makes the Ninth Circuit's objective standard of a turnover

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[148] 619 F.2d at 821.

[149] *Id.*

[150] *Id.*

[151] *Id.*

[152] See JAFFE, *supra* note 110, at 316.

[153] *Id.*

[154] *Id.*

[155] *Id.* at 317.

[156] *E.g.*, Hecht v. Harris Upham & Co., 430 F.2d 1202, 1207 (9th Cir. 1970); JAFFE, *supra* note 110, at 317-19.

[157] 619 F.2d at 822.

[158] *Id.* (citing Hecht v. Harris Upham & Co., 430 F.2d 1202, 1210 (9th Cir. 1970)). The *Hecht* court found that individual confirmation slips do not fully indicate the excessive trading of the account to the plaintiff. Hecht v. Harris Upham & Co., 430 F.2d at 1210.

[159] 619 F.2d at 822; *see* note 114 *supra* (suitability doctrine).

[160] 619 F.2d at 822.

[161] *Id.* at 817, 820.

rate of six to reflect churning unusual.[162] The turnover rates in cases in which courts have found churning vary widely.[163] Only when the court balances the objective elements against the customer's need and investment objectives can the court determine the broker's guilt.[164] The weighing of subjective elements is necessary to maintain the "uneasy balance" established in churning actions.[165] On one hand, the securities dealer in an investment counselor dispensing advice. The customer's reliance on the broker's advice will be detrimental if the dealer trades for his own interest.[166] On the other hand, the dealer is a salesman whose profits depend upon his volume of sales.[167] Therefore, a court must consider the totality of the circumstances, rather than merely a single objective factor, to determine correctly whether a broker churned an account.[168] Under the *Mihara* decision, an ambitious investor may be able to speculate, achieve a turnover rate above six and then proceed against his broker for churning. Conversely, a broker could make excessive trades for his own profit, yet avoid liability under rule 10b-5 if the turnover rate did not reach six. In future decisions, the Ninth Circuit should avoid setting arbitrary objective standards and return to a more subjective balancing of factors to determine churning.

E. CAUSATION AND PURCHASER–SELLER REQUIREMENT

When deceptive conduct accompanies a sheriff's sale of stock, unique problems arise when litigating that conduct. In *Falls v. Fickling*,[169] the

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[162] *E.g.*, Sierga & Co., Sec. Exch. Act. Rel. No. 10207 (June 7, 1973); First Sect. Corp., 40 S.E.C. 589, 591 (1961); Walter S. Grubbs, 28 S.E.C. 323, 329-30 (1948); WOLFSON, PHILLIPS & RUSSO, *supra* note 113, ¶ 2.11 (excessive trading not determined by set formula); 5A Jacobs, *supra* note 47, at 9-96 (No mathematical formula can establish churning because subjective consideration of customer's needs and resources and the character of amount must override objective factors).

[163] *Compare, e.g.*, Shearson, Hammill & Co., Exch. Act Rel. No. 7743, at 30-31 (Nov. 12, 1965) (turnover rate of eight times a month) *with* Stevens v. Abbott, Proctor & Paines, 288 F. Supp. 836, 842 (E.D. Va. 1968) (two turnovers in twelve months) *and* J. Logan & Co., 41 S.E.C. 88, 94, 97 (1962), *aff'd per curiam sub nom.* Hersh v. SEC, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964) (3.03 turnovers in twenty-three months).

[164] *See* Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 168, 171 (10th Cir. 1974) (no single rule to determine churning); Fey v. Walston & Co., 493 F.2d 1036, 1045 (7th Cir. 1974) (court must balance extent of trading against investment goals of customers); Stevens v. Abbott, Proctor & Paine, 288 F. Sup. 836, 846 (E.D. Va. 1968) (court must weigh customer's financial condition or expressed goals and character of account against totality of circumstances to determine if account churned). Prior to *Mihara*, the Ninth Circuit also recognized that the determination of churning is a subjective balancing. *See* Hecht v. Harris, Upham & Co., 283 F. Supp. 317, 432, 435 (N.D. Cal. 1968) *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) (no single formula to determine churning, court must look at customer's needs, objectives, and nature of account).

[165] *See* JAFFE, *supra* note 110, at 307; *see generally Churning*, *supra* note 110, at 870.

[166] JAFFE, *supra* note 110, at 306; *Churning*, *supra* note 110, at 870.

[167] JAFFE, *supra* note 110, at 306; *Churning*, *supra* note 110, at 870.

[168] *See* note 164 *supra*.

[169] 621 F.2d 1362 (5th Cir. 1980).

Fifth Circuit recently considered whether the mechanics of a forced sale satisfy the materiality and purchaser-seller elements of a rule 10b-5 cause of action. The court determined that a sheriff's sale comes within the '34 Act's definition of sale[170] and therefore satisfies the purchaser-seller requirement of rule 10b-5.[171] The court further concluded that a defendant's deceptive conduct can violate the rule even though the plaintiff is forced to sell.[172]

Plaintiffs Falls pledged his shares of Charter Medical Corporation (Charter) as security for two promissory notes payable to the defendants.[173] The defendants, a director-shareholder and a president and largest stockholder of Charter, obtained a judgement against Falls upon default on the note.[174] The sheriff levied upon the stock to satisfy the judgement and set a date for a sheriff's sale.[175] The parties negotiated the stock sale for several months before the sheriff's sale, but could not reach an agreement.[176] Falls attended the sale with $100,000 to ensure that his shares would sell for a fair price. Immediately before the sale, Fickling offered to bid four dollars per share. Fall rejected this price but accepted an offer of four dollars and fifty cents per share in return for his agreement not to bid on the shares.[177] The Ficklings then purchased the shares at the sheriff's sale in accordance with their settlement with Falls.[178] Two days after the sheriff's sale Charter announced an offer of an exchange of each share of common stock for a share of preferred stock valued at seven dollars.[179] Falls sued the Ficklings under rule 10b-5 alleging that the Ficklings owed Falls a fiduciary duty as a minority shareholder and that they breached that duty by purchasing Falls' stock without disclosing inside information concerning the impending sales offer.[180] The trial court dismissed Falls' claim for failure to state a cause of action, reasoning that since the sale was a forced process and not voluntary, Falls was not a seller of the stock.[181]

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[170] 15 U.S.C. § 78c(a)(14) (1976). Section 3(14) of the '34 Act defines "sale" and "sell" as including "any contract to sell or otherwise dispose of." *Id.*

[171] 621 F.2d at 1365.

[172] *Id.* at 1367.

[173] *Id.* at 1363.

[174] *Id.* The judgement against Falls was for $89,567.19. *Id.*

[175] *Id.*

[176] *Id.* at 1363-64.

[177] *Id.* at 1364.

[178] *Id.* The final settlement before the sheriff's sale was for $90,716.14, the total judgment against Falls plus interest and costs. *Id.* n.5. The settlement included a mutual release of all claims arising from acts occuring before the settlement. *Id.*; *see* text accompanying notes 60-71 *supra* (enforceability of general releases in securities cases).

[179] 621 F.2d at 1364.

[180] *Id.*

[181] *Id.* at 1364-65. The district court relied on the Supreme Court's requirement that only purchasers and sellers have standing to bring a cause of action under 10b-5. *Id.*, citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975).

On appeal, the defendants contended that Falls was not a seller because Falls already had disposed of his interest in stock by defaulting on the pledge and, therefore, the sheriff's sale was merely a formality.[182] The Fifth Circuit rejected the defendant's theory and found that whether forced or not, a sale occurred.[183] In support of this decision, the court looked to the laws of the state in which the sale occurred. Under the law of Georgia, a sheriff is the agent of a forced seller and all proceeds of the sale belong to the defendant.[184] The *Falls* court reasoned that if a transaction is a sale under state law, a court should not adopt a more restrictive test under the federal securities laws.[185] Therefore, the Fifth Circuit held that the plaintiff was a seller entitled to assert a rule 10b-5 cause of action.[186]

The defendants claimed that even if Falls technically were a seller, the defendant's conduct did not harm the plaintiff since, as a forced seller, the plaintiff had no decision to influence.[187] The *Falls* court rejected this contention, finding that the plaintiff did have some discretion since he could have purchased the stock himself.[188] The court distinguished an Eighth Circuit case on which the defendants relied.[189] In that case, a shareholder sold stock pursuant to a prior stock option agreement made without fraud.[190] According to the terms of the agreement, both the price and date of sale were fixed. The shareholder could do nothing to block the sale of the stock.[191] The *Falls* court stated that unlike the Eighth Circuit case, and no matter what the theory were labeled, whether "causal nexus," "reliance," or "materiality," the Ficklings' omissions affected the plaintiff's decision not to purchase the stock.[192] The court also reasoned that full disclosure of the impending exchange offer would have increased the amount that the plaintiff received, since anyone aware of the sheriff's sale would have bid at the sale.[193] Com-

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[182] 621 F.2d at 1365-66.

[183] *Id.* at 1365.

[184] *Id.* at 1365 n.12; Dupriest v. Bennett Bros., 61 Ga. App. 704, ___, 7 S.E.2d 293, 294 (1940); Lowe v. Ralins, 83 Ga. 321, ___, 10 S.E. 204, 204 (1889); *See* GA. CODE ANN. § 39-1307 (1975) (proceeds of sale belong to defendant).

[185] 621 F.2d at 1365 n.12.

[186] *Id.* at 1365.

[187] *Id.* at 1366-67.

[188] *Id.* at 1367.

[189] *Id.* at 1366-67 (citing St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, 562 F.2d 1040 (8th Cir. 1977)).

[190] St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 562 F.2d 1040, 1043-44 (8th Cir. 1977).

[191] *Id.* at 1050 n.15.

[192] 621 F.2d at 1368.

[193] *Id.* at 1367-68. The defendants claimed that the $4.50 per share received by Falls was the price of the stock on public exchanges and, therefore, the plaintiff received fair market value. *Id.* The court dismissed this argument as "patently false," reasoning that if the argument were accepted, any insider trading in violation of rule 10b-5 could claim that the defrauded party to the sale had received fair market value before the information became public. *Id.* at 1369.

petitive bidding would have driven the price per share to a value which reflected the omitted information.[194] Finding that the plaintiff stated a 10b-5 cause of action, the Fifth Circuit reversed and remanded.[195]

Although the *Falls* court couched its reasoning in terms of causation, the court should have focused on materiality. Causation is presumed when a plausible relation exists between the defendant's deception and the plaintiff's loss.[196] Therefore, the plaintiff need prove only materiality.[197] A misrepresentation or omission is material if disclosure would have significiantly altered the total mix of information available to a reasonable investor.[198] This standard implicitly presumes that, if disclosure of the withheld information is made, the reasonable investor has an available alternative to sale.[199] Since the Fifth Circuit required Falls to prove that he had discretionary alternatives with respect to the price of the stock at the sheriff's sale,[200] the proper focus was on the issue of whether the omissions were material.

By finding that the sherriff's sale is a sale for federal securities law purposes because the proceeding is a sale under state law, the Fifth Circuit imposed an incorrect relationship between federal and state law. Congress intended that the federal securities acts provide broader causes of action and remedies than available under state common law.[201] The securities acts determine whether a transaction is a sale securities acts purposes.[202]

A recent Supreme Court case may call into question the Fifth Circuit's analysis of whether a sale occurred. In *Rubin v. United States*,[203] the Supreme Court held that a pledge of securities constitutes a sale for the purposes of the '33 Act.[204] The Court found that a pledgor gives an in-

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[194] *Id.* at 1368.

[195] *Id.* at 1371.

[196] Mills v. Electric Auto-Lite, 396 U.S. 375, 384-85 (1970).

[197] *Id.*

[198] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

[199] *E.g.*, Fershtman v. Schechtman, 450 F.2d 1357, 1360-61 (2d Cir. 1971), *cert. denied*, 405 U.S. 1066 (1972); *Rule 10b-5*, *supra* note 84, at 901-02.

[200] 621 F.2d at 1367.

[201] *See generally* BROMBERG & LOWENFELS, *supra* note 55, § 2.7(1).

[202] *See generally* 15 U.S.C. § 77b (1976).

[203] 101 S. Ct. 698 (1981).

[204] *Id.* at 700-02. *Rubin* considered only whether a pledge of securities was a sale under § 17(a) of the '33 Act, 15 U.S.C. § 77q(a) (1976). Rubin v. United States, 101 S. Ct. 698, 701 (1981). The *Rubin* decision probably applies to § 10(b) of the '34 Act, since courts construe the '33 and '34 Acts as one body of law. Tcherepnin v. Knight, 389 U.S. 332, 342 (1967); Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1041 (7th Cir. 1979). In addition, courts directly recognize that a pledge is included within the '34 Act's definition of a sale. *E.g.*, Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1028-29 (6th Cir. 1979); Mallis v. FDIC, 568 F.2d 824, 829 (2d Cir.), *cert. dismissed sub nom.* Bankers Trust Co. v. Mallis, 435 U.S. 381 (1977). The definitions of "sale" in the '33 and '34 Act are different. The '33 Act defines a sale as a contract for disposition of a security or interest in a security, 15 U.S.C. § 77b(3) (1976), while the '34 Act defines a sale as a contract to sell or otherwise dispose of a security, *id.*, § 78(c)(a)(14) (1976).

terest in the pledged securities to the pledgee and that the '33 Act does not require full title to pass from transferor to transferee to constitute a "sale."[205] Since courts construe the '33 and '34 Acts as one body of law,[206] the question arises that if the "sale" of the securities acutally took place at the time of the pledge, the Ficklings would not have violated rule 10b-5 since Falls had alleged no deception "in connection with" the pledge. The Court's reasoning in *Rubin* suggests that this question will not preclude rule 10b-5 liability.[207] Since a pledge passes an interest in the security to the pledgee, the pledgor disposes of part of his interest at the pledge and the remainder at any later sale.[208] Therefore, the pledgee would be liable under rule 10b-5 for any fraudulent misrepresentation of omissions made both at the pledge and at any later sale.[209] Under this analysis, Falls "sold" his securities at the pledge by disposing of part of his interests in the securities to the pledgees, the Ficklings. Falls retained title in the securities, however, so that he "sold" the remainder of his interest at the sheriff's sale. The Ficklings would then be liable under rule 10b-5 for any misrepresentations or omissions made at either the pledge or the sheriff's sale. In light of *Rubin*, the Fifth Circuit's determination in *Falls* is correct.

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[205] Rubin v. United Staes, 101 S. Ct. 698, 701 (1981) (citing United States v. Gentile, 530 F.2d 461, 466 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976)). In *Gentile*, the Second Circuit found that a pledgee of securities assumed an investment risk substantially similar to that assumed by an investor who purchases securities. United States v. Gentile, 530 F.2d 461, 467 (2d Cir. 1976). Since both pledgee and investor are speculating that the securities will have a continuing value, the federal securities laws should protect the pledgee as well as the investor. *Id. But see* National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295, 1300 (5th Cir. 1978) (federal securities laws intended to protect investors, not pledgee. "Pledgee, unlike a securities purchaser, has a remedy on the note itself against makers and guarantors.").

[206] *See* note 204 *supra*.

[207] Rubin v. United States, 101 S. Ct. 698, 701 (1981).

[208] *Id. Rubin* conforms with the common law. Under common law, upon pledge, the interest in the collateral was split with the pledgor retaining title and incidences of ownership such as voting rights and the right to receive dividends, while the pledgee receives possession. *E.g.*, National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295, 1300 (5th Cir. 1978); Note, *Applicability of Rule 10b-5 to Pledges of Securities*, 68 CALIF. L. REV. 547, 548 (1980).

[209] Rubin v. United States, 101 S. Ct. 698, 702 (1981).