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RULE 10b-5: THE CIRCUITS DEBATE THE EXCLUSIVITY OF REMEDIES, THE PURCHASER-SELLER REQUIREMENT, AND CONSTRUCTIVE DECEPTION

Section 10(b) of the Securities Exchange Act of 1934 ('34 Act)[1] and Securities Exchange Commission Rule 10b-5[2] are the principal mechanisms investors use to remedy fraudulent securities transactions.[3] Courts have construed the elements of a section 10(b) cause of action[4] broadly in order to effectuate the congressional goal of full disclosure.[5] Recent Su-

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[1] 15 U.S.C. § 78j(b) (1976). Section 10(b) 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—
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> . . . .
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> (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 for the protection of investors.

[2] 17 C.F.R. § 240.10b-5 (1979). Rule 10b-5, promulgated under § 10(b) of the '34 Act, *see* note 1 *supra*, by the Securities Exchange Commission, provides:

> It shall be unlawful for any person, directly or indirectly, by use of any means of 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.

[3] *See, e.g.*, Marx v. Computer Sciences Corp., 507 F.2d 485, 487 (9th Cir. 1974); Burns v. Paddock, 503 F.2d 18, 21 (7th Cir. 1974). *See also* 5 A. JACOBS, THE IMPACT OF RULE 10b-5 § 1 (rev. ed. 1979) [hereinafter cited as JACOBS]; Lowenfels, *Recent Supreme Court Decisions Under Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891, 892 (1977) [hereinafter cited as Lowenfels].

[4] To state a cause of action under Rule 10b-5, plaintiffs must allege that the defendant, acting with scienter, employed a materially deceptive or manipulative practice in connection with the purchase or sale of a security. *See* Valente v. Pepsico, Inc., 454 F. Supp. 1228, 1236 (D. Del. 1978); Weitzman v. Stein, 436 F. Supp. 895, 902 (S.D.N.Y. 1977). Additionally, the Rule 10b-5 plaintiff must have suffered an actual loss as a direct result of the defendant's conduct. *See* Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

[5] *See, e.g.*, Eason v. General Motors Acceptance Corp., 490 F.2d 654, 660-61 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974) (standing granted under Rule 10b-5 though plaintiffs not purchasers or sellers of security); Popkin v. Bishop, 464 F.2d 714, 718 (2d Cir. 1972) (non-deceptive corporate mismanagement actionable under Rule 10b-5); Vanderboom v. Sexton, 422 F.2d 1233, 1239 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970) (negligence suffi-

preme Court decisions defining the parameters of section 10(b), however, have reversed this liberal interpretative trend by restricting defrauded plaintiffs' access to federal court.[6] In the past year, lower courts wrestled with specific interpretations of section 10(b) in light of the Supreme Court's broad mandates.[7]

A. *Rule 10b-5 and Section 18: The Conflict Between Express and Implied Remedies*

Federal courts readily have granted persons injured by fraudulent securities transactions a remedy under section 10(b) despite the absence of explicit statutory language providing a private right of action.[8] Courts im-

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cient to establish Rule 10b-5 liability). *See also* H.R. REP. No. 85, 73d Cong., 1st. Sess. 2 (1933) (purpose of Securities Act is to promote investor protection through full disclosure). "Full disclosure" is a term of art which denotes public disclosure of all material facts surrounding a securities transaction. *See* Arber v. Essex Wire Corp., 490 F.2d 414, 418 (6th Cir. 1974).

[6] *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977) (non-deceptive breaches of fiduciary duty not actionable under Rule 10b-5); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (proof of scienter necessary for recovery in a private damage action under Rule 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738-39 (1975) (private plaintiff must be purchaser or seller of security for standing under Rule 10b-5). *See generally* Lowenfels, *supra* note 3, at 892; Note, *Judicial Retrenchment Under Rule 10b-5; An End to the Rule as Law*, 1976 DUKE L.J. 789, 790.

[7] *See* Ross v. A.H. Robbins Co., 607 F.2d 545, 554 (2d Cir. 1979); Alabama Farm Bur. Mut. Cas. Co. v. American Fid. Life Ins. Co., 606 F.2d 602, 605 (5th Cir. 1979); Lincoln Nat. Bank v. Herber, 604 F.2d 1038, 1042 (7th Cir. 1979); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1032 (6th Cir. 1979); Kidwell v. Meikle, 597 F.2d 1273, 1294 (9th Cir. 1979); Maldonado v. Flynn, 597 F.2d 789, 793 (2d Cir. 1979).

[8] *See, e.g.*, Ellis v. Carter, 291 F.2d 270, 273 (9th Cir. 1961); Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 787 (2d Cir. 1951). *See generally* Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. L. REV. 627 (1963) [hereinafter cited as Ruder]. The Supreme Court began implying private rights of action in Texas & Pac. Ry. Co. v. Rigsby, 241 U.S. 33 (1916). In *Rigsby*, the Court implied a private cause of action under the Federal Safety Appliance Act. Subsequent to *Rigsby*, the Court has granted private rights of action under a wide variety of federal statutes. *See, e.g.*, Allen v. State Bd. of Elections, 393 U.S. 544 (1969) (Voting Rights Act of 1969); Wyandotte Transp. Co. v. United States, 389 U.S. 191 (1967) (Rivers & Harbors Act of 1899).

In J.I. Case Co. v. Borak, 377 U.S. 426 (1964), the Supreme Court adopted an expansive view of implied private remedies under the federal securities laws. In *Borak*, the plaintiff sought relief for damages incurred as a result of misleading proxy statements violative of § 14(a) of the Securities Act 1933. *Id.* at 429-30. Reasoning that the SEC alone could not fully enforce § 14(a), the Court held that the goals of the '33 Act necessitated implication of a private remedy. *Id.* at 432-33. Furthermore, the *Borak* Court encouraged lower courts to imply private remedies under other sections of the securities laws. *Id.* at 433. In decisions subsequent to *Borak*, however, the Supreme Court *sub silentio* declined to follow *Borak's* expansive remedial doctrine. *See, e.g.*, Securities Investor Protection Corp. v. Barbour, 421 U.S. 412, 418 (1975); National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers, 414 U.S. 453, 458 (1974). Finally, in Touche Ross & Co. v. Redington, 99 S. Ct. 2479 (1979), the Supreme Court explicitly declared that *Borak's* liberal approach is no longer good law. *Id.* at 290. *See generally* Note, *Implication of Private Actions From Federal Statutes: From* Borak *to* Ash, 1 J. CORP. L. 371, 376 (1976).

ply a private remedy under section 10(b) in order to insure widespread compliance and to effectuate the congressional goal of investor protection through full disclosure.[9] The Supreme Court, influenced by an overwhelming judicial consensus, has confirmed without substantive discussion the existence of a private right of action under section 10(b).[10] This recognition, however, does not necessarily grant defrauded plaintiffs a Rule 10b-5 cause of action in every case. In *Ernst & Ernst v. Hochfelder*,[11] the Court explicitly refrained from deciding whether private actions may lie under section 10(b) for transactions that also violate section 18 of the '34 Act.[12] Section 18 creates an express private remedy for false or misleading statements in documents filed with the Securities and Exchange Commission (SEC).[13]

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[9] *See* Speed v. Transamerica Corp., 235 F.2d 369, 373 (3d Cir. 1956); Fratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953). *See also* 78 CONG. REC. 2770-71 (1934) (statement of Sen. Fletcher) ('34 Act designed to insure full disclosure to investors).

[10] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-54 (1972). Although the district court for the Eastern District of Pennsylvania first implied a private right of action under § 10(b) in 1946, *see* Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946), the Supreme Court did not explicitly recognize this private cause of action until 1971. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

[11] 425 U.S. 185 (1976).

[12] *Id.* at 211 n.31; *cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752 n.15 (1975) (question left unresolved whether Rule 10b-5 action will lie for conduct proscribed by express remedies in the '33 Act).

Section 18 of the Securities Exchange Act of 1934 provides in pertinent part:

> (a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 780 of this title, which statement was at the time or in light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of the suit, and assess reasonable costs, including reasonable attorneys' fees against either party litigant.
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> . . .
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> (c) No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued.

15 U.S.C. § 78r (1976); *see* text accompanying notes 22-24 *infra*.

[13] 15 U.S.C. § 78r(a) (1976). Congress intended that the language of § 18 encompass omissions as well as misrepresentations. *See In Re* Pennsylvania Cent. Secs. Litigation, 357 F. Supp. 869, 876 (E.D. Pa. 1973); H.R. REP. No. 1838, 73d Cong., 2d Sess. 36 (1934); *cf.* 15 U.S.C. § 78(i)(4) (1976) (omissions not actionable under § 9(a)(4) of the '34 Act). Filing a document with a stock exchange will give rise to a § 18 remedy even though the defendant did not file the document with the SEC. *See* Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 788 (2d Cir. 1951). However, if the defendant files a misleading document with an agency

Recently, the Second Circuit, in *Ross v. A. H. Robbins Co.*,[14] held that the existence of an express remedy under section 18 of the '34 Act[15] does not preclude implication of a section 10(b) private right of action.[16] In *Ross*, the plaintiffs claimed that the A. H. Robbins Co. and its directors made material misstatements and omissions about the safety and effectiveness of the "Dalkon Shield," a birth control device manufactured and marketed by Robbins.[17] Robbins' annual report, 10-K forms,[18] and a stock prospectus contained the alleged misrepresentations.[19] The plaintiffs, suing on behalf of a class of similarly situated purchasers of Robbins' stock,[20] charged that the misrepresentations had artificially inflated

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other than the SEC, § 18 provides no remedy. *See* Dorfman v. First Boston Corp., 336 F. Supp. 1089, 1098 (E.D. Pa. 1972) (documents filed with Interstate Commerce Commission not actionable under § 18); Gann v. Bernz Omatic Corp., 262 F. Supp. 301, 304 (S.D.N.Y. 1966) (misrepresentations in non-filed documents not actionable under § 18).

[14] 607 F.2d 545 (2d Cir. 1979).

[15] A majority of courts have held that § 18 is the "catch-all" civil liability provision for violations of the reporting requirements of the '34 Act. Thus, most courts have refused to imply private rights of action under the individual reporting requirements. *See, e.g.*, DeWitt v. American Stock Transfer Co., 433 F. Supp. 994, 1005 (S.D.N.Y. 1977) (§§ 13(a) & 15(d)); Meyers v. American Leisure Time Enterprises, Inc., 402 F. Supp. 213, 214-15 (S.D.N.Y. 1975), *aff'd mem.*, 538 F.2d 312 (2d Cir. 1976) (§ 13(d)); *In Re* Pennsylvania Cent. Sec. Litigation, 347 F. Supp. 1127, 1340 (E.D. Pa. 1972), *aff'd*, 494 F.2d 528 (3d Cir. 1974) (§ 13(a)).

The '34 Act requires filing of a wide variety of documents with the SEC. Section 13(a) contains the most important reporting requirement. Under § 13(a), most publicly held companies must submit an annual report on Form 10-K and provide other financial and nonfinancial information about their operations during the course of a year. *See* 15 U.S.C. § 78m (1976). *See generally* 5 JACOBS, *supra* note 3, § 3.02[h] (discussion of all filing requirements under '34 Act).

[16] 607 F.2d at 556. Prior to the Second Circuit's decision in *Ross*, no federal circuit court had decided whether plaintiffs might proceed under § 10(b) for conduct proscribed by § 18(a). The district courts have reached divergent conclusions. *Compare* McKee v. Federals, Inc., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,958, at 96,923 (E.D. Mich. 1979) *and* Pearlstein v. Justice Mortgage Investors, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,760, at 94,474-75 (N.D. Tex. 1978) (§ 18 is exclusive remedy for misrepresentations in material filed with SEC) *with* Wachovia Bank & Trust Co. v. National Student Marketing Corp., 461 F. Supp. 999, 1006 & n.15 (D.D.C. 1978) *and* Seiden v. Nicholson, 69 F.R.D. 681, 685 (N.D. Ill. 1976) (§ 10(b) action may lie for conduct covered by § 18).

[17] 607 F.2d at 548-50. The *Ross* plaintiffs alleged that the defendants recklessly disregarded information indicating the inaccuracy of statements concerning the effectiveness of the Dalkon Shield, and that the defendants predicated their misrepresentations upon insufficient test data. *Id.* at 548-49. Additionally, the plaintiffs alleged that the defendants failed to correct their misrepresentations in a timely fashion. *Id.* at 550.

[18] Form 10-K contains year end financial and nonfinancial information about a publicly held company. *See generally* 2 L. LOSS, SECURITIES REGULATION 811-17 (2d ed. 1961) [hereinafter cited as Loss).

[19] 607 F.2d at 549. The plaintiffs in *Ross* alleged that the defendants' misrepresentations appeared in several press releases as well as in documents filed with the SEC. *Id.* Material misrepresentations in press releases give rise to Rule 10b-5 liability. *See* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 97 (10th Cir. 1971). Presumably, then, the Second Circuit did not need to address the exclusiveness of the § 18 remedy.

[20] A plaintiff seeking to represent a class must be a member of the protected class and

the price of the company's securities.[21] The plaintiffs sought relief under section 10(b) and Rule 10b-5.[22]

Although the plaintiffs in *Ross* sued under Rule 10b-5, section 18 would have provided an express remedy for the defendants' conduct since the alleged misrepresentations appeared in documents filed with the SEC.[23] In order to proceed under section 18, a plaintiff must have relied on the misrepresentation in purchasing or selling a security, and the misrepresentation must have affected the value of the security.[24] A defendant may escape liability with the affirmative defense that he acted in good faith and without knowledge of the inaccuracy of his statements.[25] The district court dismissed the complaint, holding that Congress intended section 18 to be the exclusive remedy for conduct proscribed by that section.[26]

On appeal, the Second Circuit reversed the trial court and concluded that private plaintiffs may proceed under Rule 10b-5 for misrepresentations in documents filed with the SEC.[27] In analyzing whether section 18 is an exclusive remedy, the court declined to employ the methodology for determining legislative intent used by the Supreme Court in implied private right of action cases.[28] The *Ross* court reasoned that the Supreme

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have suffered injury in the same manner as class members. *See* East Tex. Motor Freight Sys., Inc. v. Rodriguez, 431 U.S. 395, 403 (1977). *See generally* Block & Warren, *New Battles in the Class Struggle—The Federal Courts Reexamine the Securities Class Action,* 34 BUS. LAW. 455 (1979).

[21] 607 F.2d at 550. Subsequent to public disclosure of the Dalkon Shield's ineffectiveness and safety problems, the value of A.H. Robbins Co. stock dropped from $19 to $13 a share. Robbins' stock is listed on the New York Stock Exchange. *Id.*

[22] *Id.*

[23] *Id.* at 553.

[24] 15 U.S.C. § 78r(a) (1976). The SEC considers the § 18(a) requirement that plaintiffs prove that the defendant's misrepresentation affected the price of the security a major disincentive to the use of § 18(a). *See* Loss, *supra* note 18, at 1753-54. In the 1941 Amendments to the '34 Act, the Commission unsuccessfully sought to strike the requirement. *See* SEC REPORT ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, H.R. COM. PRINT, COM. ON INT. & FR. COMMERCE, 77th Cong., 1st Sess. 38 (1941).

[25] 15 U.S.C. § 78r(a) (1976).

[26] Ross v. A.H. Robbins Co., Inc., 465 F. Supp. 904, 913 (S.D.N.Y. 1979). The district court in *Ross* analyzed the '34 Act's legislative scheme in holding that § 18 precludes the use of § 10(b). The district court reasoned that the procedural and substantive requirements of § 18 manifested Congress' intention that § 18 act as an exclusive remedy. *Id.*

[27] *Id.* at 554; *see* text accompanying notes 34-53 *infra.*

[28] *Id.* at 553. The Supreme Court has adopted a two-step test for determining whether to imply a private right of action. *See* Transamerica Mortgage Advisors, Inc. v. Lewis, 100 S. Ct. 242, 249 (1979); Touche Ross & Co. v. Redington, 99 S. Ct. 2479, 2489 (1979); Note, *Section 17(a) of the '33 Act: Defining the Scope of Antifraud Protection,* 37 WASH. & LEE L. REV. 859 (1980) [hereinafter cited as *Defining the Scope of Section 17(a)*]. The Court's initial consideration is whether Congress intended to create a private remedy in favor of the plaintiff. *See* Transamerica Mortgage Advisors, Inc. v. Lewis, 100 S. Ct. at 249. In determining legislative intent, the Court examines whether the plaintiff is the intended beneficiary of the statute and whether the statute's legislative history indicates that Congress intended to

Court's analytical framework was inapplicable[29] because courts already recognize an implied right of action under section 10(b).[30] Upon examining several recent Supreme Court decisions, the court rejected the plaintiffs' contention that remedies in the securities acts are never exclusive.[31] Instead, the court adopted a nullification test which would prohibit plaintiffs from invoking an implied remedy if the terms of the implied remedy would unjustifiably nullify the procedural and substantive limitations of the competing express remedy.[32] The court reasoned that allowing an implied remedy where nullification exists would encourage circumvention of the carefully drawn express remedies included in the securities acts.[33]

The Second Circuit's analysis began by noting that plaintiffs seeking to establish reliance[34] on misrepresentations face a more difficult task under section 18 than under section 10(b).[35] In a Rule 10b-5 action, courts presume reliance once a plaintiff establishes materiality[36] or proves

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provide a private remedy. The Court also determines whether implication of a private right of action would be consistent with the overall legislative scheme. *See* Touche Ross & Co. v. Redington, 99 S. Ct. at 2489. *See also* Cort v. Ash, 422 U.S. 66, 78 (1975). If the Court's legislative intent analysis indicates that Congress did not intend to provide a private remedy, the Court will not imply a right of action. Transamerica Mortgage Advisors, Inc. v. Lewis, 100 S. Ct. at 249; Touche Ross & Co. v. Redington, 99 S. Ct. at 2489. If Congress intended to create a private remedy, however, the Court further determines whether state law so traditionally covers the defendant's alleged conduct that implication of a federal remedy would be inappropriate. *See* Touche Ross & Co. v. Redington, 99 S. Ct. at 2489; *see also* Cort v. Ash, 422 U.S. at 78.

[29] 607 F.2d at 553.

[30] *See* text accompanying notes 8-10 *supra*.

[31] 607 F.2d at 554. The *Ross* plaintiffs relied on the Supreme Court's decision in SEC v. National Securities, 393 U.S. 453, 468 (1969), as authority for the proposition that Congress intended the remedies in the securities acts to overlap. In *National Securities*, the Court held that an overlap between § 10(b) and § 14 of the '34 Act does not limit either remedy. *Id.* at 468. The *Ross* court recognized that recent Supreme Court decisions have limited the liberal philosophy of *National Securities*. 607 F.2d at 554.

[32] 607 F.2d at 553. *See also* Note, *The Exclusivity of the Express Remedy Under Section 18(a) of the Securities Exchange Act of 1934*, 46 GEO. WASH. L. REV. 845, 856-58 (1978) [hereinafter cited as *Express Remedy*].

[33] 607 F.2d at 554-55.

[34] Courts often consider the reliance requirement of Rule 10b-5 in the context of causation. *See, e.g.*, Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975). Under this approach, causation has two elements. First, plaintiffs must establish "transaction causation" by showing reliance on a defendant's misrepresentation in purchasing or selling a security. Second, the plaintiff must establish "loss causation" by proving that the defendant's misrepresentation adversely affected the value of the security. *See id.*; Valente v. Pepsico, Inc., 454 F. Supp. 1228, 1246-49 (D. Del. 1978).

[35] 607 F.2d at 552-53.

[36] *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972); Mills v. Electric Auto-Lite, 396 U.S. 375, 384 (1970). *See generally* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975).

In TSC Industries, Inc. v. Northway, 426 U.S. 438 (1976), the Supreme Court held that a misrepresentation is material if there is "a substantial likelihood that a reasonable shareholder would consider the misrepresentation important in deciding how to vote." *Id.* at 449. Although *Northway* involved an alleged violation of § 14(a), the circuit courts have readily

that the material misrepresentations affected the open market price of the stock.[37] Under section 18, courts do not recognize constructive reliance.[38] The section 18 plaintiff must plead and prove actual reliance[39] on the misrepresentation in purchasing or selling a security.[40]

While this difference seemingly supports the conclusion that section 18 is an exclusive remedy, the Second Circuit reasoned that the plaintiff's burden of establishing scienter[41] under section 10(b) offsets the relative advantage of not having to prove actual reliance.[42] Under Rule 10b-5, the plaintiff has the burden of averring specific facts which imply that the defendant acted with scienter.[43] Under section 18, however, a plaintiff

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adopted the materiality standard in § 10(b) cases. *See, 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).

[37] *See* Blackie v. Barack, 524 F.2d 891, 906 (9th Cir. 1975). Inflation in the market price of a stock immediately after a material misrepresentation circumstantially establishes that market traders relied on the misrepresented facts. *See id.*; Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 374 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973).

[38] *See* Mutual Shares Corp. v. Genesco, Inc., 266 F. Supp. 130, 133 & n.3 (S.D.N.Y.), *rev'd in part on other grounds,* 384 F.2d 540 (2d Cir. 1967); Hoover v. Allen, 241 F. Supp. 213, 220-21, 225 (S.D.N.Y. 1965); *cf. In re* Caesar's Palace Sec. Litigation, 360 F. Supp. 366, 399 (S.D.N.Y. 1973) (constructive reliance permissible in class action under § 18).

[39] *Accord,* Heit v. Weitzen, 402 F.2d 909, 916 & n.6 (2d Cir. 1968), *cert. denied,* 395 U.S. 903 (1969); Barotz v. Monarch Gen., Inc. [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,933, at 97,237 (S.D.N.Y. 1975). *But see* 5 JACOBS, *supra* note 3, § 3.02[h], at 1-104 n.22; 3 Loss, *supra* note 18, at 1753 n.227 ("actual reliance" should encompass reliance upon abstracts of documents filed with SEC).

[40] *See* 5 JACOBS, *supra* note 3, § 3.02[h], at 1-104, 5.

[41] Private plaintiffs proceeding under § 10(b) and Rule 10b-5 must plead and prove that the defendant acted with scienter. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976). Scienter is also the culpability standard under § 18. *See* Pearlstein v. Justice Mortgage Investors, [1979 Transfer Binder] ¶ 96,760, at 94,975 (N.D. Tex. 1978). Most courts consider reckless behavior sufficient to meet the scienter requirement. *See, e.g.,* Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978); Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977). *See generally* Bucklo, *The Supreme Court Attempts To Define Scienter Under Rule 10b-5:* Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213 (1977); *1978-1979 Securities Law Developments: Rule 10b-5,* 36 WASH. & LEE L. REV. 901, 923-30 (1979) [hereinafter cited as *1978-1979 Developments*].

[42] 607 F.2d at 556.

[43] *See* Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978); Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 521-22 (10th Cir. 1973). FED. R. CIV. P. 9(b) is the basis for the requirement that plaintiffs aver specific facts which establish the implication of scienter. 607 F.2d at 557. The primary purpose of Rule 9(b) is to insure that defendants have reasonable details concerning their challenged conduct. *See* Weinberger v. Kendrick, 432 F. Supp. 316, 320 (S.D.N.Y. 1977). When a complaint fails to meet the specificity requirement of rule 9(b), courts dismiss the action but liberally allow the plaintiff to replead. *See* Barry v. St. Paul Fire & Marine Ins. Co., 555 F.2d 3, 13 (1st Cir. 1977); *cf.* Mooney v. Vitolo, 435 F.2d 838, 839 (2d Cir. 1970) (court denied plaintiff alleging fraud under Rule 10b-5 leave to amend on third attempt). *See generally* 2A MOORE'S FEDERAL PRACTICE ¶ 9.03, at 9-25, 39 (3d rev. ed. 1979) [hereinafter cited as MOORE'S].

In *Ross,* the court held that the plaintiff's complaint failed to allege the specific facts necessary to raise the inference of scienter. 607 F.2d at 558. The court found that the plain-

states a cause of action merely by showing that a document filed with the SEC contained a misrepresentation and that the plaintiff relied on the misrepresentation.[44] While section 18 also requires that the defendant act with scienter, the court presumes the mental state once the plaintiff establishes a prima facie case.[45] The burden in a section 18 action is on the defendant to prove the absence of scienter.[46] The *Ross* court concluded that this burden of proof allocation adversely affects section 10(b) claims since plaintiffs may have difficulty alleging the specific facts necessary to survive a motion to dismiss.[47] Thus, the Second Circuit held that defrauded investors enjoy no substantive advantages by proceeding under section 10(b) rather than under the express remedy of section 18.[48]

The *Ross* court also relied on policy considerations in holding that section 18 is not an exclusive remedy. Initially the court stated that predicating the availability of Rule 10b-5 upon misrepresentations in an SEC filing might deny all remedies to some investors.[49] Finding that open market investors have become one of the chief beneficiaries of Rule 10b-5 protection,[50] the court reasoned that the current Congress would not condone basing Rule 10b-5 liability on such a delineation.[51] Additionally, the court speculated that forcing plaintiffs to proceed under section 18 rather

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tiffs failed to allege facts showing that the defendants were aware of information which raised serious doubts about the safety and effectiveness of the Dalkon Shield. *Id.* The court also found that the plaintiffs failed to allege when the defendants became aware of the defects in the product. *Id.* Finally, the complaint failed to specify the time period during which the price of Robbins' stock fell. *Id.* at 559. The Second Circuit remanded *Ross* with instructions that the district court provide the plaintiffs leave to amend. *Id.*

[44] *See* Gross v. Diversified Mortgage Investors, Inc., 438 F. Supp. 190, 195 (S.D.N.Y. 1977); 3 Loss, *supra* note 18, at 1752.

[45] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 211 n.31 (1976); 3 Loss, *supra* note 18, at 1752.

[46] *See* note 45 *supra.*

[47] 607 F.2d at 556; *see* note 43 *supra.*

[48] 607 F.2d at 556. The *Ross* court failed to address expressly the impact of the procedural requirements in § 18. Plaintiffs proceeding under § 18 must satisfy a one year statute of limitations and courts may require a plaintiff to post bond to cover court costs and attorney's fees. *See* 15 U.S.C. § 78r (1976); text accompanying notes 80 & 81.

[49] 607 F.2d at 556. Currently, many plaintiffs seek relief under Rule 10b-5 for misstatements in SEC filings because of an inability to satisfy the substantive or procedural requirements of § 18. *See* 5 JACOBS, *supra* note 3, § 3.02[h], at 1-106. Thus, denying these plaintiffs a remedy under Rule 10b-5 would effectively preclude litigation of their claims under the federal securities laws. 607 F.2d at 556.

[50] 607 F.2d at 556; Thill Securities Corp. v. NYSE, 433 F.2d 264, 273 (7th Cir. 1970). *Cf.* United States v. Naftalin, 441 U.S. 768, 775 (1979) (investors are not exclusive beneficiaries of '34 Act).

[51] 607 F.2d at 556. The *Ross* court's concern with whether the current Congress would concur in the court's decision is misguided. In interpreting statutes, courts seek to effectuate the legislature's intent at the time of the statute's enactment. *See* 2A SANDS, STATUTES AND STATUTORY CONSTRUCTION § 45.05 (4th ed. 1973) [hereinafter cited as SANDS]. Thus, reaction of the current Congress to a particular decision is irrelevant to a judicial inquiry. *Cf.* Touche Ross & Co. v. Redington, 442 U.S. 560, 579 (1979) (Congress should enact private right of action if Court's decision unacceptable).

than under section 10(b) would encourage officers and directors to incorporate their misrepresentations in documents filed with the SEC.[52] The Second Circuit reasoned that such incorporation would insulate these potential defendants from section 10(b) liability since once the misrepresentations appeared in an SEC filing, section 18 would become the only available remedy.[53]

In construing the federal securities laws,[54] the Supreme Court seeks to effectuate congressional intent in enacting the contested statute.[55] In determining legislative intent, courts employ extrinsic and intrinsic aids.[56] Intrinsic aids involve examining the text of the statute and inferring congressional intent from the statute's composition and structure.[57] Extrinsic aids are sources indicating legislative intent which are found outside the text of the act.[58] The primary extrinsic aid is legislative history.[59] While the Second Circuit's nullification analysis is an intrinsic aid in statutory construction,[60] the analysis does not provide a comprehensive view of congressional intent in enacting the '34 Act. The Second Circuit should have employed the analytical framework used by the Supreme Court in determining whether to imply a private right of action.[61]

The first part of the Supreme Court's analysis involves a mode of statutory construction for discerning legislative intent.[62] Courts should employ this legislative intent methodology in exclusivity of remedy cases because the methodology represents the Supreme Court's choice of how to

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[52] 607 F.2d at 556.

[53] *Id.*

[54] The primary federal securities laws are: the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976 & Supp. II 1978); the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976 & Supp. II 1978); the Public Utility Holding Co. Act of 1935, 15 U.S.C. §§ 79-79z (1976 & Supp. II 1978); the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 52 (1976 & Supp. II 1978); and the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 21 (1976 & Supp. II 1978).

[55] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976); Securities Investor Protection Corp. v. Barbour, 421 U.S. 412, 418 (1975).

[56] *See, e.g.*, NLRB v. Plasterers' Local No. 79, 404 U.S. 116, 127 (1971); Dent v. St. Louis-S.F. Ry., 406 F.2d 399, 403 (5th Cir. 1969).

[57] *See* 2A SANDS, *supra* note 52, § 47.01. Intrinsic aids are generalizations of customary legislative intent in drafting statutes. *Id.* Thus, for example, when specific words follow general words in a statutory enumeration, courts restrict application of the general term to things similar to those enumerated. *See, e.g.*, Smith v. Nussman, 156 So. 2d 680, 683 (Fla. App. 1963) (slingshot not considered "pistol or other arm or weapon"). *See also* 2A SANDS, *supra* note 51, §§ 47.17 to 47.22 (doctrine of *ejusdem generis*).

[58] *See* 2A SANDS, *supra* note 51, § 48.01. Extrinsic aids provide background information about the purpose of the statute, events surrounding the statute's enactment and post-enactment statutory history. *Id.* § 48.01, at 181.

[59] *See id.* § 48.02.

[60] *See id.* § 47.02; note 57 *supra*. Nullification analysis presumes that the legislature would not enact a provision which would encourage plaintiffs to ignore other applicable provisions within the same act. *See id.* § 47.03, at 72.

[61] *See* text accompanying note 28 *supra*.

[62] *See* Touche Ross & Co. v. Redington, 442 U.S. 560, 568 (1979); *Defining the Scope of Section 17(a)*, *supra* note 28, at 869-71.

assess the impact of intrinsic and extrinsic aids on an ambiguous statute. The Court concludes that Congress intended an implied right of action under a statute if the plaintiff is an intended beneficiary of the statute and if the legislative history of the statute indicates that Congress either explicitly or implicitly intended to create a private remedy.[63] The Court then examines whether implication of a private right of action would be consistent with the overall legislative scheme of the Act.[64] This final consideration is analogous to the Second Circuit's nullification analysis.[65] Thus, the Second Circuit failed to consider the legislative history of section 18. The fact that the Second Circuit only considered one part of the Court's three prong test demonstrates the inadequacy of the nullification analysis.

The Supreme Court's decision in *Piper v. Chris-Craft Industries, Inc.*[66] further supports application of the Court's test to determine the existence of a private cause of action. In *Piper,* the Court held that courts may imply a private right of action under section 14(e) of the '34 Act in favor of tendering shareholders but not in favor of a defeated tender offeror.[67] The selective delineation of a private remedy in *Piper* indicates that recognition of an implied right of action may depend upon the status of the petitioner.[68] Thus, judicial recognition of a private remedy under section 10(b) does not necessarily mean that courts should imply a right of action in favor of every class of plaintiffs.[69] Since the Supreme Court has sanctioned selective implication of private remedies, lower courts should use the Court's analytical framework to determine whether particular classes of plaintiffs have standing to invoke the section 10(b) private right of action.[70]

Application of the Court's legislative intent test militates against implication of a section 10(b) remedy in cases involving conduct actionable under section 18. Investors are clearly one of the prime beneficiaries of section 10(b).[71] The legislative history of section 10(b), however, indicates that Congress did not intend that an implied remedy under section 10(b) extend to conduct proscribed by express remedies.[72] Congress enacted

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[63] *See* Touche Ross & Co. v. Redington, 442 U.S. 560, 568-70 (1979). In examining legislative history to determine whether Congress intended to provide a private remedy, courts examine other legislation comparable to the contested act. If the comparable legislation contains express remedies but the act does not, courts infer that Congress did not intend to provide any remedy. *See* Transamerica Mortgage Advisors v. Lewis, 100 S. Ct. 242, 248 (1979); Abrahamson v. Fleschner, 468 F.2d 862, 883 (2d Cir. 1978) (Gurfein, J., dissenting).

[64] *See* Transamerica Mortgage Advisors, Inc. v. Lewis, 100 S. Ct. 242, 248 (1979).

[65] *See* text accompanying notes 75-77 *infra.*

[66] 430 U.S. 1 (1977).

[67] *Id.* at 37-41.

[68] *See generally 1978-1979 Developments: Implied Rights Action, supra* note 41, at 947-48 (1979).

[69] *See Express Remedy, supra* note 32, at 860.

[70] *See* text accompanying notes 71-80 *infra.*

[71] *See* note 50 *supra.*

[72] *See* text accompanying notes 72-74 *infra.*

section 10(b) for the express purpose of providing the SEC with the authority to enjoin manipulative and deceptive conduct not otherwise prohibited by the '34 Act.[73] Consequently, the legislative history of the '34 Act suggests that the conduct proscribed in section 18 is beyond the reach of section 10(b).[74]

The final consideration in the legislative intent analysis is whether implication of a private remedy is consistent with the overall legislative scheme of the Act.[75] In *Touche Ross & Co. v. Redington*,[76] the Supreme Court ruled that an implied remedy which is significantly broader than an applicable express remedy is inconsistent with the legislative scheme of the '34 Act.[77] Although all courts recognize that the stringent reliance requirement of section 18 makes that remedy narrower than section 10(b),[78] most courts and commentators do not conclude that the plaintiffs' burden of alleging scienter significantly restricts the potential use of section 10(b).[79] Furthermore, section 18 contains a restrictive statute of limitations[80] and bonding requirement[81] that have in practice discouraged potential plaintiffs from proceeding under section 18.[82] Because of section

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[73] *See Hearings on Stock Exchange Regulation Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (remarks of Thomas G. Corcoran; § 10(b) is catch-all provision to enable SEC to deal with new manipulative devices); Ruder, *supra* note 8, at 658-59 (§ 10(b) designed to give SEC enforcement power over manipulative devices new and unknown in 1934).

[74] *See* Ruder, *supra* note 8, at 659.

[75] *See* text accompanying notes 64 & 65 *supra*.

[76] 442 U.S. 560 (1979).

[77] *Id.* at 573-74. The Court in *Touche Ross* stated that considerable evidence supported the view that Congress intended § 18 to act as an exclusive remedy. *Id.* at 574 n.15.

[78] *See* 5 JACOBS, *supra* note 3, § 3.02[h], at 1-106 n.26.

[79] *See* Valente v. Pepsico, Inc., 454 F. Supp. 1228, 1251 (D. Del. 1978); Pearlstein v. Justice Mortgage Advisers, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,760, at 94,975 (N.D. Tex. 1978); Patrick, *The Impact of* Ernst & Ernst v. Hochfelder: *Pleading with Particularity*, 8 INST. SEC. REG. 381, 383 (1977) [hereinafter cited as *Pleading with Particularity]; Express Remedy, supra* note 32, at 856-57. Some courts allow plaintiffs limited discovery in order to more fully develop their scienter allegations. *See, e.g.*, Bishop v. Sklar, Civ. No. 75-H-618-5 (N.D. Ala. 1975). *But see* Segan v. Dreyfus Corp., 513 F.2d 695, 696 (2d Cir. 1975). Additionally, all courts liberally grant leave to replead. *See* note 43 *supra*. Leave to replead provides plaintiffs with the opportunity of gathering additional facts through informal or state law means. *See Pleading with Particularity, supra* at 384.

[80] *See* 15 U.S.C. § 78r(c) (1976). Under § 18, potential plaintiffs must file suit within one year after learning of misrepresentation and, in any event, within three years after the defendant made the misrepresentation. *Id.* By contrast, § 10(b) does not prescribe a limitations period. Courts apply the limitations period of the state remedy most similar to § 10(b). The law of the forum state is the controlling authority. *See* Roberts v. Magnetic Metals Co., 611 F.2d 450, 452 (3d Cir. 1979) (New Jersey's common law fraud remedy most analogous to § 10(b), thus six year limitations period applied); Ohio v. Peterson, Lowry, Rall, Barber & Ross, 472 F. Supp. 402, 406 (D. Colo. 1979) (Colorado blue sky statute identical to § 10(b); three year statute of limitations applied).

[81] 52 U.S.C. § 78r(a) (1976); *see* Rhoadside v. Kenmore, [1974-75] FED. SEC. L. REP. (CCH) ¶ 94,958, at 97,290 (S.D.N.Y. 1975); Linchuck v. Cooper, 43 F.R.D. 382, 384-85 (S.D.N.Y. 1967).

[82] *See* Pearlstein v. Justice Mortgage Investors, [1979 Transfer Binder] FED. SEC. L.

18's restrictive reliance and procedural requirements, section 10(b) appears to be significantly broader than section 18. Thus, application of the Supreme Court's legislative intent analysis indicates that Congress intended section 18 to act as an exclusive remedy.

B. *Pledges of Securities after* Blue Chip

In *Blue Chip Stamps v. Manor Drug Stores*,[83] the Supreme Court restricted standing under Rule 10b-5 to plaintiffs who actually purchased or sold a security.[84] Although the *Blue Chip* decision clearly ended the lower court practice of creating exceptions from the section 10(b) purchaser-seller requirement,[85] the Court failed to articulate the elements of a purchase or sale.[86] Thus, courts can continue to apply Rule 10b-5 broadly through liberal interpretations of the definition of a purchase or sale.[87] The securities acts define a sale as the disposition of a security or interest in a security for value.[88] In the past year, the Sixth and Seventh Circuits

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REP. (CCH) ¶ 96,760, at 94,975 (N.D. Tex. 1978); 5 JACOBS, *supra* note 3, § 3.02[h], at 1-105.

[83] 421 U.S. 723 (1975).

[84] *Id.* at 754-55. In *Blue Chip*, the plaintiffs alleged that the defendant-corporation fraudulently dissuaded investors from purchasing the corporation's stock by circulating a misleading prospectus. *Id.* at 725-26. The Supreme Court held that the plaintiffs lacked standing to proceed under Rule 10b-5 as they had neither purchased nor sold the defendant-corporation's securities. *Id.* at 755. The Court reasoned that the statutory language of § 10(b) clearly manifested congressional intent to restrict standing under that section to actual purchasers or sellers. *Id.* Additionally, the Court concluded that the absence of a firm purchaser-seller requirement would encourage vexatious litigation. Finally, the Court noted that a non-purchaser or non-seller bases his claim almost entirely on oral testimony. The Court reasoned that oral proof is too speculative to form a basis of liability under § 10(b). *Id.* at 747.

[85] Prior to *Blue Chip* federal courts recognized several exceptions to the purchaser-seller requirement in § 10(b). *See, e.g.*, Sargent v. Genesco, Inc., 492 F.2d 750 (5th Cir. 1974) (injunctive relief exception); James v. Gerber Prod. Co., 483 F.2d 944 (6th Cir. 1973) (de facto seller exception); Heprich v. Wallace, 430 F.2d 792 (5th Cir. 1970) (derivative action exception); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967) (forced seller exception); Commerce Reporting Co. v. Puretec, Inc., 290 F. Supp. 715 (S.D.N.Y. 1968) (aborted transaction exception). *See generally* Gallagher, *10b-5 After* Blue Chip Stamps: *How Stands the Judicial Oak*, 80 DICK. L. REV. 1, 36-41 (1975) [hereinafter cited as Gallagher]; *1977-1978 Securities Law Developments: Rule 10b-5*, 35 WASH. & LEE L. REV. 799, 801 n.5 (1978) [hereinafter cited as *1977-1978 Developments*]. *See also* 5 JACOBS, *supra* note 3, § 38.01[e], at 2-61, 2-79 (discussing exceptions to purchaser-seller requirement after *Blue Chip*); Note, *Standing Under Rule 10b-5 after* Blue Chip Stamps, 75 MICH. L. REV. 413, 431-37 (1976).

[86] *See* Note, *The Pendulum Swings Further: The "In Connection With" Requirement and Pretrial Dismissals of Rule 10b-5 Private Claims for Damages*, 56 TEX. L. REV. 62, 91 (1977) [hereinafter cited as *Pretrial Dismissals*].

[87] *See, e.g.*, Goodman v. Epstein, 582 F.2d 388, 414 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979) (capital call constitutes purchaser or sale); Rochelle v. Marine Midland Grace Trust Co., 535 F.2d 523, 527-28 (9th Cir. 1976) (reissuance of securities constitutes purchase or sale).

[88] *See* 15 U.S.C. §§ 77(b)(3), 78(e)(a)(14) (1976). Despite slight differences in the statutory language defining a sale under the '33 and '34 Acts, *see* note 100 *infra*, courts interpret the two definitions in the same fashion. *See, e.g.*, National Bank of Commerce v. All Ameri-

have reached conflicting results on whether a pledge of stock is the sale of a security under the '34 Act.[89]

In *Mansbach v. Prescott, Ball & Turben,*[90] the Sixth Circuit held that a pledgor of securities has standing to sue under Rule 10b-5.[91] In *Mansbach,* the plaintiff pledged a large number of corporate bonds to a brokerage house as collateral for stock transactions.[92] Several months later, after a dispute with the brokerage house, the plaintiff demanded return of his bonds.[93] The defendant delayed returning the bonds for five weeks. During this time, the market price of the bonds declined significantly.[94] Upon receiving the bonds, the plaintiff immediately sold them and filed suit under Rule 10b-5.[95] The district court dismissed the plaintiff's claim on

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can Assurance Co., 583 F.2d 1295, 1298 (5th Cir. 1978); Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd., 544 F.2d 1059, 1063 (10th Cir. 1976), *cert. denied,* 431 U.S. 965 (1977).

[89] *Compare* Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979) (pledge of securities is purchase or sale) *with* Lincoln National Bank v. Herber, 604 F.2d 1038 (7th Cir. 1979) (pledge of securities not purchase or sale); *see* text accompanying notes 90-142 *infra.*

[90] 598 F.2d 1017 (6th Cir. 1979).

[91] *Id.* at 1029. A pledge is a bailment of personal property to secure a loan or guarantee performance of an obligation. *See* R. BROWN, THE LAW OF PERSONAL PROPERTY § 128 (2d ed. 1955). Since a creditor can only perfect a security interest in an instrument under the U.C.C. by taking possession, U.C.C. § 9-304(1), the use of stocks and bonds as collateral must take the form of a pledge. *See* L. LARKIN & H. BERGER, A GUIDE TO SECURED TRANSACTIONS 6 (1970). In a pledge transaction, legal title remains with the pledgor but the pledgee acquires a property interest in the security. *See* SEC v. National Bankers Life Ins. Co., 334 F. Supp. 444, 456 (N.D. Tex. 1971), *aff'd,* 477 F.2d 920 (5th Cir. 1973). If the pledgor satisfies the loan obligation, the pledgee must return the securities. Should the pledgor default, however, the pledgee may foreclose and take full legal title. *See* note 139 *supra; see generally* J. WHITE & S. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 754-55 (1st ed. 1972).

[92] 598 F.2d at 1019.

[93] *Id.* at 1019-20.

[94] *Id.* at 1020-21. The plaintiff in *Mansbach* settled his account with the defendant on May 20, 1974. The brokerage house, however, refused to return the pledged bonds until the plaintiff executed a written release absolving the defendant from all liability in connection with disputed option trading. Although the plaintiff never executed the release, the brokerage house ultimately returned 295 of 300 pledged bonds on July 8, 1974. During the period between May 20 and July 8, the market price of the bonds allegedly dropped by approximately $55,000. *Id.*

[95] *Id.* at 1021. Although defrauded parties in pledge transactions have remedies readily available under the UCC and state common law, plaintiffs generally seek relief in federal court. *See* L. JENNINGS & H. MARSH, SECURITIES REGULATION 992-94 (1977). Rule 10b-5 is procedurally more advantageous than state remedies because plaintiffs may gain nationwide service of process and venue for both federal claims and pendent state claims. *See* Mariash v. Morrill, 496 F.2d 1138, 1142-43 (2d Cir. 1974); Allegaert v. Warren, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,189, at 96,532 (S.D.N.Y. 1979); 15 U.S.C. § 78aa (1976). Additionally, federal plaintiffs enjoy more liberal discovery and class action rules. *See* 1 A. BROMBERG, SECURITIES LAW: FRAUD §§ 2.5(3), 2.7(2) (1968); Comment, *Commercial Notes and Definition of a Security under Security Exchange Act of 1934: A Note is a Note is a Note?,* 52 NEB. L. REV. 478, 509 (1973).

the grounds that the defendant's alleged conversion[96] was not "in connection with the purchase or sale of any security"[97] as is required by section 10(b). On appeal, the Sixth Circuit reversed and held that a pledge of securities falls within the '34 Act's definition of sale.[98]

Rather than articulating independent reasoning for granting the plaintiff standing, the *Mansbach* court expressly adopted the rationale of the Second Circuit in *Mallis v. FDIC*.[99] In *Mallis*, the court concluded that a pledge satisfies the '34 Act's definition of a sale.[100] The court based its decision on the fact that a pledgee and an investor assume an identical investment risk that the securities will remain valuable.[101] In addition to relying on *Mallis*, the Sixth Circuit justified its holding on the ground

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[96] *See* text accompanying notes 93-94 *supra*. Any unauthorized act which deprives an owner of his property either permanently or for a limited time constitutes conversion. *See* Quaker Oats Co. v. McKibben, 230 F.2d 652, 654 (9th Cir. 1956).

[97] 598 F.2d at 1022.

[98] *Id.* at 1029.

[99] 568 F.2d 824 (2d Cir. 1977). In *Mallis*, the pledgee plaintiffs filed suit under Rule 10b-5 for release of cancelled securities from an escrow account. Subsequent to release, the cancelled securities were used as collateral for a personal loan. *Id.* at 826-27. The Second Circuit held that a pledge of securities constitutes a purchase or sale within the meaning of § 10(b). *Id.* at 830.

[100] 568 F.2d at 829. In holding that a pledge transaction is the purchase or sale of a security, the *Mallis* court relied on a case involving a criminal prosecution under § 17(a) of the '33 Act. *See* United States v. Gentile, 530 F.2d 461 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976). Commentators criticize *Mallis'* reliance on *Gentile* because of the arguably broader definition of a sale in the '33 Act. *See, e.g.*, Comment, *Pledge of Securities in a Loan Transaction Held to Constitute a Sale*—Mallis v. F.D.I.C., 52 N.Y.U. L. REV. 651, 660 n.67 (1977). 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), whereas the '34 Act defines a sale as a contract to sell or otherwise dispose of a security, 15 U.S.C. § 78c(a)(14) (1976). Since courts construe the '33 and '34 Acts as one body of law, *see* note 125 *infra*, criticism of *Gentile's* value as precedent is erroneous. Even courts which hold contrary to *Mallis* recognize that the '34 Act's definition of sale encompasses pledge transactions. *See, e.g.*, Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1041 (7th Cir. 1979); National Bank of Commerce v. All American Assurance Co., 583 F.2d 1295, 1298 (5th Cir. 1978).

[101] 548 F.2d at 829; *accord*, [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,738 (summarizing Brief for SEC, SEC v. National Bankers Life Ins. Co., 477 F.2d 920 (5th Cir. 1973)). While the Sixth Circuit in *Mansbach* adopted the reasoning of *Mallis*, the court also sought to distinguish factually the Fifth Circuit's decision in National Bank of Commerce v. All American Assurance Co., 583 F.2d 1295 (5th Cir. 1978), which held that a pledge transaction is not a purchase or sale. The *Mansbach* court reasoned that *All American* was inapplicable because the Fifth Circuit limited the *All American* holding to pledges made in connection with commercial loans which do not affect the securities industry. *Id.* at 1029. Although the plaintiff in *Mansbach* pledged bonds in connection with traded securities, *see* text accompanying notes 92-95 *supra*, the Sixth Circuit's distinction is untenable. The *All American* court's distinction of a pledge from a sale rested on the commercial rather than investment nature of the transaction. 583 F.2d at 1300. The Fifth Circuit reasoned that pledgees are not investors because pledgees may not sell the security except in the case of default and they do not benefit from an appreciation in the security's value. *Id.* Similarly, the pledgee-broker in *Mansbach* could only take title to the bonds through foreclosure, *see* KY. REV. STAT. ANN. § 355.9-503 (Baldwin 1969), and could not recover more than the amount of the pledgor's debt, *see id.* § 355.9-504(2).

that treating a pledge of stock as a sale is consistent with *Blue Chip*.[102] The court stated that the principal policy concern of *Blue Chip* was the elimination of potential fraud in litigation based exclusively on oral proof.[103] The problems of oral proof are not present in pledge cases, however, because written documentation supports pledge transactions. The court thus characterized a pledge as an empirically verifiable event involving a specific amount of stock.[104]

In contrast, the Seventh Circuit in *Lincoln National Bank v. Herber*[105] rejected the reasoning of *Mallis* and denied a defrauded pledgee standing under Rule 10b-5.[106] In *Lincoln National*, the defendant pledged counterfeit stock certificates as collateral for a commercial loan.[107] Upon default, but prior to foreclosure,[108] the pledgee-bank discovered that the stock certificates were counterfeit and brought suit under Rule 10b-5 and section 17(a) of the Securities Act of 1933 ('33 Act).[109] Additionally, the bank alleged that the defendant's conduct constituted common law fraud.[110] The district court held that while the pledge of a security is not a sale, foreclosure by the bank is a forced purchase[111] cov-

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[102] 598 F.2d at 1029-30; *see* note 84 *supra*.

[103] 598 F.2d at 1030; *see* note 95 *supra*.

[104] 598 F.2d at 1030.

[105] 604 F.2d 1038 (7th Cir. 1979).

[106] *Id.* at 1045. The *Lincoln National* decision conflicts with Wright v. Heizer Corp., 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978) where the Seventh Circuit found the defendants liable under Rule 10b-5 for misrepresentations made in connection with a pledge of corporate stock. *Id.* at 252. The *Wright* court, however, failed to consider whether the pledge transaction satisfied the purchaser-seller requirement. *Cf.* SEC v. Dolnick, 501 F.2d 1279, 1282 (7th Cir. 1974) (pledge of securities is sale in SEC injunctive action under § 17(a) of '33 Act).

[107] Lincoln National Bank v. Lampe, 414 F. Supp. 1270, 1274 (N.D. Ill. 1976). Sales of counterfeit and forged securities are actionable under both the '33 and '34 Acts. *See* Seeman v. United States, 90 F.2d 88, 89 (5th Cir. 1937).

[108] Actual foreclosure satisfies the purchaser-seller requirement of Rule 10b-5. *See* Boss v. Crowell-Collier and MacMillian, 565 F.2d 602, 611 (9th Cir. 1977); McClure v. First Nat'l Bank, 497 F.2d 490, 496 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

[109] 414 F. Supp. at 1274. Section 17(a) of the '33 Act prohibits fraudulent acts in connection with the offer or sale of a security. 15 U.S.C. § 77q(a) (1976). Unlike § 10(b), § 17(a) does not provide relief for defrauded sellers of securities. *See* Simmons v. Wolfson, 428 F.2d 455, 456 (6th Cir. 1970), *cert. denied*, 400 U.S. 999 (1971). *See generally* Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641 (1978).

[110] 414 F. Supp. at 1274. In order to recover for common law fraud, a plaintiff must prove that the defendant, acting with scienter, made a false representation of a material fact. Additionally, the plaintiff must show that he justifiably relied on the misrepresentation and suffered damages as a consequence. *See* RESTATEMENT (SECOND) OF TORTS, § 525 (1977). *See generally* Prosser, *Handbook of the Law of Torts* §§ 105-110 (4th ed. 1971); Note, *Fraud and Its Remedies*, 4 TEX. L. REV. 510 (1926). When a defendant is liable under both Rule 10b-5 and a pendent common law fraud claim, courts restrict the plaintiff's recovery to the maximum amount recoverable under either claim. *See, e.g.*, Andrews v. Blue, 489 F.2d 367, 377 (10th Cir. 1973); Aboussie v. Aboussie, 441 F.2d 150, 157 (5th Cir. 1971).

[111] *See* note 113 *infra*.

ered by the federal securities laws.[112] Since valueless stock had secured the loan, however, the district court ruled that a constructive foreclosure had taken place upon default since actual foreclosure would be perfunctory.[113] Although the pledgee-bank had standing under the constructive foreclosure doctrine,[114] the trial court granted summary judgment in favor of the defendants on other grounds.[115]

The Seventh Circuit affirmed the lower court's grant of summary judgment but repudiated the theory of constructive foreclosure without discussion.[116] The *Lincoln National* court instead focused on the more fundamental issue of whether a pledge transaction is the purchase or sale of a security.[117] The court conceded that the pledge of a security falls within the definition of "sale" under the '33 and '34 Acts,[118] but concluded that courts should not literally apply the definitions found in the two acts.[119] The Seventh Circuit held that courts must construe definitions in the context of the legislative purpose behind the '33 and '34 Acts[120] and in light of the economic realities underlying a transaction.[121] In following this broad mode of analysis, the court found that a pledge is not a sale. Initially, the court examined the legislative history of the '33 Act.[122] Relying on a passage from the Senate Report on the '33 Act,[123] the

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[112] 414 F. Supp. at 1278.

[113] *Id.* The district court's theory of constructive foreclosure in *Lincoln National* is analogous to the forced seller doctrine. Under the forced seller doctrine, a plaintiff who has not actually sold a security has standing under Rule 10b-5 if the defendant's conduct is certain to force a sale in the future. *See* Gallagher, *supra* note 85, at 8-9 n.39. Courts reason that delaying the suit until the actual sale takes place is a "needless formality." Vine v. Beneficial Fin. Co., 374 F.2d 627, 634 (2d Cir. 1967). Although the forced seller doctrine is an exception to the purchaser-seller requirement, the doctrine has survived the Supreme Court's decision in *Blue Chip*. *See* Houlihan v. Anderson-Stokes, Inc., 434 F. Supp. 1330, 1331 (D.D.C. 1977). *See also 1978-1979 Developments, supra* note 41, at 907-911.

[114] 414 F. Supp. at 1278. *See generally* Note, *A Pledge of Stock in a Commercial Loan: "Purchase or Sale" Under the Securities Exchange Act of 1934*, 1979 ARIZ. ST. L.J. 669, 681-83 (discussing constructive foreclosure doctrine).

[115] 604 F.2d at 1039. The district court decision granting summary judgment is unpublished. *Id.* at 1039 n.1.

[116] *Id.* at 1044.

[117] *Id.* at 1040.

[118] *Id.* at 1040-41; *see* note 100 *supra*.

[119] The definitions in the '33 and '34 Acts apply literally "unless the context otherwise requires." 15 U.S.C. §§ 77b, 78c (1976). Courts often use this context-over-text provision to alter the statutory definitions found in the securities acts. *See, e.g.*, Ballard & Cordell Corp. v. Zoller & Dannenberg Exploration, Ltd., 544 F.2d 1059, 1063 (10th Cir. 1976), *cert. denied*, 431 U.S. 965 (1977) (definition of security); Crimmins v. American Stock Exchange, 368 F. Supp. 270, 272 (S.D.N.Y. 1973), *aff'd*, 503 F.2d 560 (2d Cir. 1973) (definition of broker).

[120] 604 F.2d at 1041; *see* text accompanying notes 122-127 *infra*.

[121] 604 F.2d at 1041; *see* text accompanying notes 128-138 *infra*.

[122] 604 F.2d at 1041. *See generally* ELLENBERGER & MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 (1973) (compilation of pertinent congressional documents).

[123] *See* S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933); text accompanying note 155 *infra*.

court concluded that Congress intended to protect only investors.[124] Since courts construe the '33 and '34 Acts as one body of law,[125] the *Lincoln National* court reasoned that investor protection in the securities markets was the purpose of the '34 Act.[126] The court concluded that the pledge transaction in *Lincoln National* had no effect on any security market.[127] The court also interpreted Congress' failure to include pledges explicitly in the definition of a sale as an indication that Congress did not intend that the '34 Act regulate pledges of securities as collateral.[128]

Upon finding that Congress intended only to protect investors, the *Lincoln National* court reasoned that the protections of the '34 Act are limited to investment transactions.[129] The Seventh Circuit, in determining whether a transaction is of an investment or commercial nature, relied on two Supreme Court cases construing the definition of a security.[130] In *International Brotherhood of Teamsters v. Daniel*[131] and *United Housing Foundation, Inc. v. Forman,*[132] the Court rejected literal application of the definition of a security and instead looked to the economic realities of the challenged transactions.[133] Although the alleged securities in both *Daniel* and *Forman* peripherally involved an investment decision, the Court held that the '33 and '34 Acts did not cover the alleged securities since the plaintiffs purchased the shares primarily for non-investment

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[124] 604 F.2d at 1041. *Accord,* Mallis v. FDIC, 568 F.2d 824, 829 (2d Cir. 1977). *But see* text accompanying notes 149-159 *infra.*

[125] *See* Tcherepnin v. Knight, 389 U.S. 332, 342 (1967).

[126] 604 F.2d at 1042. Since the '34 Act extends the '33 Act's policy of full disclosure to the subsequent trading of securities in secondary markets, *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976), the *Lincoln National* court reasoned that a pledge transaction must affect the securities markets in order to constitute a sale. 604 F.2d at 1042. *Contra,* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 (1971) (coverage of § 10(b) not limited to transactions which affect a securities exchange or organized over-the-counter market).

[127] 604 F.2d at 1042. The pledgor in *Lincoln National* borrowed $842,000 from the pledgee-bank to finance a business controlled and to repay an outstanding loan. *Id.* The court concluded that use of the funds for such purposes did not affect the securities markets. *Id. But see* 15 U.S.C. § 78b(3)(a) (one purpose of '34 Act is controlling amount of national credit used in securities markets).

[128] 604 F.2d at 1042. The *Lincoln National* court noted that the Public Utility Holding Company Act of 1935 includes pledges within the definition of sale. 15 U.S.C. § 79b(a)(23) (1976). The court reasoned that the absence of a similar express inclusion in the '33 and '34 Acts indicates that Congress did not intend to regulate pledge transactions. 604 F.2d at 1042. The Seventh Circuit's reasoning is faulty, however, because Congress intended a broad definition of the statutory terms in the securities acts. *See* H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933). Consequently, Congress purposely used language less specific than language found in subsequent securities legislation. *See* 1 Loss, *supra* note 18, at 512 n.163.

[129] 604 F.2d at 1042.

[130] *Id.* at 1042-43.

[131] 439 U.S. 551 (1979).

[132] 421 U.S. 837 (1975).

[133] *See* 439 U.S. at 558;, 421 U.S. at 851-52. *See generally 1978-1979 Developments, supra* note 41, at 847-868.

purposes.[134] Thus, the *Lincoln National* court ruled that the purpose or motive underlying the pledge of securities is the preeminent factor in considering whether a pledge is a sale.[135] In accepting securities as collateral, a pledgee enters into a transaction on the assumption that foreclosure will not occur.[136] While the pledgee takes an investment risk that the security has and will continue to have value, the court concluded that banks accept pledged securities primarily for the purpose of making a commercial loan.[137] The court reasoned that a pledgee's potential ownership of the securities does not change the commercial nature of the transaction.[138] In addition to the legislative history of the '33 and '34 Acts, the *Lincoln National* court based its decision on the availability of state remedies. The court noted that the pledgee-bank could seek relief under the Uniform Commercial Code[139] and in an action for common law fraud.[140] The court interpreted the availability of these remedies as a further indication that Congress did not intend to regulate pledge transactions.[141] The court reasoned that sound judicial policy forbids extension of the federal securities laws to transactions normally regulated by the states.[142]

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[134] In *Daniel,* the Court considered whether a noncontributory compulsory pension plan constituted a security. 439 U.S. at 553. The plaintiff alleged that he invested in the plan by accepting employment and premised his acceptance on the successful management and investment of the pension fund's assets. *Id.* at 561. The Court rejected the plaintiff's assertions, holding that the need for employment rather than desire to invest was the principal reason for participation in the plan. *Id.* at 562. Similarly, in *Forman,* the Court held that the purchase of "shares" in a non-profit housing cooperative was primarily a housing transaction rather than an investment transaction. Although the purchasers might profit from the leasing of commercial space and tax benefits, the Court refused to hold that the shares constituted securities since the tenants bought the shares principally to acquire housing. 421 U.S. at 858.

[135] 604 F.2d at 1043.

[136] *Id.* at 1043; *see* L. JONES, A TREATISE ON THE LAW OF PLEDGES § 554 (1883).

[137] 604 F.2d at 1043.

[138] *Id.* at 1043. The *Lincoln National* court noted that the risk that a pledgor is not the owner of the collateral exists whether or not the collateral involves securities. *Id.*

[139] Under the Uniform Commercial Code, a "purchaser" includes a pledgee. U.C.C. § 1-201(32) & (33). Thus, the pledgee-bank in *Lincoln National* had a remedy under the U.C.C. *See* U.C.C. §§ 8-301, 8-306, 8-316, 8-320. *See generally* Note, *Security Interests in Investment Securities Under Revised Article 8 of the Uniform Commercial Code,* 92 HARV. L. REV. 1013 (1979).

Upon default, a pledgee may foreclose and take legal title to the collateral. A pledgee has the option of selling the pledged securities, U.C.C. § 9-504(1), or retaining possession of the collateral. U.C.C. § 9-505(2). If a secured party chooses to retain the collateral, a pledgor may at his discretion force a sale within 30 days. U.C.C. § 9-505(2). *See generally* Note, *Article 9, Part 5: Rights, Remedies and Liabilities Under Default,* 12 CREIGHTON L. REV. 93 (1978). Although foreclosure is a pledgee's primary means of collecting a debt, the pledgee may ignore the collateral and sue the pledgor directly. U.C.C. § 9-501(1). Direct suit is the only viable option when the collateral involves valueless or counterfeit securities. *See* R. HENSON, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 10-5 (1973).

[140] *See* note 110 *supra.*

[141] 604 F.2d at 1044.

[142] *Id. But see* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478 (1977) (existence of state law remedy not dispositive of whether Congress intended to provide similar federal

The initial consideration in statutory construction is the language of the statute.[143] Since Congress expressly intended broad interpretations of the statutory definitions in the '33 and '34 Acts,[144] a majority of courts have concluded that pledges of securities as collateral fall within the literal definition of a sale.[145] Courts look beyond statutory language, however, when legislative intent suggests a different interpretation.[146] Both the *Mallis* and *Lincoln National* courts ruled that the congressional purpose underlying the securities acts justified a departure from the language defining a sale.[147] Upon concluding that Congress enacted the '33 and '34 Acts solely to protect investors, the courts reasoned that a pledge transaction is a sale only if the pledgee is an investor in the pledged securities.[148]

The conclusion in *Mallis* and *Lincoln National* that Congress only intended to protect investors is untenable, however, when considered in light of *United States v. Naftalin.*[149] In *Naftalin,* the Eighth Circuit had found that the language of section 17(a) of the '33 Act[150] prohibited the defendant's conduct.[151] The court nevertheless vacated the defendant's conviction because the alleged fraud did not affect investors.[152] The Eighth Circuit, like the *Mallis* and *Lincoln National* courts, ruled that under the securities acts Congress intended to protect only investors.[153] On appeal, the Supreme Court rejected the Eighth Circuit's contention that a transaction must have an impact on investors in order to fall within the purview of the '33 Act.[154] The Court examined the legislative history of the '33 Act, including the Senate Report relied upon by the

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remedy); 15 U.S.C. § 78bb (1976) (rights and remedies of federal securities laws supplement all other remedies). *See generally* 5 JACOBS, *supra* note 3, § 11.01.

[143] *See* Touche Ross & Co. v. Redington, 99 S. Ct. 2479, 2489 (1979); International Bhd. of Teamsters v. Daniel, 439 U.S. 551, (1979); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976).

[144] *See* H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).

[145] *See, e.g.,* Lincoln Nat'l Bank v. Herber, 604 F.2d at 1041; National Bank of Commerce v. All American Assurance Corp., 583 F.2d 1295, 1300 (5th Cir. 1978); Mallis v. FDIC, 568 F.2d 824, 829 (2d Cir. 1977).

[146] *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975); Church of the Holy Trinity v. United States, 143 U.S. 457, 459 (1892) (actions may be within letter of statute, but not covered by statute because not within statute's spirit nor within intention of Congress).

[147] *See* 604 F.2d at 1041; 568 F.2d at 829.

[148] *See* text accompanying notes 99-101 & 123-138 *supra.*

[149] 441 U.S. 768 (1979).

[150] *See* note 109 *supra.*

[151] 579 F.2d 444, 447 (8th Cir. 1978). Naftalin, the defendant, engaged in a fraudulent "short selling" scheme by placing orders with several brokerage houses to sell securities which he falsely represented that he owned. *Id.* at 446.

[152] *Id.* at 448. The Eighth Circuit noted that only the defrauded brokers suffered losses as a result of Naftalin's actions. The brokers' purchase of replacement shares shielded the investors who originally bought the fraudulently sold securities from any injury. *Id.* at 447. Consequently the Eighth Circuit reasoned that Naftalin's actions did not have an impact on an investor. *Id.* at 448.

[153] *Id.* at 447-48.

[154] 441 U.S. at 775-76.

Lincoln National court,[155] and concluded that investors are not the exclusive beneficiaries of the securities acts.[156] The Court ruled that Congress also intended to protect ethical businessmen[157] and honest corporate business.[158] According to the Court, Congress passed the '33 and '34 Acts in order to impose a high standard of business ethics on every facet of the securities industry.[159]

Since the scope of the securities acts extends beyond investor protection, the debate among the circuits as to whether the pledge of securities is an investment or commerial transaction is pointless. Courts should adhere to a literal application of the statutory definition of sale because there is no evidence of contrary legislative intent.[160] The preamble[161] to the '34 Act further supports the conclusion that the pledge of securities constitutes a sale under the securities acts. One of Congress' express purposes in enacting the '34 Act was the fair valuation of securities pledged as collateral for bank loans.[162] Thus, the Seventh Circuit's decision in *Lincoln National* not only violates a canon of statutory construction, but also conflicts with express congressional intent underlying the '34 Act.

C. *Constructive Deception Under Rule 10b-5*

Although mere breaches of fiduciary duty are not actionable under the federal securities laws,[163] shareholders may sue derivatively under the an-

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[155] *See* note 123 *supra.*

[156] 441 U.S. at 775.

[157] *Id.* at 776; *see* 77 CONG. REC. 2925 (1933) (remarks of Rep. Kelly; '33 Act intended to protect ethical businessmen); 77 CONG. REC. 2983 (1933) (remarks of Sen. Fletcher; ethical businessmen are beneficiaries of '33 Act).

[158] 441 U.S. at 776; *see* 77 CONG. REC. 2935 (1933) (remarks of Rep. Chapman; '33 Act designed to protect not only investing public but also honest corporate business).

[159] 441 U.S. at 775 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186-87 (1963)).

[160] *See* note 146 *supra.*

[161] When a statute contains unclear and ambiguous terms, courts rely on the preamble to the legislation as an indicator of legislative intent. *See, e.g.,* U.S.D.A. v. Moreno, 413 U.S. 528, 533-34 (1973) (Food Stamp Act of 1964); Lehigh & New Eng. Ry. Co. v. I.C.C., 540 F.2d 71, 79 (3d Cir. 1976), *cert. denied,* 429 U.S. 1061 (1977). *See generally* 2A SANDS, *supra* note 51, § 47.04.

[162] *See* 15 U.S.C. § 78(b)(3)(c) (1976). In considering whether a pledge transaction constitutes a sale, courts have ignored congressional concern for the fair valuation of bank collateral. *But cf.* Franklin Nat. Bank v. Meadows & Co., 318 F. Supp. 1339, 1343 (E.D.N.Y. 1970) (bank granted implied cause of action under § 15 of '34 Act partly because Congress intended '34 Act to ensure fair valuation of securities as collateral). Presumably, the courts considered the legislative history of the '33 and '34 Acts to be a sufficient indication of legislative intent. *But see* 2A SANDS, *supra* note 51, § 48.01, at 182 (extrinsic aids alone are insufficient to determine legislative intent).

[163] *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474 (1977); Superintendent of Ins. v. Banker's Life & Cas. Co., 404 U.S. 6, 12 (1971). *See generally* Note, *Section 10(b): All That is Unfair is Not Fraud,* 19 B.C.L. REV. 939 (1978); Note, *"Fraud" Does Not Encompass Breaches of Fiduciary Duty,* 8 SETON HALL L. REV. 762 (1977).

Prior to the Supreme Court's decision in *Santa Fe,* several circuits had held that fraud

tifraud provisions of the '34 Act when material deceptions[164] or manipulations[165] accompany corporate overreaching.[166] Since the corporation is the real party in interest in a derivative action,[167] the court must initially determine whether the defendant deceived the corporation.[168] If the plaintiff establishes deception, the court must then decide whether the misrepresentation was material.[169]

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under Rule 10b-5 included breaches of fiduciary duty in connection with the purchase or sale of a security. *See, e.g.*, Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); Travis v. Anthes Imperial Ltd., 473 F.2d 515 (8th Cir. 1973); Dasho v. Susquehanna Corp., 461 F.2d 11 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972). *See also* Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir.), *vacated and remanded for consideration of mootness*, 429 U.S. 881 (1976) (breach of fiduciary duty action lies under Rule 10b-5 despite full and fair disclosure). *See generally* Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management*, 59 CORNELL L. REV. 27 (1973).

[164] Deceptive conduct under Rule 10b-5 involves affirmative misrepresentations, omissions, and the concealment of information indicating the misleading nature of a prior statement. *See* SEC v. National Bankers Life Ins. Co., 324 F. Supp. 189, 195 (N.D. Tex.), *aff'd*, 448 F.2d 652 (5th Cir. 1971). A defendant may deceive a plaintiff either by verbal or nonverbal conduct. *See, e.g.*, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 97 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971) (misleading press release); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 675 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (aiding and abetting). *See generally* 5 JACOBS, *supra* note 3, at §§ 60-67; Bromberg, *Disclosure Programs For Publically Held Companies—A Practical Guide*, 1970 DUKE L.J. 1139.

[165] Manipulation, a term of art in securities litigation, describes intentional conduct designed to defraud investors by controlling or artificially affecting the price of a security. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976). *See generally* 5A JACOBS, *supra* note 3, §§ 138-41; Note, *Regulation of Stock Market Manipulation*, 56 YALE L.J. 509 (1947).

[166] *See* 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). *But see* Hundahl v. United Benefit Life Ins. Co., 465 F. Supp. 1349, 1362-63 (N.D. Tex. 1979) (no liability under Rule 10b-5 for breaches of fiduciary duty even if nondisclosure). *See generally* Note, *Suits for Breach of Fiduciary Duty Under Rule 10b-5 After* Santa Fe Industries, Inc. v. Green, 91 HARV. L. REV. 1874 (1978) [hereinafter cited as *Fiduciary Duty Under Rule 10b-5*].

[167] *See* 3B MOORE'S, *supra* note 43, ¶ 23.1.16. A shareholder derivative action permits a stockholder to assert a claim on behalf of the corporation when the corporation has refused to proceed on its own behalf. *See generally* FED. R. CIV. P. 23.1; 3B MOORE'S, *supra* note 43, ¶ 23.1.16, 23.1.21. Since the corporation is the real party in interest in a derivative action, the corporation rather than the plaintiff-shareholder must satisfy the necessary statutory requirements. *See, e.g.*, City Nat'l Bank v. Vanderboom, 422 F.2d 221 (5th Cir. 1970) (corporation, not plaintiff, must be purchaser or seller of securities in § 10(b) derivative action).

Some states statutorially allow "special litigation" committees of disinterested directors to terminate shareholders derivative suits. *See, e.g.*, DEL. CODE ANN. tit. 8 § 141(c) (Cum. Supp. 1978); CAL. CORP. CODE § 311 (West 1978). In Burks v. Lasker, 99 S. Ct. 1831 (1979), the Supreme Court held that federal courts must resolve two questions in deciding whether to ratify derivative suits dismissed by directors pursuant to state statutes. Initially, courts should determine whether the relevant state law allows the board of directors to delegate the power to move for dismissal. Then, courts must consider whether the state law is consistent with the federal policies underlying the plaintiffs' securities claim. *Id.* at 1838.

[168] *See* text accompanying notes 185-211 *infra*.

[169] *See* text accompanying notes 212-266 *infra*.

Courts rely on the concept of constructive deception in assessing whether a defendant deceived a corporation.[170] As legal entities rather than real persons, corporations may only act through their stockholders, officers or directors.[171] State law and the corporation's by-laws and articles of incorporation govern which of these parties may be agents of the corporation for a particular transaction.[172] Since courts presume that principals possess the knowledge of their agents,[173] reliance on a misrepresentation by a corporation's agent establishes corporate deception under Rule 10b-5.[174] Thus, when a securities transaction requires only the approval of the board of directors,[175] a defendant may rebut an allegation of corporate deception by proving that the directors were aware of all pertinent facts surrounding the purchase or sale.[176] However, when a majority of the directors has a conflict of interest[177] in a given matter, courts do not attribute the board's knowledge to the corporation.[178] The knowledge of an agent does not affect the principal if the agent acts for his own benfit and against the principal's interest.[179] In effect, the parties never created an agency.[180] Unlike a normal principal, a corporation may only act through agents.[181] Faced with a conflict of interest, courts identify the majority shareholders with the board of directors.[182] Minority shareholder's become the corporation's decision-making body by default.[183] Under this theory of constructive deception, a self-dealing board of direc-

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[170] *See* Klamberg v. Roth, 473 F. Supp. 544, 550-51 (S.D.N.Y. 1979) (memorandum).

[171] *See* Sherrard, *Federal Judicial and Regulatory Responses to* Santa Fe Industries, Inc. v. Green, 35 WASH. & LEE L. REV. 695, 699 (1978) [hereinafter cited as Sherrard]. *See also* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS §§ 78-80 (1970).

[172] *See* Sherrard, *supra* note 171, at 699.

[173] *See, e.g.*, Dasho v. Susquehanna Corp., 461 F.2d 11, 26 (7th Cir.). *See also* 5A JACOBS, *supra* note 3, § 118.01, at 5-66.

[174] *See* Goldberg v. Meridor, 567 F.2d 209, 217 (2d Cir. 1977); 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 790, at 21-23 (rev. perm. ed. 1975).

[175] *See, e.g.*, DEL. CODE ANN. tit. 8 § 141(a) (1975) (directors responsible for all general business of the corporation); N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1977-78).

[176] *See* Schoenbaum v. Firstbrook, 405 F.2d 215, 220 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969); *Fiduciary Duty Under Rule 10b-5*, *supra* note 166, at 1881.

[177] *See* text accompanying notes 185-211 *infra*.

[178] *See* Wright v. Heizer Corp., 560 F.2d 236, 249 (7th Cir. 1977); Schoenbaum v. Firstbrook, 405 F.2d 215, 220 (2d Cir. 1968).

[179] *See* RESTATEMENT (SECOND) OF AGENCY § 282(1) (1958). A principal, however, may ratify an agent's conflict of interest. *Id.* §§ 236, 376. Once the principal acceeds to an agent's conflict of interest, courts impute the agent's knowledge to the principal. 2 MECHEM ON AGENCY § 1824 [hereinafter cited as MECHEM]. Thus, shareholders may ratify directors' conflicts of interest. *See* Claman v. Robertson, 164 Ohio St. 61, 128 N.E. 429 (1955) (fully informed shareholders can ratify fraudulent acts).

[180] *See* 2 MECHEM, *supra* note 179, § 1824.

[181] *See* Sherrard, *supra* note 171, at 669.

[182] *See* note 183 *infra*.

[183] *See* Dasho v. Susquehanna Corp., 461 F.2d 11, 26 (7th Cir. 1972); Schoenbaum v. Firstbrook, 405 F.2d 215, 220 (2d Cir. 1968). *See generally* Fleisher, *"Federal Corporation Law:" An Assessment*, 78 HARV. L. REV. 1146, 1163 (1965) (discussing decision-making body concept).

tors has a duty of full disclosure to all shareholders under Rule 10b-5.[184]

The determination of whether a conflict of interest exists is the first step in a constructive deception analysis. In *Maldonado v. Flynn,*[185] the Second Circuit recently examined the standards necessary for establishing a director's conflict of interest.[186] The *Maldonado* court, in affirming the district court's dismissal of the action, held that approval of a transaction by a majority of disinterested directors is an absolute defense to a claim of corporate deception.[187] In *Maldonado,* the inside directors of Zapata Corporation were beneficiaries of an employee stock option plan.[188] Immediately prior to Zapata's tender offer for repurchase of its own shares at a premium, the board amended the stock option plan to allow the inside directors and other officers early exercise of their stock options.[189] The corporation also provided these officers and directors with interest free loans to finance the stock purchases and attendant tax liabilities.[190] Plaintiffs filed a shareholder derivative suit under Rule 10b-5, alleging corporate deception as a result of the board's failure to disclose the final amendments to the stock option plan.[191]

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[184] *See* Goldberg v. Meridor, 567 F.2d 209, 217 (2d Cir. 1977). Directors have a duty to disclose only the facts of a particular securities transaction. Rule 10b-5 does not require directors to characterize their dealings in pejorative terms. *Id.* at 218 n.8. *See* Bucher v. Shumway, [Current] FED. SEC. L. REP. (CCH) ¶ 97,142, at 96,300 (S.D.N.Y. 1979) (directors not required to characterize transaction as perpetuation of management's control); Wellman v. Dickinson, 475 F. Supp. 783, 835 (S.D.N.Y. 1979) (no duty to disclose payment of premium for director's shares); Goldbarger v. Baker, 442 F. Supp. 659, 665 (S.D.N.Y. 1977) (no duty to describe transaction as unfair). Additionally, directors have no duty to disclose information to parties who should have been aware of the transaction. *See* Siegal v. Merrick, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,877, at 95,651 (S.D.N.Y. 1979) (director has no duty to disclose personal loans from corporation since information was matter of corporate record).

Courts have further limited the use of constructive deception by strictly construing the "in connection with" requirement of Rule 10b-5. In Ketchum v. Green, 557 F.2d 1022 (3d Cir.), *cert. denied,* 434 U.S. 940 (1977), the Third Circuit held that a causal connection must exist between the alleged deception and the securities transaction. *Id.* at 1029. The *Ketchum* court adopted the stricter causation test specifically in response to *Santa Fe's* concerns about the federalization of state corporate law. *Id.*; *accord,* Halperin v. Edwards & Hanley, 430 F. Supp. 121 (E.D.N.Y. 1977). *But see* Houlihan v. Anderson-Stokes, Inc., 434 F. Supp. 1330, (D.D.C. 1977) (deception need only "touch" purchase or sale of security). *See generally 1977-1978 Developments, supra* note 85, at 816-21; *Pretrial Dismissals, supra* note 86, at 62.

[185] 597 F.2d 789 (2d Cir. 1979).

[186] *See* text accompanying notes 192-198 *infra.*

[187] *Id.* at 793.

[188] *Id.* at 791. The non-qualified option plan provided "key employees" with options to purchase Zapata stock at $12.15 a share. Puchases could only be made in cash and the employees could only exercise the options in five equal installments. Under the plan, the board of directors could amend the plan in any fashion. *Id.*

[189] *Id.* At the time of the tender offer Zapata common stock was selling for approximately $19 per share. Zapata's board authorized the repurchase of shares at $25 per share. *Id.*

[190] *Id.* at 792.

[191] *Id.* The plaintiffs alleged injury to the corporation in the form of lost tax deduc-

The Second Circuit held that the defendants did not deceive the corporation, since a majority of the directors ratifying the stock option plan were disinterested and fully aware of all material facts surrounding the transaction.[192] Thus, the corporation knew that its directors were overreaching and ratified their actions.[193] The court ruled that a director is disinterested if he has no direct pecuniary interest in the contested transaction[194] and if he acts independently. If parties that would benefit from a particular corporate action dominate or control a director, a conflict of interest exists.[195] The court rejected the plaintiff's contention that otherwise disinterested directors acquire a conflict of interest by aiding and abetting[196] a violation of Rule 10b-5.[197] The *Maldonado* court reasoned that this bootstrapping theory would result in an unjustified expansion of Rule 10b-5 into the area of corporate management.[198]

In examining the status of each Zapata director,[199] the court held that partnership in a law firm receiving substantial legal fees from a corporation does not create a conflict of interest in general corporate transactions.[200] While the Second Circuit conceded that his relationship might lead the director to seek favor with corporate officers, the court ruled that a vague possibility of conflict is not sufficient to nullify a director's vote.[201] In order to be an interested party, a director must have voted for

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tions. Since a corporation may deduct the difference between the option price and the market price as compensation to employees, I.R.C. § 162(a)(1), the plaintiffs contended that allowing the defendants to exercise the stock options prior to the rise in market price resulted in lower deductions for Zapata. *Id. See generally* [1980] 2 FED. TAXES ((P-H) ¶ 11,760 (deduction of stock option expenses).

[192] 597 F.2d at 795.

[193] *Id.; see* text accompanying note 167 *supra.*

[194] 597 F.2d at 793; *see* text accompanying notes 199-204 *infra.*

[195] 597 F.2d at 793; *see, e.g.,* Wright v. Heizer Corp., 560 F.2d 236, 249 (7th Cir. 1977).

[196] Aiding and abetting under Rule 10b-5 imputes liability to parties who participated in a fraudulent securities transaction but were not the primary violators of that rule. *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification and Contribution,* 120 U. PA. L. REV. 597, 600 (1972). *See generally 1978-1979 Developments, supra* note 41, at 911-923.

[197] 597 F.2d at 794 n.6.

[198] *Id. See also* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474 (1977) (§ 10(b) does not prohibit non-deceptive corporate mismanagement).

[199] The plaintiffs in *Maldonado* challenged the status of two of the four outside directors. The Second Circuit concluded that the director who also served as outside counsel for Zapata had no conflict of interest. *See* text accompanying notes 186-191 *infra.* The second director, Woolcott, used the inside information of Zapata's stock repurchase plan to indirectly purchase Zapata stock prior to the corporation's tender offer announcement. *Id.* The plaintiffs contended that Woolcott was no longer disinterested after he engaged in conduct similar to that of the defendants. *Id.* The Second Circuit speculated that Woolcott might have approved the option plan amendments in an attempt to enlist management in a cover-up scheme. The court failed to decide whether these circumstances would create a conflict of interest since a majority of disinterested directors existed without him. *Id.* at 795.

[200] 597 F.2d at 794.

[201] *Id.*

a specific proposal in exchange for a direct benefit.[202] Anything less than a *quid pro quo* arrangement, the court concluded, would make a director conflict of interest standard unworkably vague.[203] Finally, the court reasoned that the director's election by the shareholders presumed that the shareholders were willing to trust the director's judgment, despite the director's ties to Zapata.[204] In addition to establishing that the majority of the directors approving the amendments were financially disinterested,[205] the court found that Zapata's officers did not control or dominate the outside directors.[206] At the time of the transaction, the officers were not controlling shareholders and did not dominate the outside directors.[207] Thus, the court presumed that the directors had acted independently.[208]

The *Maldonado* decision comports with the standards for director conflict of interest established by other courts.[209] The desire to retain personal control of a corporation, however, can potentially influence director conduct more than specific financial enrichment.[210] Consequently, the Second Circuit's pecuniary interest standard will effectively prevent many otherwise meritorious shareholder derivative suits.[211] Despite this result, the proof problems inherent in vague conflict of interest standards undermine the workability of such standards and could increase the amount of vexatious litigation.

A judicial finding that the board of directors deceived the corporation will cause the court to examine the materiality of the deception.[212] A misrepresentation or manipulative device is material if disclosure would have significantly altered the total mix of information available to a resonable investor.[213] Implicit in this definition of materiality is the investor's ability, given knowledge of the withheld information, to have chosen an alter-

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[202] *Id.*

[203] *Id.; accord,* Tyco Labs., Inc. v. Kimball, 444 F. Supp. 292, 297 (E.D. Pa. 1977).

[204] 597 F.2d at 794.

[205] The board meeting during which the Zapata directors approved the amendments to the stock option plan involved only the four outside directors and the president of the corporation. *Id.* at 792. Although the president's presence was necessary for a quorum, he abstained from voting. Thus, the "disinterested" directors were the only parties voting on the proposed amendments. *Id.* Under Delaware corporate law, a majority of those voting at a board meeting can approve a transaction for the corporation. *See* DEL. CODE ANN. tit. 8 § 144 (1975).

[206] 597 F.2d at 795.

[207] *Id.; cf.* Goldberg v. Meridor, 567 F.2d 209, 217 (2d Cir. 1977) (all directors controlled by parent corporation).

[208] 597 F.2d at 795.

[209] *See, e.g.,* Tyco Labs., Inc. v. Kimball, 444 F. Supp. 292, 297 (E.D. Pa. 1977); Cheff v. Mathes, 41 Del. Ch. 494, 508, 199 A.2d 548, 554-55 (1968).

[210] *See* Sherrard, *supra* note 159, at 710.

[211] *Id.*

[212] *See* Goldberg v. Meridor, 567 F.2d 209, 218 (2d Cir. 1977); Wright v. Heizer Corp., 560 F.2d 236, 249 (7th Cir. 1977).

[213] *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). A fact is material if a substantial likelihood exists that a reasonable shareholder would consider the fact important in deciding how to vote. *Id.; see* note 53 *supra.*

native course of action.[214] Thus, in *Santa Fe Industries, Inc. v. Green,*[215] the Supreme Court held that shareholders alleging deception as a breach of fiduciary duty must demonstrate the availability of a state remedy enjoining the corporate overreaching.[216] The Court left unresolved, however, the standard a shareholder must satisfy to establish the utility of the withheld information in obtaining injunctive relief in state court.[217] During the past year the Third, Fifth and Ninth Circuits addressed this issue and adopted differing standards of proof.

In *Kidwell ex rel. Penfold v. Meikle,*[218] the Ninth Circuit held that plaintiffs in Rule 10b-5 derivative suits must prove that they would have prevailed on the merits in a state injunctive action.[219] The *Kidwell* court concluded that the mere availability of a state remedy establishes the materiality of the deception.[220] Although a finding of materiality creates the presumption that the shareholder actually would have attempted to block the contested transaction,[221] the court ruled that the shareholder must additionally demonstrate that the state suit would have succeeded in order to satisfy the loss causation requirement of Rule 10b-5.[222] Thus, in the Ninth Circuit, the parties in a constructive deception suit must fully

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[214] *See* Freshtman v. Schechtman, 450 F.2d 1357 (2d Cir. 1971), *cert. denied,* 405 U.S. 1066 (1972); Sherrard, *supra* note 160, at 712.

[215] 430 U.S. 462 (1977); *see* note 153 *supra.*

[216] 430 U.S. at 474-75 nn.14 & 15; *see* SEC v. Parklane Hosiery Co., 558 F.2d 1083, 1088-89 (2d Cir. 1977), *aff'd,* 439 U.S. 322 (1979). *See generally* Note, *Rule 10b-5: Deception and Materiality Requirements in Corporate Mismanagement Cases,* 66 GEO. L.J. 1593 (1978).

In establishing materiality in constructive deception suits, courts examine state remedies in existence at the time the plaintiff filed his suit. *See* Goldberg v. Meridor, 567 F.2d 209, 219 (2d Cir. 1977). Plaintiffs may not rely on an assertion that a state court would have used the case to create new remedies for breaches of fiduciary duty. *See* Kerrigan v. Merrill Lynch, Pierce, Fenner & Smith, 450 F. Supp. 639, 646 (S.D.N.Y. 1978).

[217] *See Fiduciary Duty Under Rule 10b-5, supra* note 166, at 1893.

[218] 597 F.2d 1273 (9th Cir. 1979).

[219] *Id.* at 1294. The *Kidwell* case arose out of the sale of the assets of a non-profit corporation. *Id.* at 1280. Although the directors of the corporation concluded that the proposed sale did not require shareholder approval, the board solicited shareholder opinion in a non-binding advisory vote. The shareholders rejected the terms of the deal, but the board decided by a close vote to proceed with the sale. *Id.* at 1282. The plaintiff brought a derivative suit under Rule 10b-5 against several directors, alleging that directors' conflicts of interest created a duty of full disclosure to shareholders. *Id.* at 1285.

[220] *Id.* at 1293. The *Kidwell* court concluded that the plaintiff's could have attempted to block the sale of the corporation's assets on the statutory and common law grounds of conflict of interest and unfairness. *Id.; see* IDAHO CODE § 30-142 (1977). Additionally, the plaintiffs could have sought relief on the ground that the corporation's board did not have the requisite number of representatives from the surrounding area. *Id.* Finally, the plaintiffs might have sought to block the sale on the basis of the de facto merger doctrine. *Id. See* Farris v. Glen Alden Corp., 393 Pa. 427, 143 A.2d 25 (1958).

[221] *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151-54 (1972) (finding of materiality implies reliance). *See generally* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5,* 88 HARV. L. REV. 584 (1975).

[222] 597 F.2d at 1294. *But see* text accompanying notes 247-256 *infra.*

litigate the forum state's requirements for a grant of permanent injunctive relief.[223] The court reasoned that *Santa Fe's* emphasis on the primacy of state law in remedying breaches of fiduciary duty requires federal courts to adhere strictly to state standards in constructive deception suits.[224] Recognizing that courts do not grant permanent injunctive relief in every case, the *Kidwell* court apparently concluded that adopting a standard less stringent than actual success would not accurately reflect the shareholder's potential for relief under state law.[225]

In contrast to *Kidwell,* the Third Circuit in *Healy v. Catalyst Recovery Systems, Inc.*[226] held that plaintiffs in constructive deception suits do not need to make a special showing of success in a state injunctive action in order to establish loss causation.[227] The *Healy* court instead presumed that the defendant's conduct caused the plaintiff's injury.[228] The court characterized the proof of success issue as an aspect of materiality.[229] Noting that the theory of constructive deception assumes that the plaintiff wanted the withheld information to decide whether to seek injunctive relief,[230] the Third Circuit ruled that courts should gear the appropriate standard to an assessment of what information a reasonable shareholder would consider significant in deciding whether to institute a state action.[231] Since the test for materiality has a decision making orientation,[232]

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[223] 597 F.2d at 1294. In addition to permanent injunctive relief, the *Kidwell* court held that a grant of damages in excess of an appraisal remedy would satisfy the causation element of Rule 10b-5. *Id.*

[224] *Id. See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477-80 (1977).

[225] 597 F.2d at 1294. The *Kidwell* court stated that the question of whether a plaintiff would have prevailed in a state action is essentially a question of fact. *Id.* The Ninth Circuit ruled, however, that district courts should decide as a matter of law any state legal issues that would have arisen in the hypothetical suit. *Id.; cf.* Bernhardt v. Polygraphic Co. of Amer., 350 U.S. 198, 205 (1956) (federal courts in Erie Doctrine cases should rely on trend of state decisions in adopting new law for the state).

[226] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,268, at 96,890 (3d Cir. 1980).

[227] *Id.* at 96,890. In *Healey,* the defendant corporation merged with a subsidiary. The plaintiff, a minority stockholder of the subsidiary, alleged that the parent company breached its duty of disclosure by refusing to reveal information concerning the valuation of the subsidiary's shares. *Id.*

[228] *Id.* at 96,891; *see* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384-85 (1970); text accompanying notes 247-256 *infra.*

[229] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,268, at 96,890.

[230] *See* text accompanying notes 177-184 *supra.*

[231] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,268, at 96,890; text accompanying notes 262-265 *infra.*

[232] *See* TSC Indus., Inc. v. Northway, 426 U.S. 438, 449 (1976) (fact which would have assumed actual significance in deliberations of reasonable shareholder is material). Although *Northway* concerned an alleged violation of Rule 14a-9, courts apply *Northway's* materiality standard in Rule 10b-5 cases. *See, 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 Chem. Corp., 553 F.2d 1033, 1040 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977). *See generally* Note, *Materiality under the Anti-Fraud Provisions of the Federal Securities Acts: How Much Disclosure?,* 37 LA. L. REV. 1232 (1977).

the *Healy* court reasoned that the appropriate standard issue must be part of a court's materiality inquiry.[233]

In assessing whether withheld information is material in a constructive deception context, the *Healy* court framed the question in terms of what information would be important to a reasonable investor contemplating a state suit for injunctive relief.[234] The court concluded that a reasonable shareholder would not consider information material unless a reasonable probability existed that the shareholder could have used the information to obtain an injunction.[235] The Third Circuit refused to adopt *Kidwell's* actual success standard as an indicator of materiality. The court contested *Kidwell's* conclusion that a standard less stringent than actual success would violate *Santa Fe's* prohibition against federal intrusion into state corporate law.[236] The *Healy* court ruled that *Santa Fe's* mandate applies the extension of the federal securities laws only to conduct not covered by express statutory language.[237] Once the plaintiff alleges a misrepresentation or omission, however, the court reasoned that *Santa Fe's* holding is inapplicable.[238] In addition, the Third Circuit concluded that absolute certainty of success in a state action is both an impossible goal and impracticable standard for a jury to implement.[239] The court reasoned that the reasonable probability of success standard is a more workable standard for courts to apply since it is analogous to the reasonable likelihood of ultimate success standard used in preliminary injunction decisions.[240]

The Fifth Circuit, in *Alabama Farm Bureau Mutual Casualty Co. v. American Fidelity Life Insurance Co.*,[241] also treated the appropriate standard issue as an aspect of materiality rather than causation.[242] The

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[233] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,268, at 96,890.

[234] *Id.*; *see* note 232 *supra*.

[235] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,268, at 96,890. *But see* text accompanying notes 262-265 *infra*.

[236] *See* text accompanying note 224 *supra*

[237] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,268, at 96,890.

[238] *Id.; accord,* Goldberg v. Meridor, 567 F.2d 209, 218 (2d Cir. 1977); *Fiduciary Duty Under Rule 10b-5, supra* note 166, at 1884.

[239] [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,268, at 96,890.

[240] *Id.* Courts grant preliminary injunctive relief upon a showing of irreparable injury or reasonable probability of ultimate success. *See* Sandler v. Schenley Indus., Inc., 32 Del. Ch. 46, _, 79 A.2d 606, 610 (1951). *See generally* Laycock, *Injunctions and the Irreparable Injury Rule,* 57 TEX. L. REV. 1065 (1970); Weinreich, *Availability of Preliminary Injunctive Relief,* 45 BROOKLYN L. REV. 263 (1979).

[241] 606 F.2d 602 (5th Cir. 1979).

[242] *Id.* at 614. In *Alabama Farm,* the directors of American Fidelity Life Ins. Co. (AMFI) authorized a major repurchase of the corporation's shares. At the same time, the Alabama Farm Bureau Mutual Cas. Co. (Alabama Farm) began buying a substantial amount of AMFI's stock. *Id.* at 607. After AMFI's directors authorized another major repurchase of the corporation's stock prior to fulfilling the first repurchase plan, Alabama Farm filed a shareholder derivative suit. The suit alleged that the repurchase plans were manipulate devices designed to inflate the market price of AMFI's stock and discourage takeover attempts. *Id.*

Fifth Circuit concluded that predicating relief on proof of success in a state action would in effect force a federal district court to conduct a full trial of the state claim.[243] The *Alabama Farm* majority further reasoned that the mere establishment of a theoretical state claim is too speculative a basis upon which to grant relief under the federal securities laws.[244] The court chose a middle ground and held that shareholder-plaintiffs in constructive deception suits must establish a prima facie case for state relief.[245] The court characterized this standard as a practical alternative to the pitfalls inherent in the other courses of action.[246]

Kidwell's requirement that plaintiffs prove actual success in a hypothetical state injunctive action in order to establish loss causation is inconsistent with the presumption of causation applicable in Rule 10b-5 actions.[247] In *Mills v. Electric Auto-Lite Co.*,[248] the Supreme Court held that courts should presume loss causation when a plausible causal nexus exists between the defendant's conduct and the plaintiff's injury.[249] Although *Mills* involved an alleged[250] violation of section 14(a) of the '34 Act, lower courts have consistently applied its holding in Rule 10b-5 actions.[251] Since the *Mills* court presumed that the defendant's misleading proxy solicitations caused the plaintiff's loss,[252] the plaintiff did not have to prove that the shareholders of the defendant corporation would have actually defeated the proposed merger if management had fully disclosed all material information surrounding the transaction.[253] The fact that the shareholders could have voted differently was sufficient to establish loss causation.[254] Similarly, the possibility that a plaintiff could have at-

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[243] *Id.* at 614.

[244] *Id.*

[245] *Id.*

[246] *Id.*

[247] *See* text accompanying notes 249-257 *infra.*

[248] 396 U.S. 375 (1970).

[249] *Id.* at 385. The *Mills* plaintiffs sought to set aside a merger between Electric Auto-Lite Co. and Mergenthaler Linotype Co. on the grounds that Auto-Lite's proxy statement was materially misleading. Auto-Lite contended that the allegedly misleading proxy statement could not give rise to liability under the federal securities laws because the plaintiffs could not establish that enough shareholders would have voted differently to defeat the merger. *Id.* at 379.

[250] The defendant in *Mills* appealed from an order denying a motion for summary judgment. *Id.* at 379.

[251] *See, e.g.*, Swanson v. American Consumer Indus., Ind., 475 F.2d 516, 520-21 (7th Cir. 1973); Valente v. Pepsico, Inc., 454 F. Supp. 1228, 1247 (D. Del. 1978).

[252] 396 U.S. at 385.

[253] *Id.*

[254] *Id.* The minority shareholder's votes in *Mills* were necessary to approve the proposed merger. *Id.* at 379. The *Mills* Court expressly refrained from deciding whether a plaintiff could establish causation when management controls a sufficient number of shares to approve the transaction without any votes from the minority. *Id.* at 385 n.7. A majority of lower courts have held that the absence of voting power does not preclude a plausible causal nexus. The courts reason that full disclosure might have prompted injunctive actions and more widespread exercise of appraisal rights. *See, e.g.*, Cole v. Scheneley Indus., Inc., 563

tempted to enjoin a proposed transaction provides the causal nexus necessary for the presumption of loss causation.[255] By requiring plaintiffs to prove loss causation through a demonstration of actual success in a hypothetical injunctive action,[256] the *Kidwell* court ignored the holding of *Mills* and unjustifiably burdened plaintiffs in constructive deception suits.

In determining whether the misrepresentation in a constructive deception suit is material, courts apply the materiality test enunciated by the Supreme Court in *TSC Industries, Inc. v. Northway.*[257] Information is material, the Court held, if there is a substantial likelihood that the information would have assumed actual significance in a reasonable shareholder's deliberations regarding the appropriate course of action.[258] The Court stated that the materiality test does not require that plaintiffs show a substantial likelihood that the information would have caused the reasonable investor to change his course of action.[259] Thus, in constructive deception suits, the proper test of materiality is whether the withheld information would have assumed actual significance in a reasonable shareholder's deliberations about whether to initiate a state injunctive action.[260]

The Third Circuit's reasonable probability of success standard is a more stringent materiality test than *Northway* mandates. The *Healy* court based the reasonable probability of success standard on the premise that a reasonable shareholder would consider insignificant any information which did not at least indicate a reasonable probability of obtaining injunctive relief.[261] Under this standard, the fact that the shareholder could establish a prima facie case for relief would be insignificant in that shareholder's deliberations. *Healy's* premise, however, is flawed. Shareholders often initiate injunctive actions without knowledge of all the facts surrounding the alleged overreaching.[262] These plaintiff-shareholders rely on discovery to fully develop their claim if the action survives the defendant's motion to dismiss.[263] Additionally, once an action proceeds beyond the dismissal stage, the chances of a favorable out-of-court settlement improve greatly.[264] Finally, although a shareholder may not ultimately per-

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F.2d 35, 40 (2d Cir. 1977); Valente v. Pepsico, Inc., 454 F. Supp. 1228, 1248 (D. Del. 1978). *See generally* Note, *Loss and Transaction Causation: The Second Circuit Resolves The Causation Controversy in Majority Control Situations,* 32 WASH. & LEE L. REV. 683 (1975).

[255] *See generally Fiduciary Duty Under Rule 10b-5, supra* note 166, at 1893-98.

[256] *See* text accompanying notes 219-226 *supra.*

[257] 426 U.S. 438, 449 (1976).

[258] *Id.*

[259] *Id.*

[260] *See* text accompanying notes 233 & 234 *supra.*

[261] *See* text accompanying note 235 *supra.*

[262] *See* 13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 6021 (1970).

[263] *Id.*

[264] *See* Note, *Rule 23.1—The Need For Findings of Fact and Conclusions of Law in Approval of Proposed Settlements of Shareholder Derivative Actions,* 36 OHIO ST. L.J. 163,

suade the court to enjoin a contested transaction, the unfavorable publicity ensuing from revelations in discovery or trial often deters management from consumating a transaction for fear of damage to the corporation's reputation, credit standing, or business image.[265] As these examples indicate, shareholders file suit more on the theory that the action will survive a motion to dismiss than on a reasonable certainty of ultimate success. The Fifth Circuit's prima facie case standard best reflects what a reasonable shareholder would consider significant in deliberating whether to seek injunctive relief. Consequently, the prima facie case standard is the best indicator of materiality in a constructive deception action.

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164 (1974).

[265] *See* Note, *Causation and Liability in Private Actions For Proxy Violations*, 80 YALE L.J. 107, 117 (1970).