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SEC RULE 10b-5 A RECENT PROFILE

In the years since a private right of action was first implied under SEC Rule 10b-5, the statutory framework of securities regulation has undergone a steady metamorphosis. Today section 10(b) and Rule 10b-5 are the most dynamic of federal securities regulations. In fact, section 10(b), by way of Rule 10b-5, has usurped the function of virtually every provision of both the 1933 and 1934 Acts which specifically provide for private rights of action. This usurpation has been facilitated by the absence of statutory restrictions on the use of section 10.

Due to the unforeseen expansion of Rule 10b-5, the securities industry has been rocked by significant extensions in the area of proscribed conduct. As a result, some securities experts and corporate issuers view the advent of 10b-5 with alarm. They regard the maturation of the Rule as a cancer in the securities laws. However, other experts welcome the new remedy as a panacea for an ailing and ill-drawn statute.

The status of the elements of Rule 10b-5 is changing every day. This note, which will document the current condition of the Rule, should be helpful to the practitioner for this reason alone. However, it will go further and will examine the probable course of recent trends and where appropriate, will flag those areas most deserving of reform.

The first problem facing the practitioner when he attempts to utilize Rule 10b-5 is the determination of the elements which he must prove at trial. These include, in one form or another, scienter, materiality, reliance, causation, jurisdictional means, privity, defendant's status as a purchaser or seller, and plaintiff's status as a purchaser or seller. The scienter requirement and the purchaser-seller rules seem to be in the greatest state of flux and will be extensively treated. In addition, some familiarity with the statutory history of section 10(b) and the SEC hearings in respect to Rule 10b-5 will be helpful to the practitioner in recognizing judicial bootstrapping in the use of nebulous "policy" pronouncements contained therein in order to justify a particular case result which the judiciary feels to be equitable. Finally, the emerging area of "tippee" liability will be analyzed so as to present the reader with a practical example of the flexibility of Rule 10b-5 in a microcosm.

LEGISLATIVE HISTORY

A cursory reading of section 10(b)¹ discloses two significant charac-

1. Section 10 of the Securities and Exchange Act of 1934 provides:

teristics. First, in that it depends upon the issuance of rules and regulations by the Commission, the subsection is not self-operative. By its terms, section 10(b) refrains from prohibiting any specific conduct or activity. It confers upon the SEC a broad rulemaking power to proscribe the use of devices or contrivances, which the Commission determines to be contrary to either the public interest or the well being of investors, in connection with the purchase or sale of any security.² The second feature is the uncertainty of 10(b)'s operation, given the pervasive use of broad language in the delegation of this executing power to the Commission.

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

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

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

15 U.S.C. § 78j (1970).

2. The need for flexible delegation of rulemaking power is pointed out in the following excerpt from one of the House Reports:

The original bill submitted to the committee dealt very specifically and definitely with a number of admitted abuses. In many cases, however, the argument was made that while the solutions offered might be correct, their effects were so far-reaching as to make it inadvisable to put these solutions in the form of statutory enactments that could not be changed in case of need without Congressional action. Representatives of the stock exchanges constantly urged a greater degree of flexibility in the statute and insisted that the complicated nature of the problems justified leaving much greater latitude of discretion with the administrative agencies than would otherwise be the case. It is for that reason that the bill in dealing with a number of difficult problems singles out these problems as matters appropriate to be subject to restrictive rules and regulations, but leaves to the administrative agencies the determination of the most appropriate form of rule or regulation to be enforced. In a field where practices constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers in the administrative agency have been found practically essential, despite the desire of the Committee to limit the discretion of the administrative agencies so far as compatible with workable legislation.

H.R. REP. NO. 1383, 73d Cong., 2d Sess., 6-7 (1934).

In an attempt to isolate the meaning of this section,³ as well as Rule 10b-5 promulgated thereunder, both the intent of Congress in 1934, and in the intent of the Securities and Exchange Commission in 1942, have been extensively reviewed.⁴ Unfortunately, but understandably,⁵ these attempts at elucidation have been generally unsuccessful in formulating any commonly accepted interpretations of the section.⁶

Congressional Intent 1934

With respect to the particular Congressional purpose of 10(b) within the framework of federal securities regulation, there is a dearth of explanatory legislative material.⁷ Aside from those parts of the Congressional reports which enumerate and clarify the various sections of the Act,⁸ section 10 is specifically mentioned only once,⁹ in a rather ambiguous reference which was probably directed to present section 10(a), rather than 10(b)¹⁰

3. See generally 3 L. LOSS, *SECURITIES REGULATION* 1421-30 (2d ed. 1961) [hereinafter cited as L. LOSS]; 6 L. LOSS, 3526-28 (1969 Supp.); A. BROMBERG, *SECURITIES LAW; FRAUD—SEC RULE 10b-5* § 2.2 (1967) [hereinafter cited as A. BROMBERG].

4. See, e.g., Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C. L. REV. 482, 496-503 (1970); Joseph, *Civil Liability Under Rule 10b-5—A Reply*, 58 Nw. U.L. REV. 171 (1964); Lowenfels, *Codification and Rule 10b-5*, 23 VAND. L. REV. 590 (1970); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?* 57 Nw. U.L. REV. 627 (1963).

5. Recently a rather experienced researcher has confessed to the Supreme Court that he was unable to locate any "specific legislative history concerning the 'in connection with' phrase" of section 10(b). Brief for SEC as amicus curiae at 14, *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 92 S. Ct. 165 (1971).

6. Though there is a wealth of printed material dealing with section 10(b) and Rule 10b-5, no author has been acclaimed as having found the precise set of facts or field of liability intended by Congress when it wrote 10(b). Compare Ruder, *supra* note 4 with Joseph, *supra* note 4.

7. An outline of the legislative history of the Securities Exchange Act of 1934 and of the other Securities Acts is presented in Duncan, *Selected Bibliography Including Legislative History of the Securities and Exchange Commission and the Statutes It Administers*, 28 GEO. WASH. L. REV. 938 *et seq.* (1959).

8. S. REP. NO. 792, 73d Cong., 2d Sess. 18 (1934); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 21 (1934); H.R. REP. NO. 1838, 73d Cong., 2d Sess. 32-33 (1934). See also the remarks of Senator Fletcher for an explanation of S.2693 which was the original bill introduced in the Senate. 78 CONG. REC. 2271 (1934).

9. S. REP. NO. 792, 73d Cong., 2d Sess. 6 (1934) states:

In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function. These sanctions are found in sections 9, 10, and 16.

10. Since the quoted section of the report is prefaced "[I]n addition to the discretion-

The general remedial purpose of the 1933 and 1934 Acts is well documented,¹¹ but 10(b)'s role was never really clarified by Congress. It still remains vague at best, at least if one is searching for a direct expression of Congressional intent.¹² Nor does an examination of the sectional explanations contribute to the clarification, since none of them provide any significant insight into the purpose of 10(b), they are in actuality no more than a paraphrase of that section of the Act.¹³

The most frequently cited indicator of legislative purpose in regard to section 10(b) is the testimony of an administrative spokesman who participated in the drafting of the bill. In referring to this testimony, Professor Loss remarks:

When the Administration's spokesman, Mr. Corcoran was describing the bill in the legislative hearings, he devoted a single sentence to what is now § 10(b). "Subsection [(b)] says, 'Thou shalt not devise any other cunning devices.'"¹⁴

From this, 10(b) has been labelled an "acknowledged catchall."¹⁵ As such, the section has been the subject of much criticism by the securities

ary and elastic powers conferred on the administrative authority," it would appear that section 10(b) was not being commented upon since its terms clearly delegate such a flexible power to the Commission.

11. See, e.g., *Presidential Message*, S. REP. NO. 792, 73d Cong., 2d Sess. 1-2 (1934); 78 CONG. REC. 7861 (1934) (remarks of Congressman Lea, one of the floor leaders of the bill in the House); 78 CONG. REC. 2270 (1934) (remarks of Senator Fletcher on S. 2693).

12. In discussing implied civil liability under Rule 10b-5, one author takes the position that under the tort theory of liability, legislative intent is not relevant. Joseph, *supra* note 4, at 174.

13. Section 10(b), in substantially the same form as it exists today was originally section 9(c) of Senate bill S.2693. The Senate's sectional discussion of the bill substituted for S.2693 adds nothing to the words of the statute. S. REP. NO. 792, 73d Cong., 2d Sess. 18 (1934).

Even when the House completed work on their version of the bill prior to its submission to a Conference Committee, their report treated the section only to the extent that it related to short sales and stop loss orders. Regulation of these devices was within the ambit of section 9(b) [now section 10(a)] of the Senate bill. No mention was made of what is presently section 10(b). H.R. REP. NO. 1383, 73d Cong., 2d Sess. 21 (1934). The Conference Reports are equally lacking in helpful discussion. S. Doc. 185, 73d Cong., 2d Sess. (1934); H.R. REP. NO. 1838, 73d Cong., 2d Sess. (1934).

14. 6 L. LOSS, *supra* note 3, at 3528.

15. A. BROMBERG, *supra* note 3, § 2.2.

industry,¹⁶ as delegating to the Commission broad power to prohibit virtually anything.¹⁷

SEC Intent 1942

One commentator relates that in 1941 the Securities and Exchange Commission and representatives of the securities industry jointly proposed to Congress that a loophole in the scheme of federal securities regulation be closed.¹⁸ At that date the Securities Act contained a federal anti-fraud arsenal, as a supplement to state remedies, consisting of:

- (1) Section 17 of the 1933 Act,¹⁹ proscribing fraud in the sale of securities, and of general application to actions against fraudulent *sellers*, and
- (2) Section 15(c) [presently section 15(c)(1)] of the 1934 Act,²⁰ covering fraud in the *purchase* or *sale* of securities, which was applicable only to fraud perpetrated by brokers or dealers in securities.

At that time, section 10(b) was dormant, and there was nothing in either Act which provided a federal remedy, injunctive or otherwise, for fraud, in connection with the *purchase* of a security, and perpetrated by a person *other than* a broker or dealer.²¹ Congress has never taken action to remedy this oversight.

Given the failure to secure prior Congressional assistance, the Commission issued the Rule,²² apparently as part of an effort to close the

16. In Epstein, *supra* note 4, at 496, the author remarks that section 10(b) was generally regarded as of little significance when it was enacted. Professor Loss agrees. 6 L. Loss, *supra* note 3, at 3528.

17. See generally, *Hearings on H.R. 7852 and H.R. 8720 on Stock Exchange Regulation Before the House Comm. on Int. and For. Commerce*, 73d Cong., 2d Sess., at 115 (1934).

18. Loss, *The Fiduciary Concept As Applied To Trading By Corporate "Insiders" In The United States*, 33 Mod. L. Rev. 34, 41 (1970).

19. 15 U.S.C. § 77q (1970).

20. 15 U.S.C. § 78o (1970).

21. Loss, *supra* note 18.

22. The full text of Securities Exchange Act Release No. 3230 issued May 21, 1942, provides:

The Securities Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in

existing hiatus in the federal legislation.²³ However, Mr. Milton Freeman, who is sometimes accredited with the issuance of Rule 10b-5, suggests that it was adopted in a somewhat more casual fashion, as a result of a certain instance of fraudulent activity disclosed to the Commission, involving fraudulent misrepresentations of a purchaser in connection with his purchases of stock.²⁴ The prefatory comments of the Commission in issuing 10b-5 clearly indicate an intent to conclude fraud in the purchase of securities, and to that extent lend support to Mr. Freeman's remarks.²⁵ However, as a result of the general, nonspecific language of the Rule itself, its scope is as yet undetermined. If the Rule is directed solely at fraudulent purchasers, why does it also refer to sales?²⁶

This uncertainty was evident not only in regard to the transactions to be covered, it also left unanswered the question of the existence of a private remedy under 10b-5.²⁷ In the opinion of Mr. Freeman, no private

fraud in their purchase. The text of the Commission's action follows:

The Securities and Exchange Commission, deeming it necessary for the exercise of the functions vested in it and necessary and appropriate in the public interest and for the protection of investors so to do, pursuant to authority conferred upon it by the Securities Exchange Act of 1934, particularly Section 10 (b) and 23 (a) thereof, hereby adopts the following Rule X-10B-5:

Rule X-10B-5. Employment of Manipulative and Deceptive Devices.

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,

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) 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

23. See A. BROMBERG, *supra* note 3, § 2.2; Note, *SEC Action Against Fraudulent Purchasers of Securities*, 59 HARV. L. REV. 769 (1946). The first administrative investigatory action taken under Rule 10b-5 was settled by agreement with the parties against whom the SEC was proceeding. As a consequence no legal action was initiated. *Matter of Purchase and Retirement of Ward La France Truck Corporation Class "A" and Class "B" Stocks*, SEC Securities Exchange Act Release No. 3445 (June 11, 1943).

24. Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967).

25. *Id.*

26. See generally *Ellis v. Carter*, 291 F.2d 270, 273 (9th Cir. 1961) (the court proposes four alternative constructions for section 10(b) and Rule 10b-5); 115 U. PA. L. REV. 618, 622 (1967).

27. Neither section 10(b) or Rule 10b-5 explicitly provide a private civil remedy for

remedy was intended by the Commission, and he attributes the development of private liability under 10b-5 solely to the "ingenuity of the members of the private Bar, starting with the *Kardon* case."²⁸ The repercussions of *J.I. Case v. Borak*,²⁹ now reinforced by mere footnote mention in *Superintendent of Insurance v. Bankers Life and Casualty Company*,³⁰ have settled the question in favor of private civil liability. But neither Court actually found, or thought it necessary to find, a clear intent that Congress or the SEC originally intended private liability to accrue under section 10(b) or under Rule 10b-5.

It is obvious upon analysis that the "Classic 10b-5" is a protean creature, a product of disjointed Congressional and administrative intent.³¹ Given the lack of significant express reference to section 10(b) (or any of its progenitors) in the Congressional materials, courts and writers have often taken license to seize upon the more general sections of the reports,³² the preamble sections of the Act,³³ and the wealth of general

conduct which is in violation of their terms. Nonetheless, *Kardon v. National Gypsum*, 69 F. Supp. 512 (E.D. Pa. 1946), held that such a remedy could be implied. In *J.I. Case v. Borak* 377 U.S. 426 (1964), the securities world was again given confirmation, at least by implication, that 10b-5 was a vehicle that private parties could utilize for civil redress of their grievances. The question has recently been treated specifically in regard to 10(b) and 10b-5 by the Supreme Court decision in *Bankers Life*. Justice Douglas, delivering the opinion of the Court, saw fit to give only footnote mention to the fact that "[i]t is now well established that a private right of action is implied under § 10(b)." *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 92 S. Ct. 165 n.9 (1971). In light of this development, even though authors have vigorously argued against such a conclusion, it must now be taken as a settled matter that 10b-5 will yield damages in a federal forum. See generally North, *Implied Liability Cases Under The Federal Securities Laws*, 4 CORP. PRACT. COMM. 1 (1962).

28. Freeman, *supra* note 24.

29. 377 U.S. 426 (1964).

30. 92 S. Ct. 165, 169 n.9.

31. A comment from a recent article relating the almost boundless expansion of Rule 10b-5 states the following experience of the author:

Several weeks ago I told one of the ablest and most experienced corporate counsel in California that my assigned topic was "What lies ahead under Rule 10b-5?" He advised me to stand up and say "Chaos!", and then sit down. Another friend of mine who is a corporate lawyer said: "Really, it seems to me that it is quite simple. Under Rule 10b-5 whenever stock is sold, if the price goes up—the seller can sue the buyer; if the price goes down—the buyer can sue the seller; if the price remains absolutely the same, each one can sue the other for interest!"

Marsh, *What Lies Ahead Under Rule 10b-5?*, 24 BUS. LAW 69 (1968).

32. See, e.g., *Superintendent of Insurance v. Bankers Life and Casualty Company*, 92 S. Ct. 165 (1971); *Drachman v. Harvey*, 1972 CCH FED. SEC. L. REP. ¶ 93,345 at 91865, n.3

legislative comment in the Congressional Record,³⁴ to support the positions which they seek to advance. This factor alone significantly contributes to generating the conflicting views among the circuits as to the proper theory of 10(b), as well as the parties entitled to relief in federal courts under the terms of its provisions. Thus, future interpretations of 10b-5 will be dictated not by reference to incisive Congressional comments—rather they will rest upon judicial decisions grappling with an amorphous conception.

SCIENTER

Although section 10(b) and Rule 10b-5 have evolved as anti-fraud provisions³⁵ within the framework of the 1934 Exchange Act, courts are widely divided on the question of whether or not to include the common law fraud requirement of scienter in their judicially implied civil remedy under the section and rule.³⁶ Courts have been forced to examine common law concepts of fraud in order to determine the requisite elements of a 10b-5 cause of action.³⁷ In this examination, the courts have discovered and adopted a plethora of phrases purporting to define scienter.

Scienter originally meant a specific intent to defraud a particular plaintiff.³⁸ Specific intent has now been discarded³⁹ in favor of defining

(2d Cir. 1972); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 858 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

33. See, e.g., *Herpich v. Wallace*, 430 F.2d 792, 801 (5th Cir. 1970); *Schoenbaum v. Firstbrook*, 405 F.2d 200, 212 (2d Cir. 1968).

34. See, e.g., Brief for SEC as amicus curiae *supra* note 5, at 15, 27

35. Professor Loss finds Rule 10b-5 to be the broadest of all anti-fraud provisions. 3 L. Loss, *supra* note 3, 932-42.

36. See *Kardon v. National Gypsum*, 73 F Supp. 798 (E.D. Pa. 1946).

The courts allowing 10b-5 actions held early that a plaintiff need not prove all the elements of common law fraud to make out a 10b-5 action. *Speed v. Transamerica Corp.*, 99 F Supp. 808, 831 (D. Del. 1951).

37. The common law elements of fraud were misrepresentation, materiality, scienter, privity, reliance, and causation. See Meisenholder, *Scienter and Reliance as Elements in Buyer's Suit Against Seller Under Rule 10b-5*, 4 CORP. PRAC. COMM. 27 (1963); W PROSSER, *HANDBOOK OF THE LAW OF TORTS* 700, 736 (3d ed. 1964).

38. *Derry v. Peek*, 14 App. Cas. 377 (1889)

39. In Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 U.C.L.A. L. REV. 583, 589 (1958), the author divides the state of mind of a party making a misrepresentation into five possible classes: (1) justifiably convinced of the truth of the statement, or (2) believing in the truth of the statement, but knowing that he has insufficient knowledge on which to base such a belief, or (3) having no genuine belief whatsoever in either the truth or the falsity of the statement, or (4) realizing that the statement was probably false, or (5) convinced of the falsity of the statement.

scienter in varying degrees of culpability.⁴⁰ Professor Loss suggests that "[s]cienter has been variously defined to mean everything from knowing falsity with an implication of *mens rea*, through the various gradations of recklessness, down to such non-action as is virtually equivalent to negligence or liability without fault." ⁴¹

Courts have done little to vitiate the confusion surrounding the concept of scienter by variously defining it as: a general intent to deceive,⁴² the knowledge of misstatements,⁴³ recklessness,⁴⁴ or mere negligence.⁴⁵

Bases for the Scienter Requirement

Any proper determination of the necessary scienter requirement should come from the express language of section 10(b) and Rule 10b-5. However, it may be argued that a tort theory is also a basis for determining what degree of scienter is required in a 10b-5 action.⁴⁶

1. *Rule 10b-5*

Rule 10b-5 makes no reference to a specific scienter requirement. The Rule provides:

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

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

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security ⁴⁷

40. W. PROSSER, *supra* note 37, at 715-17.

41. 3 L. LOSS, *supra* note 3, at 1432.

42. *Gould v. Tricon, Inc.*, 272 F. Supp. 385 (S.D.N.Y. 1967); *Weber v. C.M.P. Corp.*, 242 F. Supp. 321 (S.D.N.Y. 1965).

43. *Globus v. Law Research Service, Inc.*, 286 F. Supp. 188 (S.D.N.Y. 1968).

44. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Judge Friendly, concurring).

45. *Id.* at 855 (majority opinion).

46. See RESTATEMENT OF TORTS § 286 (1934).

47. 17 C.F.R. § 240.10b-5 (1971).

Litigation has demonstrated that the language of the Rule can be used to support an argument both for and against a scienter standard.⁴⁸ The words "to defraud" in clause (a) and "operate as a fraud" in clause (c) seem to indicate that some form of scienter is necessary, but there is no such portent contained in clause (b). The problem here is whether these clauses are mutually exclusive or are to be read together. Neither the courts requiring nor those rejecting a scienter standard have bothered to distinguish the three clauses of Rule 10b-5, and most courts do not even mention which clause is the basis for their decisions.⁴⁹ The majority of textbook writers, however, feel that because of the obvious differences in the language of the clauses, distinctions should be drawn between them for scienter purposes.⁵⁰ The Securities and Exchange Commission has taken the position that the clauses are "mutually supporting rather than mutually exclusive."⁵¹

Based on the courts' treatment of the Rule, it appears that the clauses are usually read together—which leads to the conclusion that some kind of scienter standard will be necessary.⁵² This conclusion is bolstered by the fact that most courts reject any kind of absolute liability doctrine in securities fraud cases, although there is dicta which indicates that clause (b) suggests such a strict standard.⁵³

48. See notes 70-117 *infra* and accompanying text.

49. E.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1954).

50. See generally Note, *Rule 10b-5: Elements of a Private Right of Action*, 43 N.Y.U.L. Rev. 541 (1968).

51. Cady, Roberts & Co., 40 S.E.C. 907, 913 (1961). For an opposing view, see generally Meisenholder, *supra* note 37; Note, *supra* note 50.

52. One author reaches the conclusion that the scienter standard should be the same for all three clauses. See Epstein, *supra* note 4, at 492.

53. In *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14, 23 (W.D. Ky. 1960), it was stated: "A plaintiff purchaser need only prove that a statement in a prospectus or oral communication is in fact false or is a misleading omission and that he did not know of such untruth or omission."

Meisenholder has explained the relation of clauses (1), (2), and (3) thusly:

In cases which involve untruths or half-truths, Clause (2) clearly applies. However, in every such case it is possible to regard Clause (1) as applicable because a "device" or "artifice" is involved. Likewise the use of the untruth or half-truth could conceivably constitute an "act" or "practice" under Clause (3). Even in cases in which there is a duty to disclose although no affirmative statements have been made, it is possible to regard Clauses (1) and (3) as having at least the same area of operation as Clause (2). To the extent that all three clauses have the same area of operation, it appears

2. Section 10(b)

Section 10(b) is also devoid of any specific language requiring scienter. It provides in pertinent part as follows:

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

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.⁵⁴

Rule 10b-5, as any other regulation, must be within the scope of its relative enabling statute in order to establish its validity.⁵⁵ Professor Loss has commented that Rule 10b-5 is subject therefore to the language of section 10(b) with regard to "manipulative or deceptive device or contrivance."⁵⁶ He emphasizes the word "manipulative" in reaching the conclusion that section 10(b) requires scienter.⁵⁷ Since Rule 10b-5 depends for its validity on section 10(b), it must also require scienter or be void.⁵⁸ Professor Meisenholder, another commentator who has considered this problem, focuses on the word "deceptive,"⁵⁹ which he feels reaches the same result as Loss' analysis utilizing the word "manipulative." Thus, Meisenholder concludes that section 10(b) requires at least some form of scienter.⁶⁰ But, the language of section 10(b) regarding "*any* manipulative or deceptive device" raises the inference that this section may proscribe *any* deceptive conduct, whether intentional or not.⁶¹ The plain language of the statute, as with Rule 10b-5, therefore,

reasonable to conclude that requirements of scienter should be the same under each clause.

Meisenholder, *supra* note 37, at 41.

54. 15 U.S.C. § 78j(b) (1970).

55. *Hooper v. Mountain States Securities Corp.*, 282 F.2d 195, 202 (5th Cir. 1960).

56. 6 L. Loss, *supra* note 3, at 3884.

57. *Id.*

58. Another author notes the same argument but does not reach a conclusion which might invalidate a "no-scienter rule." Epstein, *supra* note 4, at 492.

59. Meisenholder, *supra* note 37

60. *Id.* at 37

61. *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961)

provides no definite guideline for determining whether scienter is required. The courts have thereby been forced to look to other areas, such as Congressional intent, in order to interpret section 10(b).⁶²

3 Statutory Tort

The majority of courts which have found that Rule 10b-5 sanctions an implied civil remedy base their decisions on a statutory tort theory, among others.⁶³ Such a theory states that the violation of a criminal statute gives rise to civil liability.⁶⁴ Rule 10b-5 does not provide criminal sanctions for violations of its proscriptions; however, section 32 of the 1934 Exchange Act⁶⁵ declares criminal any willful violation of the Act or any of its rules. Therefore, it would seem reasonable that courts should find civil liability attaching under a statutory tort theory only upon a willful violation of Rule 10b-5.⁶⁶ The courts

62. One writer has convincingly argued that Congress never intended a private remedy under section 10(b), and therefore, it would be illogical to inspect Congressional intent as an aid to determining the proper scienter requirement of a 10b-5 private action. Ruder, *supra* note 4.

63. The courts base the statutory tort theory on RESTATEMENT OF TORTS § 286 (1934).

64. The court in *Kardon v. National Gypsum*, 69 F. Supp. 512, 514 (E.D. Pa. 1946) stated:

Of course, the legislature may withhold from the parties injured the right to recover damages arising by reason of violation of a statute but the right is so fundamental and so deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly.

For a general discussion of the statutory tort theory see A. BROMBERG, *supra* note 3, § 2.4(1)(a). Professor Bromberg raises the point that section 286 of the Restatement has been rewritten since the 1934 revision. Revised section 286 provides:

The court may adopt as the standard of conduct of a reasonable man the requirements of a legislative enactment or an administrative regulation whose purpose is found to be exclusively or in part

(a) to protect a class of persons which includes the one whose interest is invaded, and

(b) to protect the particular interest which is invaded, and

(c) to protect that interest against the kind of harm which has resulted, and

(d) to protect that interest against the particular hazard from which the harm results.

RESTATEMENT (SECOND) OF TORTS § 286 (1965). The 1965 revision *allows* courts to base an implied remedy on a violation of a statute. This language does not as readily support 10b-5 liability as the original 1934 version relied on by early 10b-5 courts.

65. 15 U.S.C. § 78(a) *et seq.* (1970).

66. Professor Ruder finds it difficult to comprehend how courts have used the tort theory as a basis for a 10b-5 private remedy and then allowed claims based on negligence alone. He states:

employ a judicially implied civil liability based on a statutory tort theory which obviously requires scienter.⁶⁷ However, in determining what degree of scienter, if any, is required, the courts often completely ignore section 32 and look instead to the language of Rule 10b-5. Seizing on the word "any" contained in the Rule, some courts conclude that no scienter need be shown.⁶⁸

It is a well recognized rule of statutory construction that when varying interpretations of a statute are possible, the interpretation to be chosen is that which gives effect to the entire statute, rather than to only one part. With this in mind, is it valid for courts to look to Rule 10b-5 in determining a scienter standard under a statutory tort theory and thus effectively nullify section 32? This is not meant to imply that a definite scienter standard of willfulness should be required in a 10b-5 action, but if courts are going to base their decisions solely on a statutory tort theory, some kind of scienter standard would appear to be a necessary concomitant.⁶⁹

Case Discussion of Scienter in 10b-5 Actions

In considering the bases for a scienter requirement in a private action under 10b-5, courts have aligned themselves behind three distinct standards: knowledge of falsity, absolute liability, and negligence.⁷⁰

It is difficult to perceive how an action relating to the use of manipulative and deceptive devices and contrivances in the purchase and sale of stock which, before the passage of the 1933 and 1934 Acts was founded upon the law of fraud and deceit, or upon concepts relating to breach of fiduciary duty, can, by passage of those Acts and subsequent promulgation of Rule 10b-5, be converted into an action in negligence. It may be that the theory is entirely inapplicable, and that the courts have been erroneous in applying it to cases dealing with the Rule.

Ruder, *supra* note 4, at 632-33.

67. The courts have maneuvered around a requirement of willfulness in some cases by defining recklessness, or merely negligence, in the failure to ascertain the truth as a form of willfulness, but this does not comport with common law definition. Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 CHI. L. REV. 824, 838 (1964).

68. See, e.g., *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961); *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960).

69. *Contra*, Note, *Scienter in Rule 10b-5*, 69 COLUM. L. REV. 1057, 1062-63 (1969). See also Epstein, *supra* note 4, at 496. The author recognizes the same analysis but feels that in view of court definitions of willfulness that to require such would simply be a requirement of negligence. Although there are such decisions, it is submitted that they are inapplicable within the framework of a statutory tort basis for a private right of action.

70. For the purposes of the following discussion, scienter is defined as willful or knowing conduct.

1. Knowledge of Falsity

The first case which discussed the necessity of scienter was *Fischman v. Raytheon Manufacturing Co.*⁷¹ In *Fischman*, the plaintiffs claimed that due to material omissions and fraudulent misstatements in a prospectus and registration statement covering preferred stock, they were induced to buy common stock in defendant company. The action was brought on a section 10(b) and Rule 10b-5 theory, but the district court dismissed on grounds that the action was within the exclusive province of section 11 of the 1933 Securities Act. On appeal, Judge Frank, in attempting to reconcile the scienter requirement of Rule 10b-5 with that of section 11, held:

[W]hen, to conduct actionable under [section] 11 of the 1933 Act, there is added the ingredient of fraud, then the conduct becomes actionable under [section] 10(b) of the 1934 Act and the Rule. .⁷²

Thiele v. Shields,⁷³ a later district court case, clarified the scienter requirement of *Fischman*. The court specifically held that purely negligent action would not be actionable under 10b-5⁷⁴ and went on to state that knowing or intentional misrepresentation would be required. Similarly, in *Weber v. C.M.P. Corp.*,⁷⁵ the district court interpreted Judge Frank's "fraud" requirement as "knowledge of the falsity of the alleged untrue statements."⁷⁶

Although *Fischman*⁷⁷ remains essentially undisturbed in the Second Circuit,⁷⁸ it has been followed by only one other court, a district court

71. 188 F.2d 783 (2d Cir. 1951).

72. *Id.* at 787.

73. 131 F. Supp. 416 (S.D.N.Y. 1955).

74. *Id.* at 419.

75. 242 F. Supp. 321 (S.D.N.Y. 1965). The court went on to follow *Fischman*, although it questioned that case's rationale.

76. *Id.* at 323. The definition of fraud as made by the *Weber* court is in agreement with the interpretation given by most courts and authorities. See, e.g., R. JENNINGS & H. MARSH, *SECURITIES REGULATION CASES AND MATERIALS* 866-67 (2d ed. 1968); Comment, *Securities Regulation—Fraud in Securities Transactions and Rule 10b-5—A Survey of Selected Current Problems*, 46 N.C.L. REV. 599, 623-25 (1968).

77. 188 F.2d 783 (2d Cir. 1951).

78. The rationale of *Fischman* requiring fraud in a private damage action remains intact in the Second Circuit. *Shemtob v. Shearson, Hammill and Co., Inc.*, 448 F.2d 442 (2d Cir. 1971). *SEC v. Texas Gulf Sulphur Co.* has, however, eliminated any scienter requirement for injunctive or prophylactic relief, whether private or by the SEC.

in Colorado. In *Trussel v. United Underwriters, Ltd.*,⁷⁹ the plaintiffs as purchaser of stock, sought damages. Five separate claims were made, all alleging violation of Rule 10b-5. Of these, the first count merely accounted the misstatements and omissions, the second claim incorporated the first and further alleged knowing or intentional conduct, the fourth incorporated claim one and also alleged negligence, and the fifth also incorporated claim one and alleged knowing or intentional conduct.⁸⁰ The first and fourth claims were summarily dismissed, the court holding that the language of section 10(b) regarding "'manipulative or deceptive device or contrivance,'" ⁸¹ implies conduct which is, at the very least, either knowing or intentional."⁸²

2. Absolute Liability

Perhaps the leading case cited as authority for the elimination of a scienter requirement is *Ellis v. Carter*.⁸³ Therein, the purchaser alleged that defendant falsely represented to him that he would obtain a voice in management with the stock he was buying. Soon thereafter, defendants assumed control of the company and excluded plaintiff. The Ninth Circuit rejected the idea that Rule 10b-5 does not extend relief to all defrauded buyers.⁸⁴ In rejecting this contention, the court held that proof of common law fraud is not essential to a 10b-5 cause of action. In rejecting Professor Loss' argument⁸⁵ that scienter was re-

79. 228 F. Supp. 757 (D. Colo. 1964). For an in depth analysis of *Trussel*, see Note, *Proof of Scienter Necessary in a Private Suit Under S.E.C. Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070 (1965).

80. 228 F. Supp. at 761-62.

81. 15 U.S.C. § 78j(b) (1970).

82. The Court of Appeals for the Tenth Circuit, which includes the district of Colorado, held *contra* in *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965), stating:

It is not necessary to allege or prove common law fraud to make out a case under the statute and the rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact.

343 F.2d at 379.

In *Parker v. Baltimore Paint and Chemical Corp.*, 244 F. Supp. 267 (D. Colo. 1965), the district court distinguished *Stevens* on the facts and held the above quote to be merely dictum. In a recent case it appears that the district court has still not yielded to the court of appeals, requiring a plaintiff to prove that the defendant's misstatements or omissions were "fraudulently deceptive." *deHaas v. Empire Petroleum Co.*, 300 F. Supp. 834 (D. Colo. 1969).

83. 291 F.2d 270 (9th Cir. 1961).

84. In this respect, *Ellis* agreed with the rationale of *Fischman*.

85. It is interesting to note that Professor Loss raised his own argument for the defendants in the *Ellis* decision. 6 L. Loss, *supra* note 3, at 3886.

quired due to the presence of the "manipulative or deceptive device or contrivance" language, the court emphasized the word *any* in the phrase "any manipulative or deceptive device or contrivance."⁸⁶

It would have been difficult to frame the authority in broader terms. We see no reason to go beyond the plain meaning of the word "any" indicating that the use of manipulative or deceptive device or contrivance of whatever kind may be forbidden, to construe the statute as if it read "any fraudulent or deceptive" device.⁸⁷

This language supports the contention that even innocent misrepresentations may be actionable under the Rule, and several writers have indeed construed *Ellis* in this way⁸⁸—although the Ninth Circuit has not so held in any case to date.

Ellis stands in much the same position as does the *Fischman* case. Little judicial acceptance has been accorded it, although several courts have approved of the Ninth Circuit position on scienter by way of dictum.⁸⁹ However, a few decisions have explicitly followed *Ellis*. In one which has, *Dauphin Corp. v. Redwall Corp.*,⁹⁰ the court stated, "The reasoning of the court in *Ellis v. Carter* is particularly persuasive and is adopted by this court."⁹¹

Several courts have indicated, without actually deciding, that liability might attach for non-negligent and unintentional misrepresentations.⁹² In *Royal Air Properties, Inc. v. Smith*,⁹³ this broad dictum is found:

86. 13 U.S.C. § 78j(b) (1970).

87. 291 F.2d at 274. Professor Loss has responded:

But one gags at stretching 10(b)'s "manipulative or deceptive device or contrivance" to cover *any* material misstatement or omission on a strict liability basis—the more so since, except for the issuer's liability under section 11 of the 1933 act, none of the express civil liability provisions with respect to misstatements or omissions in either act goes that far.

6 L. Loss, *supra* note 3, at 3887

88. See A. BROMBERG, *supra* note 3, § 8.9 n.102; R. JENNINGS & H. MARSH, *supra* note 76, at 866-67

89. *Kohler v Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963); *Lorenz v. Watson*, 258 F Supp. 724 (E.D. Pa. 1966).

90. 201 F. Supp. 466 (D. Del. 1962).

91. *Id.* at 469.

92. *Texas Life Ins. Co. v. Bankers Bond Co.*, 187 F Supp. 14 (W.D. Ky. 1960).

93. 312 F.2d 210 (9th Cir. 1962).

[C]ommon law fraud need not be alleged or ultimately proved. Plaintiff is only required to prove a material misstatement or an omission of a material fact in connection with the purchase or sale of any security to make out a *prima facie* case.⁹⁴

3. Negligence

The third position taken by the courts on the issue of scienter is found in *Drake v. Thor Power Tool Co.*⁹⁵ Therein, Drake alleged that he purchased stock in reliance on false figures in defendant's financial statements, and that defendant accounting firm was negligent in conducting their audit of Thor and in giving the financial statements their approval. Defendant contended that knowledge is a necessary element in a 10b-5 suit, but the Illinois district court rejected both this argument and the position urged in *Ellis*.⁹⁶ It determined that allegations of an improper audit constituted a charge of negligence.⁹⁷ The court held that negligent as well as intentional misrepresentations fall within the scope of Rule 10b-5.⁹⁸

The Second Circuit, notwithstanding its earlier *Fischman-Thiele-Weber* doctrine, decided in *SEC v. Texas Gulf Sulphur Co.*⁹⁹ that a scienter standard equal to a specific intent to defraud was unnecessary for an SEC action. The majority concluded that a decision holding negligence to be actionable under 10b-5 was

not irreconcilable with previous language in this circuit because "*some form of the traditional scienter requirement*" is preserved. The requirement, whether it be termed lack of diligence, constructive fraud or unreasonable or negligent conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule.¹⁰⁰

While deciding that negligence is actionable under 10b-5, the court failed to confront the argument that a relaxation of the scienter requirement would allow actions which are expressly covered by sections 11 and 12 of the 1933 Act to be brought under 10b-5.¹⁰¹ The court also

94. *Id.* at 212.

95. 282 F Supp. 94 (N.D. Ill. 1967).

96. *Id.* at 102.

97. *Id.* at 104.

98. *Id.*

99. 401 F.2d 833 (2d Cir. 1968) (*en banc*), cert. denied, 394 U.S. 976 (1969).

100. *Id.* at 855.

101. See Note, *supra* note 68, at 1064.

failed to give weight to the fact that the defendants would be liable under the strict scienter requirement espoused by the cases cited in support of its position.¹⁰² In light of the existing *Fischman* rationale, the broad language of the court indicates that a major relaxation of the scienter requirement was intended.

The court was quick to point out, however, that their holding extended only to an action for injunctive relief.¹⁰³ In a concurring opinion, Judge Friendly urged the court to make their distinction quite clear in order to provide guidance to lower courts in the multiplicity of private damage suits pending at the time which also might involve allegations of negligence.¹⁰⁴

Texas Gulf raises questions about the status of scienter in the Second Circuit. In *Fischman*, the court required an "ingredient of fraud"¹⁰⁵ in a 10b-5 suit, and in *Texas Gulf* it was claimed that its negligence test did not vitiate *Fischman*, but was just another form of fraud.¹⁰⁶ Certainly the negligence standard in *Texas Gulf*, if applied to private actions, considerably dilutes the requirements of *Fischman* and departs from the court's previous decision. Even more confusing is the declaration in *Texas Gulf* that good faith will be a defense to a private action instituted under 10b-5 for misrepresentation.¹⁰⁷

One thing is certain—*Texas Gulf Sulphur* gives no positive solution to the scienter problem and it has left a wake of confusion in the Second Circuit. This is apparent in the later cases which have attempted an interpretation of *Texas Gulf*. In *Wellington Computer Graphics, Inc. v. Modell*,¹⁰⁸ a proceeding on defendant's motion for stay of federal action for alleged violation of federal securities laws, the court, citing *Texas Gulf* and *Ellis v. Carter*, held:

[T]he elements necessary to establish common law fraud differ from those essential to prove a violation of the federal securities law. Proof of a specific intent to defraud or scienter is an essential element of common law fraud, but scienter is not essential to establish a violation of Section 10(b) and Rule 10b-5 where it is

102. *Id.*

103. 401 F.2d at 863.

104. *Id.* at 866.

105. 188 F.2d at 787.

106. 421 F.2d at 855.

107. *Id.* at 862.

108. 315 F Supp. 24 (S.D.N.Y. 1970).

sufficient merely to show "lack of diligence, constructive fraud, or unreasonable or negligent conduct."¹⁰⁹

In *Gerstle v. Gamble-Skogmo, Inc.*,¹¹⁰ a derivative action for an accounting and restitution, the court, citing *Texas Gulf*, required scienter, stating "In this Circuit it appears that in a private action some type of scienter as distinguished from mere negligence is still necessary under Rule 10b-5"¹¹¹ The inconsistency in these two decisions is apparent.

The Court of Appeals for the Second Circuit, the same court which decided *Texas Gulf*, struck a blow at the confusion surrounding scienter in that circuit by its recent decision in *Shemtob v. Shearson, Hammill and Co., Inc.*¹¹² The case involved a damage suit against a broker-dealer, alleging that he did not sell out a margin account promptly after an unmet margin call, as required by a written contract, and that the sell-out eventually occurred without further notice and opportunity to meet the margin as orally agreed upon. The court held that these allegations constituted only a "garden-variety customer's suit,"¹¹³ insufficient for a 10b-5 action.

[I]n the absence of allegation of facts amounting to scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme, or artifice to defraud. It is insufficient to allege mere negligence.¹¹⁴

In *Colonial Realty Corp. v. Brunswick Corp.*,¹¹⁵ a later district court case (not citing *Shemtob*), it was held that "10b of the Securities Exchange Act and Rule 10b-5 thereunder, upon which plaintiff primarily relies, requires findings of scienter."¹¹⁶ The court went on to say that a plaintiff must prove scienter, "whether this is to be interpreted as 'actual knowledge of falsity,' or recklessness equivalent to willful fraud."¹¹⁷

Thus it appears that the Second Circuit has resolved the scienter problem on the basis of the relief sought. If the suit is for injunctive

109. *Id.* at 26.

110. 298 F Supp. 66 (E.D.N.Y. 1969).

111. *Id.* at 97

112. 448 F.2d 442 (2d Cir. 1971).

113. *Id.* at 445.

114. *Id.*

115. CCH [1970-71 Transfer Binder] FED. SEC. L. REP. ¶ 93,219 (S.D.N.Y. 1971)

116. *Id.* at 91, 384-85.

117. *Id.* at 91, 385.

or prophylactic relief, an allegation of negligence is sufficient to defeat a motion to dismiss. But in a private action for damages, plaintiff must allege facts amounting to scienter or fraud.

Conclusion

Scienter represents the most confused element of a section 10(b), Rule 10b-5 cause of action. The courts are widely dispersed among such positions as absolute liability (Ninth Circuit),¹¹⁸ negligence (Seventh Circuit),¹¹⁹ and a combination of both negligence and scienter in the confused Second Circuit.¹²⁰

A strict scienter standard, although the easiest to administer from an evidentiary standpoint in relation to other 10b-5 elements, is least effective in achieving the purpose of the 1934 Act and its egalitarian concept of total investor equality. An absolute liability standard, although most effectively carrying out the purpose of the 1934 Exchange Act, would provide added impetus to the almost complete displacement effect of Rule 10b-5 on the express anti-fraud provisions of both securities acts.¹²¹

Perhaps the best method would be a continuum approach which would vary from absolute liability to negligence to willful conduct depending on the relative positions of the parties and their access to material information. This method would continue the case-by-case analysis, but is perhaps most effective in realizing the purpose of the 1934 Act.¹²²

MATERIALITY

Common Law

At common law any person making a material misrepresentation in conjunction with the consequent elements of reliance, causation, scienter, and privity, was liable in tort for deceit.¹²³ Common law, how-

118. *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).

119. *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94 (N.D. Ill. 1967).

120. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

121. See notes 439-75 *infra* and accompanying text.

122. Mann, *Rule 10b-5. Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U. L. Rev. 1206 (1970)

123. See, e.g., *McKay v. Anheuser-Busch, Inc.*, 199 S.C. 335, 79 S.E.2d 457 (1942). The RESTATEMENT OF TORTS § 525 (1938) reiterates the common action providing:

One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or refrain from

ever, did not as a general rule require a person in possession of a material fact to disclose the same in any purchase or sale.¹²⁴ As an exception to the rule, the concept of fiduciary duty¹²⁵ required anyone in such a relationship to disclose any material fact in a transaction involving his principal.¹²⁶ A majority of early common law courts found that a fiduciary relation existed between corporation officers or insiders and their corporation, but not between the insider and the stockholder of his corporation.¹²⁷ Corporation insiders were then left free to purchase shares from their own stockholders without disclosing material inside information which formed the basis for their purchases. The inequities of the majority rulings¹²⁸ prompted a minority of jurisdictions, spear-headed by *Oliver v. Oliver*¹²⁹ to extend the fiduciary relation to the interrelationship of corporate officer and stockholders.¹³⁰

Dissatisfaction with the results evolving from both the majority and minority rule¹³¹ led to the creation of an intermediary doctrine involving the elements of both, known as the special fact doctrine.¹³² The Supreme Court in *Strong v. Repide*¹³³ held that the existence of special

action in reliance thereon in a business transaction is liable to the other for the harm caused to him by his justifiable reliance upon the misrepresentation.

124. See, e.g., *Windfram Mfg. Co. v. Boston Blacking Co.*, 239 Mass. 123, 131 N.E. 554 (1921); *Boileau v. Records & Breen*, 165 Iowa 134, 144 N.W. 336 (1913); W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 695-99 (4th ed. 1971)

125. For a discussion of the fiduciary duty concept as applied in securities see Nielson, *So What Else Is New In The Law? Texas Gulf Sulphur Restates Peek v. Gurney*, 1971 UTAH L. REV. 327, 328-48.

126. *McDonough v. Williams*, 77 Ark. 261, 92 S.W. 783 (1905)

127. In *Smith v. Hurd* the court stated:

There is no legal privity, relation, or immediate connection, between holders of shares in a bank, in their individual capacity, on the one side, and the direction of the bank on the other. The directors are not the bailees, the factors, agents, or trustees of such individual stockholders.

53 Mass. (12 Met.) 371, 384 (1847) See also Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53 (1960)

128. In *Bd. of Commissioners v. Reynolds*, 44 Ind. 509, 15 Am. R. 245 (1873), a corporate insider acquired stock for \$27,000, actually worth \$342,000, through non-disclosure of future merger plans.

129. 118 Ga. 362, 45 S.E. 232 (1903).

130. 45 S.E. at 233.

131. The fiduciary relation was often analogized to the trustee-*cestui que trust* with often inequitable results. See Note, *Insiders and Materiality of Information Disclosed*, 18 AM. U.L. REV. 427, 431 (1969).

132. The majority of courts view the special facts doctrine as a rule of full disclosure. E.g., *Amen v. Black*, 234 F.2d 12 (10th Cir. 1956); *Seagrave Corp. v. Mount*, 212 F.2d 389 (6th Cir. 1954); *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947)

133. 213 U.S. 419 (1909).

facts, such as the defendant's position as an insider, required a full disclosure of material facts rather than the finding of any fiduciary duty between the officer and the stockholder.¹³⁴

Rule 10b-5 (b),¹³⁵ promulgated under section 10(b)¹³⁶ has adopted the common law prohibition of affirmative material misrepresentation and extended the common law disclosure requirements. Since a civil remedy was first implied by *Kardon v. National Gypsum*,¹³⁷ it has been firmly established that liability exists under 10b-5 for the failure to disclose material inside information.¹³⁸

The questions concerning proscribed conduct and extent of liability are, therefore, essentially moot in most situations. The most important question for courts reviewing 10b-5 claims is then, "Was defendant's misleading statement material?"¹³⁹

Statutory and Regulatory Criteria: Section 10(b) and Rule 10b-5

Courts looking for some statutory aid in developing a proper definition of materiality have experienced little success. Section 10(b)¹⁴⁰ is devoid of any mention of "material," only prohibiting the use of "any manipulative or descriptive device or contrivance in contravention of such rules"¹⁴¹ as the SEC might promulgate to enforce the section.

Rule 10b-5¹⁴² lays out the specific requirement of materiality for a violation of its proscribed conduct in clause (b), but furnishes no guidelines for an interpretation of the requirement.¹⁴³ Clause (b) does, however, provide a limit on any determination of materiality by requiring any finding to be made "in the light of the circumstances under which the misleading statement was made."¹⁴⁴

The only definition of materiality found in the statutes or official rules of the SEC is located in Rule 405 of Regulation C under the 1933 Act.¹⁴⁵ The definition provides:

134. 213 U.S. at 432-35.

135. 17 C.F.R. § 240.10b-5 (1971).

136. 15 U.S.C. § 78j(b) (1970).

137. 73 F Supp. 798 (E.D. Pa. 1947).

138. See Comment, *Insider Liabilities Examined*, 18 SYR. L. REV. 808, 816 (1967).

139. See, e.g., *SEC v. Great Am. Indus., Inc.*, 407 F.2d 453, 459 (2d Cir. 1968); *Richland v. Crandall*, 262 F Supp. 538, 553 (S.D.N.Y. 1967).

140. 15 U.S.C. § 78j(b) (1970).

141. *Id.*

142. 17 C.F.R. § 240.10b-5 (1971).

143. *Id.*

144. *Id.*

145. 17 C.F.R. § 230.405(1) (1971).

The term 'material', when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered.¹⁴⁶

This definition has, however, received slight judicial cognizance in 10b-5 actions.¹⁴⁷

Case Discussion of Materiality

Finding no relevant statutory or regulatory guidelines in forming a definition of materiality, the courts have been forced to look to common law. Materiality represents the only element of common law fraud which has been incorporated basically unchanged into Rule 10b-5.¹⁴⁸

The rationale behind the common law requirement of materiality was to prevent a purchaser or seller from avoiding a bad deal, by claiming reliance on *any* misleading statement by the other party to the transaction.¹⁴⁹ In order to prevent such occurrences, the courts implemented a reasonable man test,¹⁵⁰ thus requiring not only that the plaintiff must have relied on the misrepresentation, but his reliance must also have been justifiable.¹⁵¹

Although the courts in concert pay lip service to the requirement of materiality, confusion has surrounded court pronouncements of the proper test. Materiality has been most clearly delineated in the more subtle cases, almost always those involving non-disclosure, with the courts using various formulae to reach a result essentially equivalent to the common law reasonable man test.¹⁵³ In *Kardon v. National Gyp-*

146. *Id.*

147. The definition of materiality included in the rule has not been explicitly followed even by the SEC. In *Cady, Roberts and Co.*, 40 S.E.C. 907 (1961), the Commission defined material facts as those "which if known would affect the investment judgment of the person with whom the insider deals." *Id.* at 911.

148. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965).

149. Keeton, *Actionable Misrepresentation*, 2 OKLA. L. REV. 56, 59 (1949).

150. See *Babb v. Bolyard*, 194 Md. 603, 72 A.2d 13 (1950).

151. In *List* the court cautions that the requirement that the plaintiff's reliance be justifiable should be distinguished from the common law requirement that a reasonable man would have believed the misleading statement. The court finds that such requirement may not exist at all under Rule 10b-5. 340 F.2d 457, 462 n.3. (2d Cir. 1965).

152. Dykstra, *The Battle Grounds of 10b-5*, 1971 UTAH L. REV. 297, 304.

153. The common law materiality test as stated in the RESTATEMENT OF TORTS § 538 (1938) provides:

(1) Reliance upon a fraudulent misrepresentation of fact in a business

*sum*¹⁵⁴ the court held that the defendant, a majority stockholder, should have disclosed his negotiations for sale of the corporate assets before purchasing more stock in the corporation, stating: "Insiders must disclose a fact coming to their knowledge by reason of their position which would *materially* affect the judgment of the other party to the transaction."¹⁵⁵ Materiality was defined in *Kohler v. Kohler*¹⁵⁶ as any fact "which would, in reasonable anticipation, affect the other party's judgment."¹⁵⁷ The common law definition was specifically adopted by the Second Circuit, in *List v. Fashion Park, Inc.*,¹⁵⁸ where the court, citing Professor Prosser and the *Restatement of Torts*, held:

The basic test of "materiality," on the other hand, is whether "a reasonable man would attach importance to the fact misrepresented in determining his choice of action in the transaction in question."¹⁵⁹

Although the courts are in agreement that the misleading statements in question must be subjected to a reasonable man test, a review of the language in recent decisions indicates that the materiality concept may have been extended. It is essential that some degree of probability be shown indicating that a reasonable investor would have acted differently in the transaction at hand.¹⁶⁰ At common law and in the *List* test this degree of probability is measured by the word "would."¹⁶¹ In the sub-

transaction is justifiable if, but only if, the fact misrepresented is material.

(2) A fact is material if

- (a) its existence or nonexistence is a matter to which a reasonable man would attach importance in determining his choice of action in the transaction in question, or
- (b) the maker of the representation knows that its recipient is likely to regard the fact as important although a reasonable man would not so regard it.

(3) The recipient in a business transaction of a fraudulent misrepresentation of a material fact is justified in relying upon it whether or not he believes the maker to have an antagonistic interest in the transaction.

154. 73 F Supp. 798 (E.D. Pa. 1947).

155. *Id.* at 800.

156. 319 F.2d 634 (7th Cir. 1963).

157. *Id.* at 642.

158. 340 F.2d 457 (2d Cir. 1965).

159. *Id.* at 462.

160. *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 569 (E.D. N.Y. 1971).

161. See RESTATEMENT OF TORTS § 538 (1938).

sequent landmark decision, *SEC v. Texas Gulf Sulphur Co.*,¹⁶² the court cited both the *List* and *Kohler* tests, but in summation substituted the word "may," holding:

Thus material facts include not only information disclosing the earning and distributions of a company but also those facts which affect the probable future of the company and those which *may* affect the desire of investors to buy or sell, or hold the company's securities.¹⁶³ [Emphasis supplied.]

In addition, *Texas Gulf* extended the concept of a reasonable investor by including under the protection of 10b-5 the reasonable speculator or chartist.¹⁶⁴

The Supreme Court, discussing "material" as applied to proxy violations under section 14(a) of the 1934 Act,¹⁶⁵ held in *Mills v. Electric Auto-Lite*¹⁶⁶ that a finding of materiality "indubitably embodies a conclusion that the defect was of such a character that it *might have been* considered important by a reasonable shareholder who was in the process of deciding how to vote."¹⁶⁷ In a later Second Circuit case, *Chasins v. Smith, Barney and Co.*,¹⁶⁸ the Court cited *List* and *Kohler* in concluding that the question of materiality "becomes whether a reasonable man in Chasins' position *might well have* acted otherwise." ¹⁶⁹

This possible trend was recognized in *Fett v. Leasco Data Processing Equipment Corp.*¹⁷⁰ The court in *Fett* found that a fair summary of the current status of the probability requirement would find a fact material when "it is more probable than not that a significant number of traders would have wanted to know it before deciding to deal in the security" ¹⁷¹

162. 401 F.2d 833 (2d Cir. 1968).

163. *Id.* at 849.

164. *Id.*

165. 15 U.S.C. § 78n(a) (1970)

166. 396 U.S. 375 (1970).

167. 396 U.S. at 384. [Emphasis supplied].

168. 438 F.2d 1167 (2d Cir. 1970).

169. *Id.* at 1171. [Emphasis supplied].

170. 332 F Supp. 544 (E.D.N.Y. 1971).

171. *Id.* at 570.

Conclusion

Although courts have been confused in their formulations of a materiality test,¹⁷² materiality still represents the least confused of the elements of a 10b-5 implied action. However, if the language of recent decisions is liberally construed, a trend toward the expansion of materiality may be in progress. The logical result of such a trend would further the courts' current tendency to accept any affirmative misrepresentation as material,¹⁷³ and require insiders to disclose all or forego any dealings in their corporation's stock. Coupled with a no scienter standard, such as the Ninth Circuit employs,¹⁷⁴ insiders would then be liable for almost any non-disclosure, regardless of due diligence exerted to determine what facts should be disclosed.

RELIANCE

There is no language in Rule 10b-5 which suggests the necessity for a defrauded plaintiff to prove reliance.¹⁷⁵ Things are not this simple, however, because reliance is an integral part of the scheme of implied liability which has evolved outside of the strict construction of the Rule. It is also, of course, an element of the classic fraud case, in which the plaintiff must prove reliance upon the misrepresentation in order to recover.¹⁷⁶

Although courts often say that reliance by the defrauded party is essential for recovery under 10b-5,¹⁷⁷ this is not a hard and fast rule, and the requirement has been treated with a great deal of flexibility. This is especially true in those instances in which reliance is particularly

172. Bromberg favors a substantial market impact test over the reasonable investor test laid out in *Texas Gulf*. A. BROMBERG, *supra* note 3, § 7.4(3) (b)-(h).

173. The majority of courts considering affirmative misrepresentation claims under 10b-5 fail to analyze the materiality tests, merely finding the misrepresentation material. See, e.g., *SEC v. Broadwall Securities, Inc.*, 240 F. Supp. 962 (1965).

174. See discussion of *Ellis v. Carter* in text accompanying notes 83-88 *supra*.

175. Section 12(2) of the 1933 Act which expressly provides for a private right of action also contains no language requiring reliance. See *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757 (D. Colo. 1964).

176. See RESTATEMENT OF TORTS §§ 536, 538 (1938).

177. See, e.g., *Rogen v. Ilikon Corp.*, 361 F.2d 260, 266-68 (1st Cir. 1966); *Janigan v. Taylor*, 344 F.2d 781, 785-86 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). But see *Vine v. Beneficial Finance Co.*, 374 F.2d 627, 635 (2d Cir. 1967) (reliance is "unnecessary in the limited instance where no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoers").

difficult to prove, as in non-disclosure cases¹⁷⁸ or where large numbers of persons are involved.¹⁷⁹ In some cases reliance has been neglected, rejected, or watered down, depending on the situation.¹⁸⁰

The end result has been a constant process of blending and shifting so that reliance has become almost indistinguishable from causation and difficult to discern relative to materiality.¹⁸¹ The three elements have become at least partially interchangeable, and combinations of one or two of them seem to be sufficient in different cases to defeat a motion to dismiss.¹⁸² The required proof of reliance also seems to depend on whether the case involves nondisclosure or active misrepresentation.

Non-disclosure

There seems to be scant rationale for requiring reliance in nondisclosure cases. One district court required active reliance on the defendant's silence,¹⁸³ but this test was rejected by the Second Circuit Court of Appeals when it affirmed the finding of non-reliance, holding, "[T]he proper test in a nondisclosure situation is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact."¹⁸⁴

178. See, e.g., *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 797 (2d Cir. 1969); *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); *Astor v. Texas Gulf Sulphur Co.*, 306 F Supp. 1333 (S.D.N.Y. 1969); *Trussell v. United Underwriters, Ltd.*, 228 F Supp. 757 (D. Colo. 1964) (noted the distinction between 10b-5(2) requiring a showing of reliance not required under section 12(2) of the 1933 Act).

179. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

180. See, e.g., *Vine v. Beneficial Finance Co.*, 374 F.2d 627, 635 (2d Cir. 1967); *Entel v. Allen*, 270 F Supp. 60 (S.D.N.Y. 1967); *Voegel v. American Sumatra Tobacco Co.*, 241 F Supp. 369 (D. Del. 1965); *Pettit v. American Stock Exchange*, 217 F Supp. 21 (S.D.N.Y. 1963).

181. *Joseph v. Farnsworth Radio and Television Corp.*, 99 F Supp. 701, 706-07 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952), was the first case to require privity, but the court suggested reliance would be an acceptable substitute. The dissent on appeal indicates that if the defendants intended that the plaintiff rely on their misstatements privity would be unnecessary 198 F.2d at 885.

182. The need for such reliance by a plaintiff has been the subject of much scholarly analysis. See, e.g., Painter, *Insider Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1366-72 (1965); Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 667-74 (1965).

183. *List v. Fashion Park, Inc.*, 227 F Supp. 906, 911-12 (S.D.N.Y. 1964)

184. *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

*List v. Fashion Park, Inc.*¹⁸⁵ involved a sale of securities to an insider and a claim that the insider had failed to disclose material facts to the seller. The plaintiff seller sued the buyer on a 10b-5 theory, alleging deception by means of failure to disclose. The court held that even were there material misrepresentations through nondisclosure, nevertheless the plaintiff could not recover under the Rule since it had failed to establish reliance upon the facts represented. Thus, reliance upon the misrepresentation was held to be an essential element of a 10b-5 claim. Included in the requirements for a section 10(b) cause of action is what the *List* court described as that "basic element of tort law . . . the principle of causation in fact."¹⁸⁶

The test elicited from *List* suggests that reliance must be shown in a 10(b) case in order to establish causation and materiality. The court first drew a distinction between the common law elements of materiality and reliance and concluded that the reason for the reliance requirement is to show that the defendant actually caused the plaintiff's injury.

Insofar as is pertinent here, the test of "reliance" is whether "the misrepresentation is a substantial factor in determining the course of conduct which results in the recipient's loss." The reason for this requirement, as explained by the authorities cited, is to certify that the conduct of the defendant actually caused the plaintiff's injury.¹⁸⁷

The test for materiality, on the other hand, is whether "a reasonable man would attach importance to the fact misrepresented in determining his choice of action in the transaction in question."¹⁸⁸ The *List* holding therefore retains the common law distinction between "reliance" and "materiality" in a 10b-5 action by substituting the individual plaintiff for the reasonable man.¹⁸⁹

In rejecting the idea that reliance should be discarded, the Second Circuit went on to say:

Assuredly, to abandon the requirement of reliance would be to facilitate outsiders' proof of insiders' fraud, and to that extent the

185. 340 F.2d 457 (2d Cir. 1965).

186. *Id.* at 463. See also *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 800 (E.D. Pa. 1947).

187. 340 F.2d at 462.

188. *Id.*

189. *Id.* at 463.

interpretation for which plaintiff contends might advance the purposes of Rule 10b-5. But this strikes us as an inadequate reason for reading out of the rule so basic an element of tort law as the principle of causation in fact.¹⁹⁰

The *List* test of reliance is still the most frequently cited authority for requiring reliance in nondisclosure actions, being held applicable in private damage actions based on nondisclosure in anonymous stock exchange transactions,¹⁹¹ and in direct-dealing non-disclosure cases.¹⁹²

There is, however, authority for dispensing with a reliance requirement in cases of nondisclosure. The Second Circuit, in *Vine v. Beneficial Finance Co.*¹⁹³ held:

Whatever need there may be to show reliance in other situations, we regard it as unnecessary in the limited instance when no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoer. Since the complaint alleges that plaintiff, in effect, has been forced to divest himself of his stock and thus is what defendants conspired to do, reliance by plaintiff on the claimed deception need not be shown. What must be shown is that there was deception which misled Class A stockholders and that this was in fact the cause of plaintiff's claimed injury.¹⁹⁴

In still another Second Circuit case, *Crane Co. v. Westinghouse Air Brake Co.*¹⁹⁵ the court cited the *List* test of reliance, followed by the exception forwarded in *Vine*, and summed up by saying, "reliance is an element of causation which plays little role in non-disclosure cases."¹⁹⁶

From the apparent confusion in the Second Circuit can it fairly be assumed that if a plaintiff in a nondisclosure case can prove a deception which caused his claimed injury, no reliance need be shown? Seemingly, *Vine* and *Crane* have altered *List*, and in the Second Circuit at least, the answer is yes.

190. *Id.*

191. *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333 (S.D.N.Y. 1969)

192. *Kohler v. Kohler Co.*, 208 F. Supp. 808, 823 (E.D. Pa. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963).

193. 374 F.2d 627 (2d Cir. 1967).

194. *Id.* at 635.

195. 419 F.2d 787 (2d Cir. 1969)

196. *Id.* at 797

Misrepresentation

Reliance is a less confused issue in cases of affirmative misrepresentation, particularly if the untrue statements come to the plaintiff's attention. This will occur in person-to-person or other direct transactions. But Professor Bromberg suggests that if the misstatement does not come to the plaintiff's attention, as in many open market trades, it is meaningless to demand reliance.¹⁹⁷ He also feels that such a demand would be unfair, since investors who trade with an eye on market conditions might be influenced by the misstatement even though he never hears it.¹⁹⁸

Other Theories

As an alternative to the *Crane* test of reliance,¹⁹⁹ there is some judicial recognition that reliance may be presumed from materiality.²⁰⁰ Bromberg characterizes this presumption as sensible, since once materiality is proved, the reasonably prudent investor can be expected to rely.²⁰¹ The corporate relationship has also been found to support a presumption of reliance when the plaintiff is a stockholder suing the corporation or its directors.²⁰²

Proof of Reliance

Cases involving affirmative misrepresentation are particularly susceptible to a production of empty pleading and plaintiff's testimony that "I relied."²⁰³ In any type of case, however, evidence of plaintiff's conduct is admissible to show that he did not rely.²⁰⁴ Bromberg suggests that

197. A. BROMBERG, *supra* note 3, § 8.6(2).

198. *Id.*

199. The *Crane* court held that reliance is an element of causation. 419 F.2d at 797

200. See *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); A. BROMBERG, *supra* note 3, § 8.6(2).

201. A. BROMBERG, *supra* note 3, § 8.6(2)

202. *Voege v. American Sumatra Tobacco Co.*, 241 F. Supp. 369, 375 (D. Del. 1965).

203. See *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966), *rev'g* 250 F. Supp. 112 (D. Mass. 1966). The trial court held plaintiff had failed to prove reliance and materiality and granted summary judgment for defendants. Although it was concerned about plaintiff's possible lack of reliance, the court of appeals reversed.

204. For misrepresentation cases, see, e.g., *Mutual Shares Corp. v. Genesco, Inc.*, 266 F. Supp. 130, 133 (S.D.N.Y. 1967); *Nicewarner v. Bleavins*, 244 F. Supp. 261, 264 (D. Colo. 1965); *Nash v. J. Arthur Warner & Co., Inc.*, 137 F. Supp. 615 (D. Mass. 1955); *Carr v. Warner*, 137 F. Supp. 611 (D. Mass. 1955). For cases involving nondisclosure, see, e.g., *Kohler v. Kohler Co.*, 208 F. Supp. 808. (E.D. Pa. 1962), *aff'd*, 319

materiality and other factors provide standards against which the reasonableness of plaintiff's reliance may be measured.²⁰⁵

New Decisions Considering Reliance

Several recent decisions in 10b-5 cases have attempted to create some order out of the muddled waters of reliance. In *Kaban v. Rosenstiel*,²⁰⁶ the Third Circuit held that "[p]roof of reliance is not an independent element which must be alleged to establish a cause of action."²⁰⁷ The court noted the language in *Mills v. Electric Auto-Lite Company*,²⁰⁸ a section 14(a) suit, wherein the Supreme Court held that reliance on false or misleading proxy statements is not required in order to maintain a 14(b) cause of action.²⁰⁹ One of the primary reasons for the Supreme Court's holding was their belief that "[p]roof of actual reliance by thousands of individuals would not be feasible and reliance on the nondisclosure of a fact is a particularly difficult matter to define or prove.

"²¹⁰ [Emphasis supplied.]

The import of the *Kaban* opinion takes on added significance in light of the recent Second Circuit opinion in *Chasins v. Smuth, Barney and Company*.²¹¹ There, the court of appeals gave increased support to its holding in *Crane*²¹² that reliance is an element of causation with little

F.2d 634 (7th Cir. 1963); *Connelly v. Balkwell*, 174 F Supp. 49 (N.D. Ohio 1959), *aff'd per curiam*, 279 F.2d 685 (6th Cir. 1960).

205. A. BROMBERG, *supra* note 3, § 8.6(2). But see Note, *supra* note 182, at 688-89 and Note, *supra* note 67, at 841-44, which argue that in cases involving negligent misstatements, the plaintiff's reliance must be justifiable.

206. 424 F.2d 161 (3d Cir. 1970).

207. *Id.* at 173.

208. 396 U.S. 375 (1970).

209. Justice Harlan wrote for the majority in *Mills*:

Where the misstatement or omission in a proxy statement has been shown to be "material," as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote. This requirement that the defect have a significant propensity to affect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).

396 U.S. at 384.

210. 396 U.S. at 380, *citing* the Seventh Circuit at 403 F.2d 429, 436 n.10.

211. 438 F.2d 1167 (2d Cir. 1970).

212. 419 F.2d 787 (2d Cir. 1969).

role to play in nondisclosure cases. *Chasins* involved nondisclosure by a broker-dealer of his position as market maker to a purchaser of stock at the time of sale. The court held that the question was not whether the defendant sold to plaintiff at a fair price, but whether nondisclosure of defendant's market maker status might have influenced plaintiff's decision to buy the stock. The court found that a market maker position was a material fact which should have been disclosed; that plaintiff relied on defendant's advice without disclosure of the material fact; that plaintiff purchased the stock and suffered a loss on resale; and that "[c]ausation in fact or adequate reliance was sufficiently shown by *Chasins*."²¹³ The test of reliance used by the court in *Crane* was the basis for the test used in *Chasins*: "To the extent that reliance is necessary for a finding of a 10b-5 violation in a nondisclosure case such as this, the test is properly one of tort 'causation in fact.'"²¹⁴

In *Gordon v. Lipoff*,²¹⁵ the district court noted that the Eighth Circuit follows the *List* test in requiring both reliance and causation in a section 10(b)—Rule 10b-5 action.²¹⁶ The court cited with approval the recent holding in the Tenth Circuit case of *Reynos v. United States*.²¹⁷ In *Reynos*, the court of appeals agreed with the district court's ruling that the defendants failed to disclose material facts, but reversed because

[I]n the case before us the facts of misrepresentation have been shown as to several of the transactions. The record, however, does not contain any evidence relating to reliance by the plaintiffs on the representations of the defendants Gale and Haslem. This is a necessary element of the cause alleged.²¹⁸

The Maryland district court confronted the reliance problem in *Johns Hopkins University v. Hutton*,²¹⁹ and noted Judge Winter's decree in *Baumel v. Rosen*,²²⁰ that "most of the authorities require *some* reliance by the plaintiff upon the data that was furnished."²²¹ The court went on to consider the discussions of reliance contained in *List*, *Crane*, *Mills*,

213. 438 F.2d at 1172.

214. *Id.*, citing *Crane v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969).

215. 320 F. Supp. 905 (W.D. Mo. 1970).

216. *Id.* at 921.

217. 431 F.2d 1337 (10th Cir. 1970).

218. *Id.* at 1348.

219. 326 F. Supp. 250 (D. Md. 1971).

220. 283 F. Supp. 128 (D. Md. 1968).

221. *Id.* at 140 [Emphasis supplied].

and *Rosenstiel*, and the contention that *Mills* and *Rosenstiel* have dispensed with the need to prove reliance in a 10(b) case where materiality and causation are present. Unfortunately, the court failed to reach this argument, since it found all three elements present and determined that the reliance shown exceeded Judge Winter's degree of "some."²²²

Conclusion

Since the Second Circuit's decision in *List v. Fashion Park, Inc.*, the requirement of reliance has undergone a steady transformation, particularly within that circuit. In *List*, reliance was held to be distinct from materiality and necessary to prove causation. However, since the court's holding in *Vine*, *Crane*, and *Chasins*, reliance is presumed if causation is present, at least in nondisclosure cases.

To add to the confusion, the First Circuit will presume reliance if materiality is proved;²²³ the Third Circuit seems to have expressly discarded reliance in nondisclosure situations; but the Seventh, Eighth, and Tenth Circuits still adhere to the *List* test.

In light of the courts' liberal application of section 10(b) and Rule 10b-5 in securities fraud cases, and the apparent unwillingness to limit the scope of the section and Rule beyond what is absolutely necessary to prevent frivolous suits, it is safe to conclude that in non-disclosure cases reliance is no longer an element which must be alleged and proved in and of itself. In such cases a showing of causation or materiality or both will suffice to defeat a motion to dismiss and get the case to the jury. However, courts will probably still require at least some allegation that plaintiff relied on defendant's statements in cases involving affirmative misrepresentations in direct, person-to-person transactions.

CAUSATION

The rather flexible approach taken by courts in dealing with the reliance requirement extends also to the judicial treatment of causation. As with reliance, there is no language in Rule 10b-5 demanding proof of causation, unless such is gleaned from the "in connection with" phrase. Causation becomes even more inscrutable when it is realized

222. "In this case, materiality and causation, and reliance in and of itself are independently established by the undisputed facts insofar as the two 10b-5 counts are concerned." 326 F Supp. at 260.

223. See *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1969); A. BROMBERG, *supra* note 3, § 8.6(2)

that very few courts have discussed this element in any detail, quite possibly because it has been difficult to evaluate what the law is or what it should be in this area.

It is logical and reasonable to condition private recovery under 10b-5 upon some causal relation between defendant's misconduct and plaintiff's injury, and indeed, courts have so held.²²⁴ Professor Bromberg traces the hazy origins of the requirement²²⁵ from the pronouncements that 10b-5 was not promulgated as a scheme of investor's insurance,²²⁶ to the language of section 28(a) of the 1934 Securities Exchange Act: "[N]o person permitted to maintain a suit for damages under the provisions of this Act shall recover a total amount in excess of his actual damages on account of the act complained of."²²⁷ The concept of proximate cause is so essential to general tort law that courts have also frequently grounded recovery in 10b-5 suits upon a showing of that factor.²²⁸

In view of the indefinite origins from which the causation requirement springs, it is not surprising that the same blending and shading which confuses reliance also obscures causation. Thus, causation is sometimes merged into reliance,²²⁹ materiality,²³⁰ or privity,²³¹ while other times it is considered a necessary element in and of itself.²³² The result

224. See, e.g., *Trussell v. United Underwriters, Ltd.*, 228 F Supp. 757, 771 (D. Colo. 1964); *Rogers v. Crown Stove Works*, 236 F Supp. 572 (N.D. Ill. 1964) (while no express mention of causation was made, the court denied relief to a plaintiff whose loss was not caused in any substantial way by a 10b-5 violation). Compare *W. Prosser, HANDBOOK OF THE LAW OF TORTS* § 41 (3d ed. 1964) with the language in *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965), regarding "so basic an element of tort law as the principle of causation in fact."

225. A. BROMBERG, *supra* note 3, § 8.7(1).

226. *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965); *Barnett v. Anaconda Co.*, 238 F Supp. 766 (S.D.N.Y. 1965).

227. Section 32 does not apply in non-damage actions, but probably is applicable in all implied actions.

228. See, e.g., *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (2d Cir. 1969); *Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967).

229. This was the premise in *List v. Fashion Park, Inc.*, wherein the court said the reason for requiring reliance is to certify that defendant's actions actually caused plaintiff's loss. 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965).

230. A. BROMBERG, *supra* note 3, § 8.7(1).

231. See, e.g., *Joseph v. Farnsworth Radio and Television Corp.*, 99 F Supp. 701, 706-07 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952).

232. See, e.g., *Globus, Inc. v. Jaroff*, 266 F Supp. 524, 530-31 (S.D.N.Y. 1967); *Laurenzano v. Einbender*, 264 F Supp. 356, 360-62 (E.D.N.Y. 1966); *Eagle v. Horvath*, 241 F Supp. 341 (S.D.N.Y. 1965); *Hoover v. Allen*, 241 F. Supp. 213, 231 (S.D.N.Y. 1965); *Barnett v. Anaconda Co.*, 238 F Supp. 766 (S.D.N.Y. 1965).

is that it is not clear at all how proximate the causation must be,²³³ or whether proximate cause is even required any more.²³⁴ In addition, Bromberg notes that courts have adopted a "but for" test of causation in various cases which may be extended to other factual situations.²³⁵

Cases Discussing Causation

One of the first cases to come to grips with the causation question was *Barnett v. Anaconda Co.*,²³⁶ in which a minority shareholder brought suit on behalf of the corporation for damages resulting from a sale of shares by the corporation for a price allegedly below fair market value. The plaintiff alleged fraudulent and deceptive omissions in the notice of the shareholders' meeting at which the transaction was to be approved. No allegation was made in support of a causal connection between the alleged fraud and the later ratification of the agreement. The *Barnett* decision involved both sections 14(a) and 10(b) of the Securities Exchange Act. With respect to section 14(a) the necessity for causation was strictly construed: "[P]revious decisions under 14(a) emphasize the necessity for causation—that is to say, that the alleged violation of that section of the statute resulted in the damage claimed."²³⁷ However, the requirement for 10b-5 suits was held to be only "some causal relationship to the damage complained of."²³⁸ The court in *Bar-*

233. The court did not consider this issue in *Barnett v. Anaconda Co.*, 238 F. Supp. 766 (S.D.N.Y. 1965), but referred to the language in *Smith v. Bear*, 237 F.2d 79, 88 (2d Cir. 1956), that a violation permits the injured party to recover "any loss proximately resulting therefrom." *Laurenzano v. Einbender*, 264 F. Supp. 356, 360-62 (E.D.N.Y. 1966), frames the test in the less severe term "transactional function."

234. See notes 236-64 *infra*.

235. A. BROMBERG, *supra* note 3, § 8.7(1) See also *Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967). In *Voege v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369, 375-76 (D. Del. 1965), the court said:

In *Barnett* relief under Rule 10b-5 was denied because the plaintiff failed to show a causal relationship between the fraud alleged and the injury claimed. The present Complaint discloses no such infirmity. The frauds alleged [e.g., nondisclosure of true value factors in a tender offer aggregating enough stock to permit a short form merger in which minority shareholders would receive cash] culminated in the merger under which plaintiff became obligated to sell her stock at \$17 per share, when, according to the Complaint, it was worth substantially more. This would not have occurred in the absence of the frauds.

For a case which rejected on public policy grounds the requirement that causation be proved, see *Weber v. Bartle*, 272 F. Supp. 201 (S.D.N.Y. 1967).

236. 238 F. Supp. 766 (S.D.N.Y. 1965).

237. *Id.* at 772.

238. *Id.* at 775 [Emphasis supplied].

nett expressly refused to decide whether the causal connection required must rise to the level of proximate causation,²³⁹ since no causal connection whatsoever had been alleged.²⁴⁰

In 1967, the same court that decided *Barnett* again considered the causation problem in *Globus v. Jaroff*,²⁴¹ where it was alleged that stockholder approval of a transaction, necessary under state law, would not have been given but for misleading proxy statements. The court reaffirmed its language in *Barnett*,²⁴² and stated in connection with the allegations of the complaint:

Specifically, the plaintiff alleges that the issued and outstanding shares would not have been obtainable without the proxies procured through use of the allegedly defective notice and that a majority of the stockholders would not have ratified the stock option if they had knowledge of the omissions in the notice. Such express and potentially provable allegations of causality are surely sufficient to avoid dismissal.²⁴³

The court went on to suggest that even lesser allegations might sustain a 10b-5 action: "This court will not, however, go so far as to say that such allegations are necessary, nor that allegations of some lesser or minimal causal nexus would not be sufficient."²⁴⁴

In *Swanson v. American Consumer Industries, Inc.*,²⁴⁵ the Seventh Circuit rejected the contention that the *Barnett* causation test for a 14(a) suit should be applied in a 10b-5 action. The court held that *Barnett* was decided mainly on 14(a) grounds and was concerned with "but for" causation. Citing *SEC v. National Securities, Inc.*,²⁴⁶ Judge Cummings stated:

239. *Id.*

240. *Id.*

241. 266 F Supp. 524 (S.D.N.Y. 1967).

242. *Id.* at 530-31.

243. *Id.* at 530.

244. *Id.* In *Smith v. Muchison*, 310 F Supp. 1079, 1084 (S.D.N.Y. 1970), the court stated:

In order to state a claim under Rule 10b-5, however, it must appear not only that a purchase or sale took place, but that there was a loss and that the loss flowed directly from the purchase or sale.

See also *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 300 F. Supp. 1083 (S.D.N.Y. 1969); *Cohen v. Colvin*, 266 F Supp. 677 (S.D.N.Y. 1967); *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965).

245. 415 F.2d 1326 (7th Cir. 1969).

246. 393 U.S. 453 (1969).

"The gravamen of the complaint was the misrepresentation, not the merger." Thus, unlike Section 14 cases, we are not concerned primarily with whether the merger or sale of assets could have been affected absent the deceptive statements, but rather with injury to shareholders or to the corporations which results from the use of deceptive devices proscribed by Rule 10b-5. To apply the *Barnett* rationale to the present claim under Section 10(b) and Rule 10b-5 would be to sanction all manner of fraud and over-reaching in the fortuitous circumstance that a controlling shareholder exists.²⁴⁷

The *Swanson* court was apparently loath to apply any strict construction upon the causation requirement in a 10(b) complaint, but no discussion as to what degree of causal nexus will suffice was offered.

The Second Circuit confronted the causation issue in a short form merger situation in *Vine v. Beneficial Finance Company*,²⁴⁸ and held that "[w]hat must be shown is that there was deception which misled stockholders and that this was in fact the cause of plaintiff's claimed injury" ²⁴⁹

A later Second Circuit decision, *Globus v. Law Research Service, Inc.*,²⁵⁰ reinforced the *Vine* holding and firmly committed the circuit to a proximate cause test. The appellate opinion quoted with approval Judge Mansfield's trial court instructions to the jury:

[T]he plaintiff is required to prove by a fair preponderance of the evidence that he or she suffered damages as a proximate result of the alleged misleading statements and purchase of stock in reliance on them. In other words, the plaintiff must show that the misleading statement or omission played a substantial part in bringing about or causing the damage suffered by him or her and that the damage was either a direct result or a reasonably foreseeable result of the misleading statement.²⁵¹

The court went on to say that "[t]he instructions were sufficient to bring home the basic concept that causation must be proved else defendants could be liable to the whole world." ²⁵²

247. 415 F.2d at 1331.

248. 374 F.2d 627 (2d Cir. 1967).

249. *Id.* at 634-35.

250. 418 F.2d 1276 (2d Cir. 1969).

251. *Id.* at 1291.

252. See also *Mutual Shares Corp. v. Genesco Inc.*, 384 F.2d 540, 544 (2d Cir. 1967);

The *Globus* case seemed to leave no doubt that the Second Circuit considered proximate cause to be the proper standard in a 10b-5 case, but proximate cause took a giant step backwards in two recent district court cases. In *Chasms v. Smith, Barney and Company*,²⁵³ the court did not require that the loss be proximately caused by defendant's 10b-5 violation, but rather that defendant be shown to have engaged in activity in violation of the Rule, that plaintiff be shown to have relied upon such violation, and that loss be shown ultimately to result therefrom.²⁵⁴

Since the *Chasms* court either attached no importance to reliance in nondisclosure cases, or presumed it from materiality, the case seems to stand for a test of tort causation in fact where the nondisclosure results in a loss to the plaintiff. Certainly it is apparent that nothing resembling proximate cause is any longer necessary in private 10b-5 actions. The Second Circuit impliedly approved of this new causation test by not discussing causation at all in affirming the trial court's decision.²⁵⁵ Thus, the circuit seems to have abandoned its proximate cause standard enunciated in *Vine* and *Globus* and has shifted toward causation in fact, while at the same time substantially discarding any foreseeability requirement.²⁵⁶

The *Chasms* decision received considerable support in a California district court case, *Robinson v. Cupples Container Company*.²⁵⁷ Stating that *Chasms* has cleared away a great deal of the confusion surrounding the treatment of "causal nexus" in 10b-5 cases, the court declared, "it is clear that the 'causation' required is simply that the action on defendant's part, which is alleged to have violated Rule 10b-5, must have been relied upon by plaintiff when he entered the transaction."²⁵⁸ To squelch any doubt as to the test of causation it was using, the court held "that the 'causation in fact' required in Rule 10b-5 cases has been sufficiently alleged in this action to allow the complaint to withstand a

Vine v. Beneficial Finance Co., 374 F.2d 627, 635 (2d Cir. 1967); *Barnett v. Anaconda Co.*, 238 F Supp. 766, 776 (S.D.N.Y. 1965); 6 L. Loss, *supra* note 3, at 3880-81.

253. 305 F. Supp. 489 (S.D.N.Y. 1969), *aff'd*, 438 F.2d 1167 (2d Cir. 1970).

254. 305 F Supp. at 495-96.

255. 438 F.2d 1167 (2d Cir. 1970).

256. Defendant's argument that it should not be held liable because it had relied on customary industry practice was rejected by the *Chasms* court, suggesting that any test of foreseeability was also rejected.

257. 316 F Supp. 1362 (N.D. Cal. 1970).

258. *Id.* at 1366.

motion to dismiss.”²⁵⁹ In reaching this test, the court first examined the concept of “causal nexus” in 10b-5 cases in which causation was crucial,²⁶⁰ and concluded that the precedent in this area was very unclear.

In contrast to the shifting of position which has characterized the courts’ stance on causation in damage actions under 10b-5, courts are more uniformly aligned on the issue in claims for injunctive relief. The Second Circuit faced such a case in *Mutual Shares Corporation v. Genesco Co.*²⁶¹ wherein plaintiffs alleged the defendant insiders manipulated the market price of a corporation’s stock by keeping dividends paid on the stock to a minimum in order to acquire the stock from minority shareholders at depressed prices. These allegations were held to be sufficient to state a 10b-5 claim since injunctive relief rather than monetary damages was sought. The court noted that while the above allegations would not support a claim for damages because of the lack of causal connection, claims for injunctive relief avoid the strict causal relationship which must be shown in private damage actions.²⁶²

The watered-down approach to causation expressed in *Genesco* was explicitly followed by the Sixth Circuit in *Britt v. Cyril Bath Company*,²⁶³ another case involving a claim for injunctive relief:

We choose to follow the relaxed causation-reliance approach of the Second Circuit, particularly in this case involving a claim for injunctive relief against an alleged violation consisting primarily of nondisclosure of facts material to the price of the company’s stock.²⁶⁴

Taken together, *Genesco* and *Britt* point out a trend toward extending a rather relaxed causation requirement to a plaintiff seeking injunctive or prophylactic relief, a trend which could influence a plaintiff to abandon his claim for damages if it appears he may have trouble proving a causal connection between defendant’s actions and his loss.

259. *Id.*

260. *Id.* at 1365, discussing *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); *Smith v. Murchison*, 310 F Supp. 1079 (S.D.N.Y. 1970); *Bound Brook Water Co. v. Jaffe*, 284 F Supp. 702 (D.N.J. 1968); *Barnett v. Anaconda Co.*, 238 F Supp. 766 (S.D.N.Y. 1965). See also the cases listed in 6 L. Loss, *supra* note 3, at 3887

261. 384 F.2d 540 (2d Cir. 1967).

262. *Id.* at 547

263. 417 F.2d 433 (6th Cir. 1969).

264. *Id.* at 436.

Conclusion

It appears that causation, long one of the most nebulous elements involved in 10b-5 litigation, has entered a period of relative stability. In damage actions, *Chasms* and *Robinson* indicate that the tort concept of proximate cause has been discarded in favor of a less rigid requirement of causation in fact. In actions for injunctive relief, *Genesco* and *Brutt* suggest that the requirement of allegations of causation may have been so relaxed as to be almost completely discarded, or at least substantially diminished. Certainly such relative unanimity behind such an important element of a 10b-5 action cannot help but strengthen the Rule's status as an all-inclusive anti-fraud statute.

JURISDICTIONAL MEANS—VENUE—SERVICE OF PROCESS

Jurisdictional Means

In order to establish a valid claim under Rule 10b-5, one of the three jurisdictional means requirements must be satisfied. Both section 10(b)²⁶⁵ and Rule 10b-5²⁶⁶ provide:

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 any facility of any national securities exchange [to carry out the proscribed conduct of Rule 10b-5].²⁶⁷

The majority of courts hold that the misleading statement need not be transmitted through the jurisdictional means.²⁶⁸ It is necessary to show only that the transaction involved the use "of" interstate commerce means, the mails, or the facilities of a national stock exchange.²⁶⁹

265. 15 U.S.C. § 78j(b) (1970).

266. 17 C.F.R. § 240.10b-5 (1971).

267. *Id.*

268. *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965) (mails used to introduce plaintiff and defendant); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961) (defendant's transportation of stock certificate on commercial aircraft after sale); *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956) (interstate teletype involving sale of securities and land); *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953) (use of mails to instruct defendant's bank concerning delivery of stock); *Contra*, *Kemper v. Lohnes*, 173 F.2d 44 (7th Cir. 1949).

269. The majority of courts have reached the same result concerning section 12(2) of the 1933 Act which contains basically the same jurisdictional language as 10b-5. Section 5 as incorporated into section 12(1), however, prohibits certain conduct "in" interstate commerce. *United States v. Robertson*, 181 F. Supp. 158 (S.D.N.Y. 1959). The use of "in" is construed to indicate Congressional intent that the misleading statement be transmitted through an avenue of interstate commerce.

In *Myzel v. Fields*,²⁷⁰ the Eighth Circuit probably reached the most liberal extension of federal jurisdiction, finding an intrastate telephone call sufficient because the same lines were used in other situations to carry interstate messages.

Venue—Service of Process

Venue and service of process for all claims under the 1934 Act are regulated by section 27²⁷¹ which provides:

Any suit or action to enforce any liability or duty created by this [Act] or rules and regulations thereunder, or enjoin any violation may be brought in any such district, or in the district where the defendant is found, or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.²⁷²

Suit may therefore be brought in any jurisdiction where the violation takes place, where the defendant may be found, where the defendant transacts business, or where the defendant resides. Bromberg notes that the courts have generally construed venue requirements liberally in determining whether an act within the forum district constituted the violation.²⁷³

Service of process establishing personal jurisdiction is permitted wherever the defendant resides or wherever he can be found.²⁷⁴

PRIVITY

One of the first cases to address the question of privity as an element in a 10b-5 cause of action was *Joseph v. Farnsworth Radio & Television Corp.*²⁷⁵ Therein, it was alleged by the plaintiff purchasers of stock, who were also suing derivatively, that the directors and officers of the defendant corporation had intentionally issued false and misleading financial statements simultaneously with their own sales of the corporation's shares. As a result of the misrepresentations, defendants were able to

270. 386 F.2d 718 (8th Cir. 1967).

271. 15 U.S.C. § 7899 (1970).

272. *Id.*

273. A. BROMBERG, *supra* note 3, § 11.4.

274. *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965).

275. *Joseph v. Farnsworth Radio & Television Corp.*, 198 F.2d 883 (2d Cir. 1952).

sell their stock at an inflated price. Thus, plaintiffs suffered loss by purchasing the stock based on inaccurate information and later sold at a lower price due to a market decline. The lower court²⁷⁶ dismissed the derivative suit and, in dealing with the plaintiff's claims as individuals, concluded:

A semblance of privity between the vendor and purchaser of the security in connection with which the improper act, practice, or course of business was involved seems to be requisite and it is entirely lacking here.²⁷⁷

This decision was affirmed,²⁷⁸ but Judge Frank, in a strong dissent,²⁷⁹ pointed out that since the purpose of the Act was to curtail fraud in security transactions, it would seem illogical to require privity since even at common law privity of contract was not necessary in an action for fraud. Although *Joseph* has been followed,²⁸⁰ its validity as precedent has been completely eroded in later decisions.²⁸¹ Foremost among these is *Miller v. Bargain City, U.S.A., Inc.*²⁸² with facts similar to those in *Joseph*. Judge Lord reasoned that since the private right of action under the securities laws derives from common law tort concepts which impose liability for violating a statute designed to prevent certain types of injury, it would seem that the requirement of privity would be an "unwarranted constriction" on the broadness envisioned by the federal securities laws.²⁸³ Similarly, the Second Circuit has discredited the *Joseph* case.²⁸⁴ In *Iroquois Industries, Inc. v. Syracuse Chma Corp.*²⁸⁵ the court in discussing two other decisions,²⁸⁶ concluded that "for a claim under Rule 10b-5 the purchase or sale need not be between plaintiff and

276. *Joseph v. Farnsworth Radio & Television Corp.*, 99 F. Supp. 701 (S.D.N.Y. 1951).

277. *Id.* at 706.

278. 198 F.2d 883 (2d Cir. 1952).

279. *Id.* at 884.

280. *See, e.g., Donovan, Inc. v. Taylor*, 136 F. Supp. 552 (N.D. Cal. 1955).

281. *See Gann v. Berzomatic Corp.*, 262 F. Supp. 301 (S.D.N.Y. 1966); *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962).

282. 229 F. Supp. 33 (E.D. Pa. 1964).

283. *Id.* at 37.

284. Other cases simply ignored *Joseph*. *See Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962); *Cooper v. North Jersey Trust Co.*, 226 F. Supp. 972, 978 (S.D.N.Y. 1964); *Cochran v. Channing Corp.*, 211 F. Supp. 239, 243-45 (S.D.N.Y. 1962).

285. 417 F.2d 963 (2d Cir. 1969).

286. Here the court was discussing *Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967) and *A.T. Brod and Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967).

defendant, [and] that there need not be privity between plaintiff and defendant.”²⁸⁷ Thus, the question of privity as an element in a 10b-5 action is moot.

DEFENDANT'S STATUS AS A PURCHASER OR SELLER

In addition to the privity issue the question remains, must the *defendant* be a purchaser or seller of securities in order for the *plaintiff* to recover damages in a 10b-5 action? In situations where the plaintiff alleges reliance on the defendant's false or misleading statements, the *Miller* court has held sufficient plaintiff's claims that defendant's fraud was related to plaintiff's purchase or sale²⁸⁸—indicating that a purchase or sale by the defendant is not necessary. Other courts have reached opposite results.²⁸⁹ However, recent decisions seem unconcerned with defendant's status as a purchaser or seller. In fact it seems well settled that any disseminator of false information can be held liable—as in the *Texas Gulf Sulphur* case.²⁹⁰ The principal inquiry since the Second Circuit decided *Texas Gulf*²⁹¹ has shifted from an examination of the defendant as a purchaser or seller to the question of whether plaintiff must be a purchaser or seller to maintain a 10b-5 action. The view of determining plaintiff's status as a purchaser or seller has come to be known as the *Birnbaum* doctrine in dubious honor of the 1952 decision of the Second Circuit imposing this seemingly arbitrary burden on would-be plaintiffs.²⁹²

PLAINTIFF'S STATUS AS A PURCHASER OR SELLER

In affirming a motion to dismiss pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, the Court of Appeals for the Second Circuit rendered one of the landmark decisions in the field of federal

287. 417 F.2d 963, 968 (2d Cir. 1969). See also 3 L. Loss, *supra* note 3, at 1767-71.

288. 229 F Supp. 33 (E.D. Pa. 1964).

289. *Mooney v. Vitolo*, CCH FED. SEC. L. REP. ¶ 92,116 (S.D.N.Y. 1967); *Howard v. Levine*, 262 F Supp. 643 (S.D.N.Y. 1965).

290. *Carroll v. First National Bank of Lincolnwood*, 413 F.2d 353 (7th Cir. 1969). The court states that the “in connection with” language of the statute is sufficient even though the bank “may have neither bought nor sold for its own account.” 413 F.2d 353, 357. See also *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969) where the court held there was no requirement that defendants trade in securities.

291. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 883 (2d Cir. 1968).

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

securities regulation—*Birnbaum v. Newport Steel Corporation*.²⁹³ After acknowledging that Rule 10b-5 “may have been somewhat loosely drawn,”²⁹⁴ the court concluded:

- (1) that Section 10(b) was directed solely at that type of misrepresentation or fraudulent practice *usually associated* with the purchase or sale of securities,
- (2) that it extended protection only to the defrauded purchaser or seller, and
- (3) that it was not intended to provide a remedy for fraudulent mismanagement of corporate affairs.

Thus, under the initial *Birnbaum* construction of 10b-5, the courts examined the character of the alleged fraud, determined whether it was of the type *usually associated* with the purchase or sale of securities rather than with fraudulent corporate mismanagement, and then allowed a plaintiff to proceed only after a showing that he was a purchaser or seller of a security

In 1960, *Birnbaum's* first holding received a serious blow from the Fifth Circuit in *Hooper v. Mountain States Securities Corp.*²⁹⁵ Therein the court granted recovery to an issuer of stock whose shares were fraudulently acquired in a rather unique transaction—the corporation netted no consideration whatsoever for its shares. More recently, as a result of *A. T. Brod v. Perlow*,²⁹⁶ which was followed by the Supreme Court in *Superintendent of Insurance v. Bankers Life and Casualty Co.*,²⁹⁷ it has now become apparent that the “usually associated with” limitation of *Birnbaum* has finally been put to rest. A portion of the *Brod* opinion is indicative of this fact:

We believe that 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities

293. *Id.*

294. *Id.* at 463. Judge Augustus N. Hand remarked “[w]hile the Rule may have been somewhat loosely drawn its meaning and scope are not difficult to ascertain when reference is had to the scheme of SEC Regulation and the purpose underlying the adoption of X-10B-5.” Judge Hand continued that the only purpose of the Rule was to make the “prohibitions of Section 17(a) of the 1933 Act applicable to purchasers as well as sellers.” *Id.*

295. 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

296. 375 F.2d 393 (2d Cir. 1967).

297. 92 S.Ct. 165 (1971).

whether the artifices employed involved a garden type variety of fraud, or present a unique form of deception. [The use of] novel or atypical methods should not provide immunity²⁹⁸

Nevertheless, the other *Birnbaum* holdings, that 10b-5 cannot remedy corporate mismanagement and that the plaintiff must be a purchaser or seller of a security, continue in varying degrees to restrict the availability of federal relief.²⁹⁹

However, before embarking on a discussion of the continued vitality of the two remaining prongs of *Birnbaum*, it is helpful to review the definitions of "purchase" and "sale" and also the distinction which has developed between the elements necessary to support claims for equitable, as opposed to legal, relief.

What Constitutes a "Purchase" or "Sale"?

The proscribed activities under Rule 10b-5 are actionable only when they are perpetrated "in connection with the purchase or sale of any security"³⁰⁰ Perhaps to avoid the harshness of the *Birnbaum* purchaser-seller requirement, the courts have expressed almost no hesitation³⁰¹ in construing the definitional provisions of the 1934 Act in a broad fashion.

Section 3(a)(13) provides that "[t]he terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire." [Emphasis supplied]³⁰² Similarly, section 3(a)(14) states that "[t]he terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." [Emphasis supplied]³⁰³ It was observed by Judge Schnackenberg, in *Dasbo v. Susquehanna Corp.*,³⁰⁴ that the breadth of these definitional sections clearly indicates a Congressional intent that their scope be much

298. 375 F.2d at 397

299. See generally Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1147 (1965); Lowenfels, *Rule 10b-5 and the Stockholder's Derivative Action*, 18 VAND. L. REV. 893 (1965); Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW U.L. REV. 185 (1964); Susman, *Use of Rule 10b-5 as a Remedy for Minority Shareholders of Close Corporations*, 22 BUS. LAW 1193 (1967).

300. See note 22 *supra*.

301. For cases which have hesitated, see, e.g., *Cohen v. Colvin*, 266 F Supp. 677 (S.D.N.Y. 1967); *Kremer v. Selheimer*, 215 F Supp. 549 (E.D. Pa. 1963).

302. 15 U.S.C. § 78c(13) (1970).

303. 15 U.S.C. § 78c(14) (1970).

304. 380 F.2d 262 (7th Cir. 1967).

larger than the traditional common law connotation of a purchase or sale.³⁰⁵

In *M. L. Lee & Co. v. American Cardboard and Packaging Corp.*,³⁰⁶ the court was confronted with a situation in which an issuer and an underwriter made a binding contract for the purchase of the corporation's shares for resale to the public. Because of a drop in the market, the sale was never consummated. In denying a motion for judgment on the pleadings, the court looked to section 3 in holding that the defrauded plaintiff had a viable 10b-5 claim where the alleged fraud was in connection with a *contract* to purchase or sell securities, even though the actual sale was never completed.³⁰⁷

It was also observed in the *Vine* decision that the word "includes" in each section is a key indication that the definitions were not meant to be exhaustive of all possible types of situations which Congress intended to be covered.³⁰⁸ Other language similarly emphasizes the breadth of this section.³⁰⁹ In *Hooper v. Mountain States Securities Corp.*³¹⁰ the court held that the "otherwise dispose[d] of" language in section 3(a) (14) was broad enough to encompass the issuance of securities.³¹¹

On the other hand, the mechanical approach to the scope of 10(b) has been criticized. In *SEC v. National Securities, Inc.*,³¹² the Court

305. *Id.* at 266.

306. 36 F.R.D. 27 (E.D. Pa. 1964).

307. See also *Allico Nat. Corp. v. Amalgam. Meat Cutters & Butcher Workmen of North America*, 397 F.2d 727 (7th Cir. 1968) (fraudulent breach of contract to sell securities held actionable under 10b-5).

308. In *Vine v. Beneficial Finance Company, Inc.*, 374 F.2d 627 (2d Cir. 1967), the court stressed that Congress selected the verb "includes" rather than the verb "means" for these critical definitions. It went on to remark that "the phrases 'or otherwise acquire' and 'or otherwise dispose of' are hardly limiting." *Id.* at 634.

309. The original Senate bill (S.2693) took an even more expansive approach to the purchase-sale definitions. In part, it provided:

11. The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire, contract of purchase, attempt or offer to acquire or solicitation of an offer to sell a security or any interest in a security

12. The terms "sale" and "sell" each include any contract of sale or disposition of, contract to sell or dispose of, attempt or offer to dispose of, or solicitation of an offer to buy a security or any interest therein.

78 Cong. Rec. 2264 (1934). At some later point in its travels, the "attempt or offer" language was apparently deleted by Congress.

310. *Hooper v. Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1960).

311. *Id.* at 202.

312. 393 U.S. 453 (1968).

indicated that the definitional sections were basically "unhelpful." Justice Marshall felt that the policy question—whether or not the alleged conduct was of a type meant to be prohibited—should be the main inquiry³¹³ Further, sections 3(a)(13) and 3(a)(14) themselves are qualified by the prefatory phrase "unless the context otherwise requires." This dictates that the definitions not be applied in a rigid or restrictive manner and further emphasizes the need for inquiry into the purposes of section 10.³¹⁴

Equipped with these broad definitional tools, the *Birnbaum* requirement of a purchase or sale would not appear to limit severely standing to sue under 10b-5. However, by deciding that an injured party must himself be a purchaser or seller, the *Birnbaum* court would close the door to many prospective plaintiffs.

The inroads made available by the definitional arguments do mitigate the harshness of the purchaser-seller rule. But they are not solely responsible for the expansive trend in the 10b-5 area. Another equally important factor has been the more lenient attitudes of the federal courts in cases where the plaintiff seeks equitable relief under 10b-5

Equitable Relief

Although the plaintiffs in the *Birnbaum* case were seeking damages, the purchaser-seller requirement was not initially confined to damage actions but was also extended to claims for equitable relief.³¹⁵ Beginning with *SEC v. Capital Gains Research Bureau, Inc.*,³¹⁶ which was decided by the Supreme Court, a number of courts have held that in equity all of the elements required in a suit for monetary damages need not be proved or alleged by the plaintiffs. In *Mutual Shares Corp. v. Genesco*³¹⁷ this logic was directly applied to 10(b) *Mutual Shares* involved the defendant's acquisition of a controlling interest in S.H. Kress & Co.—half via market purchases and the balance through public tender offers. It was during the tender offer period that the plaintiffs *purchased* their shares. The claim for damages and injunctive relief was divided into two periods: First, during the time before plaintiffs purchased, it was alleged that defendants fraudulently failed to disclose an under-

313. *Id.* at 466-67

314. *Id.* at 467

315. See *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967); *Studebaker Corp. v. Allied Products Corp.*, 256 F Supp. 173 (W.D. Mich. 1966).

316. 375 U.S. 180 (1963).

317. 384 F.2d 540 (2d Cir. 1967).

valuation of Kress's real estate holdings and concealed an intent to manage Kress solely for their own benefit. Second, dealing with the time interval after the plaintiffs became Kress shareholders, it was alleged that defendants had operated Kress solely for the defendants' benefit and had manipulated the market price of the Kress stock (by lowering dividends) so as to acquire additional shares at depressed prices.

After a summary dismissal of the plaintiff's damage claims, the court addressed itself to the requests for equitable relief. In brushing aside defendants' argument that plaintiffs were neither purchasers nor sellers, the court commented: "[W]e do not regard the fact that plaintiffs have not sold their stock as controlling on the claim for injunctive relief."³¹⁸

This declination to require a purchase or sale in claims for equitable relief has been justified on several grounds:

- (1) upon a showing of a continuing manipulative scheme, injunctive relief is justified,³¹⁹
- (2) injunctive actions avoid proof of loss problems, and thus a purchase or sale is unnecessary as monetary damages need not be established,³²⁰
- (3) private injunctive actions constitute a necessary supplement to SEC regulation,³²¹
- (4) the prophylactic nature of the securities laws justifies prevention of inchoate violations.³²²

Several courts have taken a more expansive view of this so-called "equitable relief exception" to the purchaser-seller requirement. The Third Circuit in *Kahan v. Rosenstiel*³²³ indirectly faced this question

318. *Id.* at 546. See also *Symington-Wayne Corp. v. Dresser Industries, Inc.*, 383 F.2d 840 (2d Cir. 1967), where the court decided an injunction case on the merits after glossing over the *Birnbaum* rule by "assum[ing] arguendo that plaintiffs [had] standing." 383 F.2d at 842.

319. 384 F.2d at 546.

320. *Id.* at 547. See also *Britt v. Cyril Bath Company*, 417 F.2d 433 (6th Cir. 1969).

321. See *Ruckle v. Roto America Corp.*, 339 F.2d 24 (2d Cir. 1964); *Moore v. Greatamerica Corp.*, 274 F. Supp. 490 (N.D. Ohio 1967).

322. In *Kahan v. Rosenstiel*, 424 F.2d 161 (3d Cir. 1970), the court stated:

A suit which seeks to enjoin deceptive practices which if continued *would lead to completed purchases and sales* that give rise to a cause of action under a 10(b) is not inconsistent with [the] policy [of the act] and will in fact promote free and open public securities markets. [Emphasis supplied].

323. 424 F.2d 161 (3d Cir. 1970).

an action brought for attorney fees by a representative shareholder who had neither purchased nor sold. The interesting point in this case is that although the shareholder suit failed to make a specific request for equitable relief, the complaint did ask for such "further relief as may be just."³²⁴ Seizing upon this phrase as sufficiently invoking the court's equitable powers, Judge Adams held that any form of relief may properly be granted including an injunction where a cause of action for injunctive relief is in fact inherent in the complaint.³²⁵ Although other courts have followed a similar line of reasoning to deny a defendant's motion to dismiss,³²⁶ it has been pointed out that such an approach necessarily breeds confusion due to the "inappropriateness of looking to the ultimate power of the court to provide relief in the case before it, and equating that power with the ability of the plaintiff to invoke it in the first instance."³²⁷

The aforementioned cases have dealt with the question of prospective relief, but the natural extension of their logic also raises the issue of the availability of retrospective relief. When this problem arose in *Crane Co. v. Westinghouse Air Brake Co.*,³²⁸ it received little attention. Upon remand to the trial court, the opinion concluded "[W]ithout limitation [Crane's] remedies may include damages, if any, prospective injunctive relief, as well as appropriate retrospective relief"³²⁹ Although no detailed explanation was given, Judge Smith apparently relied on the statement in *J.I. Case Co. v. Borak*³³⁰ that "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose"³³¹ of the Act.³³²

Most recently in *Tully v. Mott Supermarkets*,³³³ the Third Circuit squarely addressed itself to the question of the availability of equitable relief under 10b-5. Plaintiffs therein, formerly controlling shareholders

324. *Id.* at 173-74.

325. *Id.*

326. See, e.g., *F.S.L.I.C. v. Fielding*, CCH FED. SEC. L. REP. ¶ 92,680 (D. Nev. 1969)

327. Kellog, *The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b-5 Involved*, 20 BUFF. L. REV. 93, 105 (1970).

328. 419 F.2d 787 (2d Cir. 1969)

329. *Id.* at 803.

330. 377 U.S. 426 (1964).

331. *Id.* at 433.

332. In *Berne St. Enterprises, Inc. v. American Export Isbrandtsen Co.*, CCH FED. SEC. L. REP. ¶ 92,711 (S.D.N.Y. 1970), the court interpreted *Mutual Shares* as authority for granting only prospective relief and not available where the fraudulent exchange is fully consummated.

333. CCH FED. SEC. L. REP. ¶ 93,377 (D.N.J. 1972).

who had neither purchased nor sold their stock, complained of the fraudulent issuance of voting shares by their corporation which effected a shifting in the locus of the corporate control. The complaint prayed for the validation of the issuance of shares and also for a new election of directors to purge the taint already visible as a result of the fraud.

When the defendant contended that the plaintiffs had no standing under *Birnbaum's* purchaser-seller rule, the court stated that (1) no such limitation on the plaintiffs is found in the language of the statute, (2) nothing in the Rule supports such an argument, and (3) that to imply such a requirement "ignores the recent edict by the Supreme Court mandating a flexible as opposed to a technical or restrictive construction of the Rule."³³⁴ Furthermore, Judge Whipple viewed the defendant's position as "directly opposed to the present trend in the law"³³⁵ The opinion then concluded:

Accordingly this court holds that the nature of the injunctive relief sought in the *absence or presence* of a buyer or seller is not determinative of federal jurisdiction under Rule 10b-5. Instead, federal jurisdiction hinges on the existence of a *causal relationship* between fraud in connection with the purchase or sale of securities and plaintiff's loss. [Emphasis supplied].³³⁶

Allegations of Corporate Mismanagement

After a review of the *Birnbaum* opinion, it becomes apparent that the court was concerned that the antifraud provisions of section 10(b) and Rule 10b-5 should not be construed to provide a federal means for the wholesale enforcement of corporate management's fiduciary duties. The fact that these claims might well be cognizable in state courts³³⁷ and the concomitant irritation stemming from the already overloaded federal dockets clearly could have colored Judge Augustus Hand's atti-

334. *Id.* ¶ 91,932.

335. *Id.*

336. *Id.* ¶ 91,933.

337. Recently as amicus in the *Bankers Life* case, the SEC expressed to the Supreme Court its concern arising from "the court of appeals' apparent view that the availability of a remedy under state law for the alleged fraud is relevant in determining the applicability of the federal securities laws." The brief continued "[i]t would be a most unsatisfactory basis for determining the coverage of the federal securities laws to have to decide, on a case-to-case basis, whether state law would provide an adequate remedy for the particular fraud involved." Brief for the SEC as amicus curiae at 10-11, *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 92 S.Ct. 165 (1971).

tude regarding the propriety of creating (or acknowledging) a federal remedy in this area. However, the attitudes of the federal bench notwithstanding, prospective plaintiffs have much to gain by pursuing their claims under the federal securities laws. When an action is based upon the violation of the 1934 Act, the venue,³³⁸ choice of forum,³³⁹ nationwide service of process provisions,³⁴⁰ and the resulting escape from the state security for costs statutes in derivative suits³⁴¹ all combine to tantalize litigants to seek federal rather than state redress of their grievances. In light of these and other significant federal statutory advantages,³⁴² it is obvious why the scope of section 10(b) and Rule 10b-5 have been subjected to continual testing in private actions. Traditionally, as a result of *Birnbaum*, the strategic use of 10b-5 in damage suits to remedy corporate mismanagement has been decided on the basis of one central inquiry—were the plaintiffs (or their corporations in a derivative suit)³⁴³ injured as purchasers or sellers of securities.

1. Sale of Control Shares—Focus on the Plaintiff

Management abuses take on various forms in the administration of corporate affairs by persons who act in fiduciary capacities. One vexing and continuing problem has been the determination of whether a remedy under 10b-5 is available where directors have breached a fiduciary duty by means of, or in connection with, their own purchase or sale of a security³⁴⁴

In the *Birnbaum* case, the plaintiff stockholders of Newport Steel sued the corporation's directors based upon a violation of section 10(b) and Rule 10b-5. The plaintiffs complained that the directors rejected

338. 15 U.S.C. § 78aa (1970).

339. See *Zorn v. Anderson*, 263 F. Supp. 745, 747-48 (S.D.N.Y. 1966).

340. 15 U.S.C. § 78aa (1970).

341. See *McClure v. Borne Chemical Co.*, 292 F.2d 824 (3d Cir. 1961), *cert. denied*, 368 U.S. 939 (1961); *Weitzen v. Kearns*, 262 F. Supp. 931 (S.D.N.Y. 1966), *aff'd sub nom.* *Epstein v. Solitron Devices, Inc.*, 388 F.2d 310 (2d Cir. 1968).

342. For a discussion of class actions under Rule 10b-5 and an analysis of the implications of the rapid substantive expansion in this area see Note, *The Impact of Class Actions on Rule 10b-5*, 38 U. CHI. L. REV. 337 (1971).

343. In a derivative suit under 10b-5, the corporation is the real party plaintiff; thus "the question presented is not whether a purchase or sale was made by an individual shareholder, but [rather] whether there was a purchase or sale by the corporation itself." *Dasho v. Susquehanna Corp.*, 380 F.2d 262, 266 (7th Cir. 1967). See also *Howard v. Furst*, 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957).

344. See generally *Bloomenthal, From Birnbaum To Schoenbaum: The Exchange Act And Self Aggrandizement*, 15 N.Y.L.F. 332 (1970).

a merger offer favorable to all the corporation's shareholders, misrepresented the status of the rejected merger, and then sold their controlling shares at a premium to a third party³⁴⁵ In dismissing the action, the *Birnbaum* court held that a corporation or its shareholders cannot utilize Rule 10b-5 unless, as a prospective plaintiff, one or the other has purchased or sold a security³⁴⁶ Thus, the transactional status of the plaintiff in relation to the fraudulent act was firmly established as the exclusive means by which to weed out those breaches of fiduciary duty cognizable under the Rule from the remainder that were not.³⁴⁷

At least in the sale of control cases, this focus upon the actions of the plaintiff has generally remained unchanged.³⁴⁸ In *Christophides v. Parco*,³⁴⁹ the Second Circuit indicated that *Birnbaum's* purchaser-seller requirement was still the rule. And in the recent Fifth Circuit case of *Erling v. Powell*,³⁵⁰ another federal forum confirmed the vitality of the purchaser-seller aspect of *Birnbaum*. In the words of the *Erling* court:

[N]either Erling individually nor the corporation participated in the capacity of "purchaser" or "seller" in the allegedly fraudulent sales of stock.³⁵¹

In essence, Erling's claims rest upon an alleged breach of fiduciary duty owing the corporation and other shareholders not [upon] deception practiced in the actual buying or selling of securities.³⁵²

On the other hand, where a shareholder can demonstrate that he has sold, a claim may be asserted under 10b-5 even though the sale was not to the defendant. In *Ferraioli v. Cantor*,³⁵³ *Birnbaum* was distinguished where minority shareholders disposed of their stock while unaware that a premium purchase offer had been made to the corporation's directors.

345. 98 F Supp. 506, 508 (S.D.N.Y. 1951).

346. 193 F.2d at 464.

347. One case decided four years prior to *Birnbaum* apparently took a more expansive approach to 10b-5. However, it was decided without opinion. See *McManus v. Jessup & Moore Paper Co.*, Civ. No. 8015 (E.D. Pa. 1948).

348. See generally *Cashin v. Mencher*, 255 F. Supp. 545, 548 (S.D.N.Y. 1965); *Beury v. Beury*, 127 F. Supp. 786 (S.D. W Va. 1954).

349. 289 F Supp. 403 (1968).

350. 429 F.2d 795 (5th Cir. 1970).

351. *Id.* at 799.

352. *Id.* at 800.

353. 281 F Supp. 354 (S.D.N.Y. 1967).

The existence of such an offer was held to be material information³⁵⁴—knowledge of which the directors extended to only a select group of shareholders.³⁵⁵ The gist of the plaintiffs' complaint was that they would not have sold to the third parties at the lower price had they known of the outstanding premium offer.

However, even this material information theory, which can be advanced only after the plaintiff has sold, has itself been qualified due to the most recent appeal in *Dasho v. Susquehanna Corp.*³⁵⁶ The *Dasho* court, commenting upon the duty of disclosure, stated:

We do not believe Rule 10b-5 imposes an obligation on controlling shareholders to make prompt disclosure of *every* offer they receive, and [we] find no evidence that an earlier disclosure of the offer would have benefitted plaintiffs in any way.³⁵⁷

Consequently, it is evident that even today the purchaser-seller rule must be satisfied in a situation involving the sale of control stock.³⁵⁸ Otherwise, as in *Birnbaum*, the plaintiffs must turn to state law, and state courts (absent diversity of citizenship) for the adjudication of their monetary claims.³⁵⁹

2. Issuance of Securities

When director misconduct results in the issuance of corporate shares whereby the corporation is defrauded, an instance is presented where a breach of fiduciary duty arises in connection with a securities transaction.

In the *Hooper*³⁶⁰ case, a derivative suit, the Court of Appeals for the Fifth Circuit found little difficulty in holding the issuance of stock to be a "sale"³⁶¹ despite the fact that the corporation was not acting as an "investor." The court justified this application of the Rule to an entity not technically an "investor" by pointing to the rulemaking power dele-

354. *Id.* at 358.

355. *But see* *Haberman v. Murchison*, 1972 CCH FED. SEC. L. REP. ¶ 93,305 (S.D.N.Y. 1971)

356. 1972 CCH FED. SEC. L. REP. ¶ 93,342 (7th Cir. 1972)

357. *Id.* ¶ 91,841.

358. *See generally* *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970); *Shell v. Hensley*, 430 F.2d 819 (5th Cir. 1970)

359. In *Pearlman v. Feldman*, 219 F.2d 173 (2d Cir. 1955), the *Birnbaum* defendants were subsequently held liable to the minority shareholders under state law

360. 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961)

361. *Id.* at 203.

gated to the SEC under the "public interest" clause of section 10(b).³⁶² Thus, 10b-5 was construed to protect a corporation not only as an "investor" but also as an "issuer."

Hooper was not a "fiduciary duty" type case because the perpetrators of the fraud were outsiders. Nonetheless, in *Pett v. American Stock Exchange*,³⁶³ the court did follow the *Hooper* rule, that the corporate issuer has a cause of action under 10b-5 stemming from the breach of a fiduciary duty in connection with the issuance of stock. However, *Pett's* facts are somewhat different from *Hooper* in that a public distribution of the issuer's stock was indispensable to the successful completion of the fraud. The *Pett* case is most significant because the court adopted the position that merely because the fraud was perpetrated by insiders, there was no reason why 10b-5 should not apply.

It is of course true that irrespective of the broad language of Rule 10(b)5, the courts have been disinclined to allow "innumerable facets of internal corporate affairs" to be included within federal question jurisdiction on the basis of a purchase or sale of securities that is only *incidental* to a major mismanagement issue. *On the other hand, that the fraud was perpetrated by insiders does not render Section 10(b) inapplicable*, if the transaction represents an abuse of the securities trading process, and should be properly subject to SEC regulations for an adequate remedy [Emphasis supplied].³⁶⁴

Pett adhered to the second *Birnbaum* rule, found a seller, and disregarding the third rule allowed a 10b-5 recovery. Generally, the courts dealing with "issuance of stock" cases have also found the corporation to be a seller by following *Hooper* and *Pett*.³⁶⁵ *Ruckle v. Roto Am. Corp.*³⁶⁶ is typical of this trend. In an action to enjoin the issuance of treasury shares, the court had little trouble with *Birnbaum's* sale requirement, and acknowledged:

362. The court argued that the SEC was authorized to promulgate rules and regulations not only "for the protection of investors" but also had power to be exercised "in the public interest." *Id.* at 202.

363. 217 F. Supp. 21 (S.D.N.Y. 1963).

364. *Id.* at 25.

365. See, e.g., *Papas v. Moss*, 257 F. Supp. 345 (D. N.J. 1966), *rev'd on other grounds*, 393 F.2d 865 (3d Cir. 1968); *Kane v. Central American Mining & Oil, Inc.*, 235 F. Supp. 559 (S.D.N.Y. 1964); *Dauphin Corp. v. Redwall Corp.*, 201 F. Supp. 466 (D. Del. 1962).

366. 339 F.2d 24 (2d Cir. 1964).

[A]s a matter of authority and principle, the issuance by a corporation of its own shares is a "sale" to which the anti-fraud policy expressed in the securities acts extends.³⁶⁷

The court went on to emphasize:

[I]t cannot be that the federal regulatory scheme is promoted by allowing a private person to sue [under 10b-5] but not a private corporation.³⁶⁸

Thus, with respect to the issuance cases, courts have observed that they are treading in the realm of fiduciary relationships. But as a practical matter,³⁶⁹ it hardly appears that this has dampened their adventure-some approach in determining whether the issuance of stock constitutes a "sale."³⁷⁰

3 *Fraud Related to Mergers*

When a plaintiff alleges fraudulent director activities incident to a merger (or a proposed merger) and seeks damages under 10b-5, the purchaser-seller constraints of *Birnbaum*, though somewhat softened, are still present. Under the theory of *Dasho v. Susquehanna*,³⁷¹ a merger that involves the exchange of stock is a "sale" by the corporate entity. Hence, a 10b-5 action can be maintained, either by the corporation or by its shareholders in a derivative capacity.

However, individual shareholders suing in their own stead are still plagued by *Birnbaum* since a plaintiff must demonstrate that he *person-*

367. *Id.* at 27.

368. *Id.* at 28.

369. The *Bankers Life* decision (discussed *infra*) has already evidenced its influence upon those seeking to put a restrictive interpretation upon 10b-5. See *Drachman v. Harvey*, 1972 CCH FED. SEC. L. REP. ¶ 93,345 (2d Cir. 1972).

370. Even though plaintiff shareholders may locate a "sale" upon which they are entitled to assert a claim under 10b-5, recovery is by no means automatic. In *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964), the court required an affirmative showing that the corporation was deceived. Implicit in *O'Neill* is a holding that 10b-5 imposes no duties beyond honest disclosure. 339 F.2d at 767. It should be noted, however, that *O'Neill* was decided before the Second Circuit's expansive holdings in *Vine and Brod*. See also *Jannes v. Microwave Communications*, 325 F. Supp. 899 (N.D. Ill. 1971); *Baehr v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 1972 CCH FED. SEC. L. REP. ¶ 93,227 (S.D.N.Y. 1970); *Schoenbaum v. Firstbrook*, 268 F. Supp. 385 (S.D.N.Y. 1967), *aff'd on other grounds*, 405 F.2d 200 (2d Cir.), *rev'd en banc*, 405 F.2d 215 (1968).

371. *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967).

ally was a buyer or seller. In *Mader v. Arnel*,³⁷² wherein a stockholder exchanged his shares as a result of a merger, the court found a "sale."³⁷³

In *Vine v. Beneficial Finance Company*,³⁷⁴ the plaintiff was a shareholder of Crown Finance, a corporation that was dissolved after the completion of a short form merger which did not require his consent to be effective. Plaintiff alleged that the defendant (Beneficial) had secured the requisite control of Crown by means of a fraudulent scheme involving non-disclosure of its underlying intent to effect a merger. Since *Birnbaum* required that plaintiffs be purchasers or sellers, the court was faced with a problem—the plaintiff had not sold. In order to grant recovery, the court judicially transformed Vine into a "forced seller,"³⁷⁵ reasoning that completion of the merger forced plaintiff either to surrender his shares to the corporation for cash, or to retain his certificates of ownership in a non-existent entity. The court did focus on the plaintiff, however, by more liberally construing the concept of a "seller" under 10b-5,³⁷⁶ and recovery was permitted.³⁷⁷

The Second Circuit was again called upon to deal with director misconduct incident to merger-related activities, in *Greenstein v. Paul*.³⁷⁸ There the plaintiff, who held a minority interest in Sagamore Corporation, complained of a conspiracy by the defendant directors and the majority shareholder of Sagamore. The defendants' alleged scheme was to depress the market price of Sagamore stock, to acquire the minority shares at a lower price by means of a "freeze out," and then

372. 402 F.2d 158 (6th Cir. 1968).

373. The SEC originally took the position that an exchange of stock as a result of a merger did not constitute a "sale." Since 1951, however, their arguments have been to the contrary. *Mader v. Arnel*, 402 F.2d 158, 160 (6th Cir. 1968).

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

375. 374 F.2d at 635. In another Second Circuit case, *A.T. Brod v. Perlow*, 375 F.2d 393 (2d Cir. 1967), the court was again forced to search for a purchase or sale by the plaintiff in an action for damages under 10b-5. Allegedly the defendant had directed the plaintiff broker to purchase certain shares of stock intending to honor his obligation to pay only in the event that the market advanced. When the value of the stocks fell, the defendant failed to pay, and the broker was forced to cover at the settlement date. Subsequently the broker sold these shares at a loss. Although the alleged fraud was incident to the defendant's aborted purchase, the court felt that it extended itself and also attached to the plaintiff's sale.

376. 374 F.2d at 636.

377. See also *Voegel v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369 (D. Del. 1965) (focus on the plaintiff's purchase of stock rather than her status as a forced seller after a short form merger was used to support a 10b-5 claim).

378. 400 F.2d 580 (2d Cir. 1967).

to merge Sagamore into another corporation. The plaintiff refused to sell despite the manipulations, and the merger was called off. In dismissing the plaintiff's individual action for damages, the court continued to follow *Birnbaum* by demanding that the plaintiff himself be a seller, or at least be a "forced seller" "Had this merger been carried out the *Vine* case would be in point. But it was not."³⁷⁹

Then came *Crane Co. v. Westinghouse Air Brake Co.*³⁸⁰ where a frustrated tender offeror sued to block a proposed merger. In June of 1967, Crane began to purchase Air Brake shares and subsequently proposed a merger to Air Brake's board. Air Brake rejected Crane as a suitor and made plans to merge with Standard. Crane then embarked on a tender offer campaign (to purchase Air Brake stock) which was defeated at the last minute when Standard engaged in wash transactions in Air Brake stock which "painted the tape" and deterred Air Brake's shareholders from tendering to Crane. The Air Brake-Standard merger was completed and, under threat of an anti-trust divestiture suit, Crane was forced to dispose of the shares.

The trial court dismissed the action.³⁸¹ On appeal, the court not only held Crane to be a seller, but most significantly the Second Circuit finally aimed its inquiry at the act of the *defendant* in effecting a securities transaction, rather than telescoping exclusively upon the plaintiff's status as a purchaser or seller under *Birnbaum*. The court commented:

Standard's failure to disclose its manipulations [of Air stock] operated as a fraud or deceit on Crane in connection with the purchase and sale of securities, creating a right to relief in Crane *quite apart from Crane's rights as a forced seller under 9(a)(2)*.³⁸²

Of equal importance is Judge Smith's holding with respect to Crane's right to relief because the court's language clearly did not preclude a recovery of damages.³⁸³

In the interim between the arguments in *Crane* and the time that decision was actually handed down, the Second Circuit passed upon *Iroquois Industries, Inc. v. Syracuse China Corp.*³⁸⁴ This case dealt

³⁷⁹ 400 F.2d at 581. See also *Chris Craft Industries, Inc. v. Piper Aircraft Corp.*, 1972 CCH FED. SEC. L. REP. ¶ 93,301 (2d Cir. 1971).

³⁸⁰ 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

³⁸¹ 326 F Supp. 766 (S.D.N.Y. 1968).

³⁸² 419 F.2d at 795.

³⁸³ *Id.* at 803.

³⁸⁴ 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970).

with fraudulent misrepresentations emanating from the Syracuse management which caused the failure of a tender offer by Iroquois. Unlike *Crane*, the shareholders were tricked by written communications as opposed to market transactions. *Iroquois* was dismissed³⁸⁵ despite the urgings of the SEC, as amicus,³⁸⁶ that the purchaser-seller rule be discarded. Because the decisions were handed down so closely together within such a short period of time, and given the brief mention of *Iroquois* in the *Crane* opinion, it is tenuous to rely upon *Crane* for the proposition that a focus on the defendant is now the rule. However in an equitable action, *Tully*³⁸⁷ used *Crane* in just this manner. It appears that the plaintiff must still demonstrate his injury as a purchaser or seller.

4. Purchase and Sale of Corporate Assets

When the corporate asset disposed of is a security, or when the corporation is by contract transferring its assets in exchange for a security,³⁸⁸ fraudulent mismanagement incident to these transfers has been held actionable under 10b-5. As in the merger cases, the central question is whether the individual or corporate plaintiff was a purchaser or seller. Again the capacity in which the shareholder seeks relief is significant.

385. *Id.* at 965.

386. SEC Brief as amicus curiae, *Iroquois Industries, Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969).

387. 1972 CCH FED. SEC. L. REP. ¶ 93,377 (D.N.J. 1972).

388. Section 3(a)(10) of the 1934 Act provides:

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(12) (1970). Recently in *Movielab Inc. v. Berkey Photo Inc.*, 1972 CCH FED. SEC. L. REP. ¶ 93,291 (2d Cir. 1971), the Second Circuit was again presented with a sale of assets transaction. In a per curiam opinion, the court held that the fraudulent exchange of assets for a promissory note between two publicly held corporations constituted a fraud "in connection with the purchase or sale of a security"

Dasbo v. Susquehanna,³⁸⁹ discussed earlier, also concerned the Susquehanna Corporation's use of 10b-5 in another light. Its directors had caused the corporation to dispose of 140,000 shares of Vanadium Corporation in return for Susquehanna stock and cash. The plaintiff shareholders of Susquehanna brought a derivative suit alleging, *inter alia*, that the corporation's Vanadium stock had been transferred for less than its true value to placate a dissident group of shareholders. In deciding whether such a misuse of the director's powers was a violation of 10b-5, the court stated:

We are of the opinion that an acquisition or disposition of securities in exchange for other securities falls within the statutory definitions [of a purchase or sale] 390

In *Entel v. Allen*,³⁹¹ the existence of a derivative claim was also confirmed and the defense that the shareholders were not purchasers or sellers was apparently rejected. In that case corporate control was allegedly misused to effect a sale of stock and notes at a price substantially less than their market value. On rehearing, Judge Bonsal vacated a prior summary judgment with respect to the derivative suit and a shareholder class action against the directors. *Entel* was admittedly decided after the Second Circuit's holdings in *Vine*³⁹² and *Brod*³⁹³ had enlarged the scope of a "sale" under 10b-5. But neither of these decisions purported to eliminate the *Birnbaum* purchaser-seller requirement.³⁹⁴ And in *Greenstem v. Paul*,³⁹⁵ decided four months after *Entel*, Judge McLean realized this fact, dismissing a class action by non-selling plaintiffs.³⁹⁶ *Greenstem*

389. 380 F.2d 262 (7th Cir. 1967).

390. *Id.* at 266.

391. 270 F Supp. 60 (S.D.N.Y. 1967).

392. 374 F.2d 627 (2d Cir. 1967).

393. 375 F.2d 393 (2d Cir. 1967).

394. Both courts actually followed *Birnbaum* by finding the respective plaintiffs to be purchasers or sellers. In *Vine* the court remarked: "the Commission advances the alternative argument that plaintiff need not even be a selling stockholder to sue under 10b-5."

In view of our disposition of the case [that *Vine* was a forced seller], it is unnecessary to deal with this interesting contention." 374 F.2d 627, 636. And in *Brod*, language is found that "[t]he Commission, in recent cases, has urged that [the *Birnbaum* interpretation] of [10b-5] is too narrow."

We need not consider that contention since appellant is clearly a purchaser of a security" 375 F.2d 393, 397.

395. 275 F Supp. 604 (S.D.N.Y. 1967).

396. *Id.* at 606. See also *SEC v. Fifth Avenue Coach Lines, Inc.*, 289 F Supp. 3 (S.D.N.Y. 1968), where the court granted injunctive relief in an action by the SEC to secure injunctive relief against fraudulent director activities incident to the sale of stock by a corporation held as an investment.

was then affirmed on appeal³⁹⁷ by a three-judge panel, one member of which was Judge Smith who also sat on the *Vine* appeal.³⁹⁸ *Entel* still stands as a mystery with respect to the individual non-selling shareholders.

Another recent case, *Drachman v. Harvey*,³⁹⁹ indicates that while the purchaser-seller rule has been relaxed, it has not been abandoned. In *Drachman*, a scheme causing an issuer to redeem convertible debentures was held actionable in a 10b-5 derivative suit only because the redemption was deemed a purchase within the meaning of the Act.⁴⁰⁰

The presence of definitional expansion was also evidenced in the Seventh Circuit in the case of *Bailey v. Meister Brau, Inc.*⁴⁰¹ Therein, a shareholder's derivative suit withstood a motion to dismiss where the plaintiff alleged that his corporation was induced to transfer its assets worth \$1,870,000 in exchange for stock having a value of \$440,000. The defendant directors contended that 10b-5 was not designed to encompass the "transfer of securities as a vehicle for the sale of a going business."⁴⁰² Without any significant discussion of the matter, the court concluded that "the form of the transaction necessarily brought into being a buyer and a seller of securities." The defendant's motion to dismiss was denied.⁴⁰³

Due to the liberal approach of the courts in construing the definitional sections, a significant intrusion into *Birnbaum's* third holding has developed. As the next section indicates, 10b-5 continues to march on deeper into the realm of director misconduct—but the requirement of a purchase or sale, by the plaintiff, remains.

397. 400 F.2d 580 (2d Cir. 1967).

398. See also *Iroquois Industries, Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969).

399. 1972 CCH FED. SEC. L. REP. ¶ 93,345 (2d Cir. 1972) (*en banc*).

400. But see *GAF v. Millstein*, 1972 CCH FED. SEC. L. REP. ¶ 93,300 (2d Cir. 1971); *Levine v. Selion, Inc.*, 439 F.2d 328 (2d Cir. 1971).

401. 1972 CCH FED. SEC. L. REP. ¶ 92,936 (N.D. Ill. 1970).

402. *Id.* ¶ 90,471.

403. See also *Swanson v. American Consumer Industries*, 415 F.2d 1326 (7th Cir. 1969), wherein the court declared:

It is no longer open to question that the exchange of shares in connection with a . . . sale of assets constitutes a "purchase or sale" within the meaning of Section 10(b) and Rule 10b-5.

415 F.2d at 1330. But see *Chiodo v. General Waterworks Corp.*, 380 F.2d 860 (10th Cir. 1967) (the court hints at the same conclusion); *Cohen v. Colvin*, 266 F Supp. 677 (S.D.N.Y. 1967) (stating that a "C" type stock for assets reorganization is not a "sale" unless there is also a commitment by the seller to liquidate).

5 *Management Abuse Plus*

The above discussion has dealt primarily with actions by a corporation or its shareholders against directors. However, 10b-5 has recently been utilized in another direction. In *Superintendent of Insurance v Bankers Life and Casualty Company*,⁴⁰⁴ Bankers Life agreed to sell all of its stock in Manhattan Casualty Company, a wholly owned subsidiary, to two individuals. In connection with their purchase, the buyers fabricated a plan to utilize Manhattan's assets, rather than their own funds, to pay Bankers for the sale.⁴⁰⁵ Unfortunately for the defendants,⁴⁰⁶ the property belonging to Manhattan which they selected to appropriate was \$5,000,000 of United States Treasury bonds. Manhattan's board was then induced to sell the bonds with the expectation that it would in turn net the proceeds for the sale. Actually what Manhattan received in return was a fully-collateralized \$5,000,000 certificate of deposit, but the certificate was worthless.

After viewing the gravamen of the complaint as alleging a misappropriation of assets, the district court restricted its central inquiry to Bankers' sale of Manhattan stock.⁴⁰⁷ It then dismissed the suit,⁴⁰⁸ relying on *Birnbaum*, because the plaintiff Manhattan took no part in that sale (even though the proceeds of its Treasury bonds were used to pay the purchase price). The court of appeals affirmed on a different basis⁴⁰⁹—a deception theory involving the contract for the sale of the bonds—stating that “[w]ith respect to the terms of the [bond] sale, neither the purchaser or the seller was deceived or defrauded.”⁴¹⁰ In addition, the court held that there is “a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received.”⁴¹¹ Thus, to summarize, the lower court found plaintiff's status as a seller to be

404. 92 S.Ct. 165 (1971).

405. The plaintiff's complaint was grounded upon three transactions: Manhattan's sale of the Treasury bonds; the sale of Manhattan stock by Bankers Life; and certain transactions involving the certificate of deposit. The court explicitly stated that its inquiry was restricted to the sale of bonds. 92 S.Ct. 165, 169 n.10 (1971).

406. It would be interesting to speculate on the outcome of this case had \$5,000,000 of land been sold instead.

407. 300 F Supp. 1083 (S.D.N.Y. 1969).

408. *Id.* at 1095.

409. 430 F.2d 355 (2d Cir. 1970).

410. *Id.* at 360.

411. *Id.*

irrelevant and dismissed the action because the case dealt primarily with misappropriation not within the scope of 10b-5. On appeal it was held that there was no deception in the sale in which the plaintiff participated as a seller because the price was not unfair.

The Supreme Court looked only upon the sale of the Treasury bonds⁴¹² and found fraud in connection with this sale "because a seller [Manhattan] was duped into believing that it . . . would receive the proceeds" when in fact there was a scheme in the making to insure that it would not. From the standpoint of when 10b-5 can be used to remedy a breach of fiduciary duty, Justice Douglas was equivocal. He agreed that Congress had no intention that 10(b) be used to regulate transactions which constitute "no more than internal corporate mismanagement."⁴¹³ But in an earlier paragraph of the opinion, he deemed it irrelevant that the fraud was perpetrated by an officer of the corporation.⁴¹⁴ According to the Court, the crux of the case was that Manhattan was injured by a deceptive practice which "touched" its sale of a security as an investor.⁴¹⁵

6. Conclusion

In addition to the above, the Supreme Court's *Bankers Life* decision dictated that "Section 10(b) must be read flexibly, not technically and restrictively"⁴¹⁶ The Court as well announced the doctrine that fraud, if it "touches" a securities transaction, will be actionable under 10b-5 regardless of the fact that it is perpetrated by an officer of the corporation. Responding to the *Bankers Life* edict, Judge Whipple, in *Tully v. Mott Supermarkets, Inc.*,⁴¹⁷ declared that 10b-5 was not a "select remedy" available only in "the fortuitous absence of corporate mismanagement."⁴¹⁸

Since under the new "touching concept" almost any instance of fraudulent corporate mismanagement is now automatically converted into a Rule 10b-5 case, it is suggested that the third *Birnbaum* prong is about to be "flexibly touched" out of existence.

412. 92 S.Ct. 165 (1971).

413. *Id.* at 169.

414. *Id.* at 168.

415. *Id.* at 169.

416. *Id.*

417. 1972 CCH FED. SEC. L. REP. ¶ 93,377 (D.N.J. 1972).

418. *Id.* ¶ 91,934.

Aborted Transactions

Although the courts appear to have curtailed their rigid adherence to the *Birnbaum* doctrine,⁴¹⁹ this leniency has been evidenced only in selective cases and there remains to be considered those situations commonly referred to as "abortive" purchases or sales.⁴²⁰ Neither section 10(b) nor Rule 10b-5 mandate that a plaintiff be a purchaser or seller.⁴²¹ As has been pointed out, this requirement originated in the *Birnbaum* decision where the court was distinguishing those situations involving fiduciary misconduct not actionable under Rule 10b-5.⁴²² It is submitted that in the absence of a fiduciary relationship, the crucial inquiry in determining standing to sue under the Rule should be the influence of the fraudulent activity on the plaintiff's investment decision rather than the overly technical inquiry as to his status as a purchaser or seller. The purchaser-seller requirement appears to be unduly restrictive when it is realized that the decision to purchase or sell is logically indistinguishable from a decision to abstain from such transactions. Ironically, the landmark Second Circuit opinion in *Texas Gulf* hinted at a recognition of this thesis in defining materiality. The court said material facts are those which may affect the desire of investors to "buy, sell, or hold the company's securities."⁴²³

In *Commerce Reporting Co. v. Puretec, Inc.*,⁴²⁴ plaintiff secured an option to purchase all the shares of Puretec. The option was coupled with an exclusive agency contract authorizing the plaintiff to locate a buyer. The plaintiff argued that the two sole stockholders of Puretec had no intention of honoring the option agreement if they could secure a more favorable offer through their own private negotiations. The plaintiff further alleged that it assigned the options, but the Puretec shareholders refused to sell. Despite the fact that a sale was never consummated, the court allowed the plaintiff's suit under Rule 10b-5, stating that it found no necessity for a consummated transaction.⁴²⁵

419. See notes 315-36 *supra* and accompanying text.

420. These situations arise when an investor has decided either to purchase or sell and the fraudulent influence of the defendant aborts the implementation of that investment decision.

421. See text of Rule, *supra* note 22.

422. See notes 337-43 *supra* and accompanying text.

423. 401 F.2d at 849 [Emphasis supplied].

424. 290 F Supp. 715 (S.D.N.Y. 1968).

425. Although the purchase option could have been considered as a basis for recovery in such a case, there would be no need for the court to discuss whether or not there was a consummated transaction because the option would be within the statutory

In *Goodman v. H. Hentz and Co.*,⁴²⁶ the court permitted an action against a broker whose fraudulent scheme resulted in a purchase by the plaintiff of non-existent securities. In noting that the purchase of fictitious securities could never be consummated, the court found it incorrect to interpret the "in connection with" language of Rule 10b-5 as if it read "in the purchase or sale" rather than "*in connection* with the purchase or sale."⁴²⁷ Recovery under 10b-5 was allowed.

Thus, the above two decisions, when read together, indicate that not only is a consummated transaction unnecessary to a 10b-5 cause of action, but also that the fraudulent activity need only be *connected with* a purchase or sale. This inroad into *Birnbaum* is both clear and justified. However, there exists another possible inroad into *Birnbaum* which has not properly been pursued by the courts. This involves an interpretation of what injury to the plaintiff absent a purchase or sale should be actionable under 10b-5. Specifically, there exists the possibility that a current owner of shares who intends to sell may be fraudulently induced to retain them, and correspondingly a potential investor with the intent and means to purchase specific securities may be fraudulently prevented from purchasing. This persuasion to forego the consummation of intended transactions may be said to render the above described parties abortive sellers or purchasers who should be able to seek relief in a 10b-5 action.

1. Broker's Fraud

Perhaps the best example of the abortive purchaser-seller theory is presented in circumstances in which brokers have fraudulently induced their customers to pursue or forego a particular course of action. A classic illustration can be found in *Stockwell v. Reynolds and Co.*⁴²⁸ Therein the broker defendant fraudulently induced the plaintiffs⁴²⁹ to retain certain shares after they had expressed a desire to sell. After a market decline, plaintiffs sold their shares at a loss. The plaintiffs thereafter

definition of a purchase—a contract to purchase. See notes 302-14 *supra* and accompanying text. By using the agency contract as a basis for relief, the court seems to eliminate the purchaser-seller requirement and find liability on something less than a mutually binding executory agreement. 1969 DUKE L.J. 349.

426. 265 F. Supp. 440 (N.D. Ill. 1967).

427. *Id.* at 444.

428. 252 F. Supp. 215 (S.D.N.Y. 1965).

429. One plaintiff merely retained his shares while another plaintiff actually purchased additional shares in reliance on the broker's fraudulent statements.

brought an action against the broker for damages. In rejecting the defendant's contention that plaintiffs were neither purchasers nor sellers, the court looked to the "in connection with" language in stating that section 10 and Rule 10b-5 "do not require that the purchase or sale immediately follow the alleged fraud."⁴³⁰

Although both plaintiffs sold their stock before trial, Judge Bonsal noted that "a seller is injured as much when he suffers a loss on the sale of securities which he has been fraudulently induced to retain as when he is fraudulently induced to sell them."⁴³¹ This position has received little judicial following.⁴³²

Judge Bonsal's inquiry into the injury sustained by the plaintiff is based upon the recognition that the resolution to purchase, sell, or retain is fundamentally nothing more than the translation of an investment decision into an overt act. Once an investment intent is formulated, it is then coupled with some outward manifestation to attain its fruition.

Where an investor holds cash and reaches a favorable value judgment regarding a certain security, an investment intent is formulated. This intention is carried out by the act of purchase. On the other hand, if the investor's portfolio already contains this item, the act of retention is the product of his decision. Were a fraud to be injected into the above decision-making process, under *Birnbaum* only the purchase translation would yield standing under 10b-5.

The phrase "in connection with a purchase or sale" indicates breadth. It makes clear the fact that Congress was speaking not only to the legal conception of a transfer but also to the critical foundations upon which an execution is based.

It is suggested that a focus upon the entire investment decision-making process is the most efficacious manner by which to define the scope of 10b-5. Once a judgment has been tainted by fraudulent means, it seems unduly arbitrary to remedy such an evil *only* when the resolution is translated into a purchase or sale.⁴³³

430. 252 F Supp. at 219.

431. *Id.*

432. Compare *Voege v. American Sumatra Tobacco Co.*, 241 F Supp. 369 (D. Del. 1965) with *Morrow v. Schapiro*, CCH FED. SEC. L. REP. ¶ 93,251 (E.D. Mo. 1971).

433. The utility of this theory has not gone totally unrecognized. An analysis detached from the purchaser-seller rule has been observed in *Neuman v. Electronic Specialties, Inc.*, CCH FED. SEC. L. REP. ¶ 92,591 (N.D. Ill. 1969), wherein the court held: "[A]s a condition of any recovery under the private damage remedy, the shareholders must prove that his reliance on any alleged representation was the cause of his refusal to [sell]."

2. *The Timespan of Causation*

One further problem remains to be considered if the *Birnbaum* rule is to be replaced with a workable substitute. If situations exist in which the fraudulent activity can be related to an investment decision made at an earlier time, necessarily there must be a determination as to how long the defendant's fraudulent activity can reasonably be expected to influence the plaintiff's inaction. For example, assume an investor desires to purchase 5,000 shares of XYZ corporation currently selling at \$50 per share, and his broker fraudulently induces him *not* to purchase. If within three days the price has risen to \$55 per share, should not the investor be able to maintain an action alleging that he has been damaged to the extent of \$25,000 by the broker's fraud? If so, the investor may want to wait until the price reaches \$65 per share (for example, a month later) before he brings his action. Clearly, such a delay would not entitle plaintiff to recover \$75,000 because there is a point in time at which the broker's fraud ceases to have causal connection to the plaintiff's *entire* loss. In the recent case of *Morrow v. Schapiro*,⁴³⁴ a district court in Missouri, although apparently infected with the *Birnbaum* philosophy,⁴³⁵ denied relief to an aborted seller who alleged that the directors and officers of the corporation fraudulently induced him to retain his shares at a time when the defendants themselves had an investment strategy of selling.⁴³⁶ The plaintiff, realizing that his plight was hopeless without a purchase or sale, argued that the defendant's fraudulent scheme related back to when plaintiff was first induced by these same defendants to purchase the shares.⁴³⁷ The court held that since the plaintiff's purchase was initially profitable,⁴³⁸ his theory failed. Implicit in the decision is an indication that the defendant's fraud could not have been a material factor for so long a period of time. Thus, it is suggested that a case-by-case determination of the duration of defendant's fraudulent activity and the extent to which it could reasonably influence the

434. CCH FED. SEC. L. REP. ¶ 93,251 (E.D. Mo. 1971).

435. *Id.*

436. Plaintiff purchased his shares in 1969 for \$582,620. When he was fraudulently deceived into retaining his stock, it had a market value of \$700,000 which had declined drastically to \$56,000 at the trial date.

437. Cf. *Voege v. American Sumatra Tobacco Co.*, 241 F Supp. 369 (D. Del. 1965), which dealt with facts similar to *Vine*. The court granted relief to an aborted seller in a merger situation by examining the original purchase by the plaintiff of the merged corporation's shares.

438. The court was referring to the unrealized increase in market value from \$582,620 to \$700,000.

plaintiff either to hold or to refrain from purchasing is far superior to an examination of the facts to find a purchase or sale. By allowing such actions to serve as notice to all those who desire to profit through fraudulent activities in securities negotiations and transactions, the goal of fair trading based on equal access to investment data can be achieved.

DISPLACEMENT

As previously noted, the securities acts were drawn so as to establish a particular balance between the broad injunction power of the SEC and the limited power of investors. In carefully circumscribed circumstances, the acts expressly provide for private causes of action in the event of particular types of fraudulent conduct—this right is contingent upon the proof of specific elements and is often subject to enumerated defenses.

As originally interpreted, section 10(b) did no violence to this statutory framework as no private right of action was expressly provided in that section. However, once the courts implied a private cause of action under section 10(b)⁴³⁹ and expanded its scope to the same situations covered by the express provisions of the acts, conflict developed. Section 10(b) actions were not subject to the same limitations as those brought under the express sections. As a result, section 10(b) has become more appealing to potential plaintiffs as the basis for a cause of action and has displaced the express sections of both acts, rendering them superfluous. This section will discuss the limitations of the express provisions which have precipitated this obsolescence.

Statute of Limitations

Civil actions brought under the express provisions of the Securities Act—Section 11 (concerning registration statements)⁴⁴⁰ or section 12

439. See *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Kardon v. National Gypsum Co.*, 69 F Supp. 512 (E.D. Pa. 1946); *Speed v. Transamerica Corporation*, 71 F Supp. 457 (D. Del. 1947), 99 F Supp. 808 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956); *Osborne v. Mallory*, 86 F Supp. 869 (S.D.N.Y. 1949).

440. 15 U.S.C. § 77k (1970). Although a 10b-5 claim was abandoned in *Fischman v. Raytheon*, 188 F.2d 783 (2d Cir. 1951), dictum in that case indicates that a *buyer* can utilize 10b-5 "whether or not he could maintain a suit under § 11 of the 1933 Act" because 10b-5 requires proof of fraud, 188 F.2d at 787. Other cases have held that purchasers of registered securities can only sue under section 11; see *Montague v. Electronic Corporation of America*, 76 F Supp. 933 (S.D.N.Y. 1948); *Rosenberg v. Globe Aircraft Corp.*, 80 F Supp. 123 (E.D. Pa. 1948). Therefore, it should be noted

(dealing with prospectuses or communications)⁴⁴¹—are governed by the statute of limitations provisions in section 13.⁴⁴² Since no statute of limitations is expressly provided under section 10 of the Exchange Act, the limitations statute in the forum state governs.⁴⁴³ This usually results in a longer statute of limitations due to either a longer limitation period or the designation of a later date regarding when the statute begins to run.⁴⁴⁴ Due to the broad scope of Rule 10b-5, it may be possible to utilize this rule even though the same suit under sections 11 and 12 might be barred by the statute of limitations in section 13.

Similarly in the Exchange Act, section 9 (market manipulation)⁴⁴⁵ and section 18 (filed documents),⁴⁴⁶ prescribe their own statute of limitations as one year after discovery of the facts constituting the violation and no more than three years after the violation itself actually occurred. Since no civil remedies are expressed in section 17⁴⁴⁷ of the Securities Act or in sections 13,⁴⁴⁸ 14⁴⁴⁹ or 15(c)⁴⁵⁰ of the Exchange Act, they present no barrier to 10b-5's encroachment as far as the applicable statute of limitations is concerned since actions thereunder are also governed by the statutes effective in the forum state.

that section 11 and its relative desirability in obtaining relief as opposed to a 10b-5 action is discussed herein as if the two actions were or could be utilized in regard to the same fact situation.

441. 15 U.S.C. § 77l (1970).

442. 15 U.S.C. § 77m (1970) Section 13 provides:

No action shall be maintained to enforce any liability created under section 77k or 77l (2) of this title unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section 77l (1) of this title, unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability created under section 77k or 77l (1) of this title more than three years after the security bona fide offered to the public, or under section 77l (2) of this title more than three years after the sale.

443. See, e.g., *Chiodo v. General Waterworks Corp.*, 380 F.2d 860 (10th Cir. 1967); *Azalea Meats, Inc. v. Muscat*, 386 F.2d 5 (5th Cir. 1967); *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953); *Ernon v. Connell*, 236 F.2d 447 (9th Cir. 1956); *Fischman v. Raytheon Manufacturing Co.*, 188 F.2d 783 (2d Cir. 1951).

444. In most states the statute begins to run when the fraud is or should have been discovered, which avoids the three year maximum in section 13.

445. 15 U.S.C. § 78i (1970).

446. 15 U.S.C. § 78r (1970).

447. 15 U.S.C. § 77q (1970).

448. 15 U.S.C. § 78n (1970).

449. 15 U.S.C. § 78n (1970).

450. 15 U.S.C. § 78o (1970).

Security for Costs

Several of the sections mentioned above (section 11 of the Securities Act and sections 9 and 18 of the Exchange Act) specifically provide that the courts in their discretion may require security to be posted for both costs and attorney fees to lessen the possibility of harassment and nuisance value litigation. Section 10, Rule 10b-5, and the other provisions that do not provide expressly for civil remedies have no such requirement (section 17 of the Securities Act is also included here), and therefore they often enable prospective plaintiffs to escape the security for costs requirement.⁴⁵¹

Privity

Section 12(1),⁴⁵² which incorporates section 5,⁴⁵³ grants an express civil remedy for violations regarding the sale of a security during the pre-filing, post-filing, and post-effective period of the registration statement. Section 12(2)⁴⁵⁴ grants a remedy for fraud in the sale of a security. Both sections 12(1) and 12(2) require privity between the plaintiff and defendant. However, a cause of action under 10b-5, which has been held to encompass section 12 violations⁴⁵⁵ does not require privity.

Reliance

Section 11 of the Securities Act provides that any purchaser or seller may sue when there is either an untrue material statement or omission of a material fact in a registration statement.⁴⁵⁶ However, reliance must be affirmatively shown if the issuer had publicly made available a financial statement covering a period of at least 12 months subsequent to the effective date of the registration statement.⁴⁵⁷ This does not appear to be overly-burdensome because the statute further provides that reliance can be shown without establishing that the plaintiff read the registra-

451. See, e.g., *Epstein v. Solitron Devices, Inc.*, CCH FED. SEC. L. REP. ¶ 92,127 (2d Cir. 1968); *McClune v. Borne Chemical Co.*, 292 F.2d 824 (3d Cir. 1961), *cert. denied*, 368 U.S. 939 (1961).

452. 15 U.S.C. § 77l (1970).

453. 15 U.S.C. § 77e (1970).

454. 15 U.S.C. § 77l (1970).

455. See *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961); *Fischman v. Raytheon Manufacturing Co.*, 188 F.2d 783 (2d Cir. 1951).

456. 15 U.S.C. § 77k (1970).

457. *Id.*

tion statement. Reliance is also expressly required in an action under section 18⁴⁵⁸ of the Exchange Act.

Although actions brought under 10b-5 seem to require the plaintiff to establish reliance in a misrepresentation situation, as opposed to a non-disclosure setting,⁴⁵⁹ the other advantageous provisions in section 10 and Rule 10b-5 negate the notion that proving reliance would be a significant factor in determining which section to use.

Defenses

Section 11 of the Securities Act extends to everyone, except the issuer, the defense of due diligence—the standard of care being that of a prudent man in the management of his property.⁴⁶⁰ Section 12(2) also provides two specific defenses. The defendant may escape liability upon a showing that he did not know, and in the exercise of reasonable care could not have known, of the misstatements or omissions.⁴⁶¹ In addition, plaintiff's suit is barred upon a showing of his knowledge of the untruth or omission.⁴⁶² A possible defense to a violation of section 9 of the Exchange Act would be lack of scienter or requisite intent since, via subsection (c), only willful violations are actionable.⁴⁶³ Similarly, section 18 delineates the two defenses of good faith and lack of knowledge.⁴⁶⁴ A suit instituted under 10b-5 and section 10 of the Exchange Act has no expressed defenses but some courts increase the plaintiff's burden by requiring reliance,⁴⁶⁵ scienter,⁴⁶⁶ and causation.⁴⁶⁷

Damages

In any action alleging violations of the various provisions of the Exchange Act, the amount of damages recoverable is limited to actual damages by section 28(a).⁴⁶⁸ Hence, a 10b-5 action has no advantageous position in this regard. However, several sections in the Securities Act have specific damage provisions. Section 11 limits damages to the amount

458. 15 U.S.C. § 78r (1970).

459. See notes 197-98 *supra* and accompanying text.

460. 15 U.S.C. § 77k (1970).

461. 15 U.S.C. § 77l (1970).

462. *Id.*

463. 15 U.S.C. § 78i (1970).

464. 15 U.S.C. § 78r (1970).

465. See notes 175-222 *supra* and accompanying text.

466. See notes 35-122 *supra* and accompanying text.

467. See notes 224-64 *supra* and accompanying text.

468. 15 U.S.C. § 78bb (1970).

paid for the security, less its value at the time of suit, but in no event can the damages exceed the total offering price.⁴⁶⁹ Similarly, section 12 sets the damages at the consideration paid less the income received or at actual damages if the security has been sold.⁴⁷⁰ In light of these provisions, suit under 10b-5 appears to offer no substantial advantage or disadvantage with the possible exception of section 11.

Other

Section 17 of the Securities Act contains basically the same wording as Rule 10b-5, but, like section 12(2), it can only be utilized by a defrauded buyer.⁴⁷¹ Rule 10b-5, however, is much broader and provides implied civil remedies for both buyers and sellers due to the "in connection with a purchase or sale of securities" language. Also, section 15(c)⁴⁷² of the Exchange Act prohibits market manipulative schemes, but applies only to brokers. Section 9 of the Exchange Act⁴⁷³ provides similar proscriptions regarding any person who "rigs" the market, but is only relevant to securities listed on a national exchange. Since 10b-5 applies to all fraudulent activities, it can be employed to combat these evils, as well as those which do not involve a broker or a security listed on a national exchange. Finally, 10b-5 may be the basis of an action to recover for violations of the proxy rules expressed in section 14(e) of the Exchange Act,⁴⁷⁴ if, in reliance on the proxies, plaintiff either purchased or sold securities.⁴⁷⁵

TIPPEE LIABILITY

In the landmark decision of *Cady, Roberts and Co.*,⁴⁷⁶ the SEC dealt a decisive blow against the trading of a corporation's securities by corporate "insiders"⁴⁷⁷ on the basis of material,⁴⁷⁸ non-public information

469. 15 U.S.C. § 77k (1970).

470. 15 U.S.C. § 77l (1970).

471. 15 U.S.C. § 77q (1970).

472. 15 U.S.C. § 78o (1970).

473. 15 U.S.C. § 78i (1970).

474. 15 U.S.C. § 78n (1970).

475. See, e.g., *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967); *Globus, Inc. v. Janoff*, 266 F Supp. 524 (S.D.N.Y. 1967).

476. 40 S.E.C. 907 (1961).

477. Generally, insiders are considered to include officers, directors, controlling shareholders, and responsible employees of the issuer. Note, *Securities Fraud: Caveat Tippee—The Creation and Development of a Doctrine*, 33 U. PITT. L. REV. 79, 80 n.6 (1971). See also, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

478. "A material fact is one to which a reasonable man would attach importance

about their corporation. Based upon alleged violations of section 10(b) of the 1934 Exchange Act and Rule 10b-5, the SEC proceeded against the Cady, Roberts brokerage firm and against one of its partners. The gravamen of the complaint was that a representative of the defendant firm, who was a member of the Board of Directors of Curtiss-Wright Corp., had divulged information on a selective basis concerning an impending Curtiss-Wright dividend cut to Cady, Roberts prior to the public announcement of that information. On the basis of this disclosure, stock held in various discretionary accounts was sold by Cady, Roberts.

In accepting a settlement offer, the SEC described the elements giving rise to the duty to disclose inside information before trading:

[T]he obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. ⁴⁷⁹

It should be noted that the dual elements in the *Cady, Roberts* test—the “inside relationship” and the “inherent unfairness” in the use of the information to the detriment of the investing public—portend liability for the corporate insider only. But, history has shown that not all corporate insiders are parsimonious with corporate secrets. Occasionally, they have disclosed this information to close friends and business acquaintances for use in the market. This type of conduct has raised the serious question as to the extent of liability, if any, of these “tippees” ⁴⁸⁰ for their trading on the basis of this non-public information.

It would seem that a finding of liability on the part of the “tippee” would be consistent with the purposes of the securities law ⁴⁸¹. More-

in determining his choice whether to make a sale or not.” *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967), *citing* *List v. Fashion Park, Inc.*, 340 F.2d 457, 461-63 (2d Cir. 1965).

479. 40 S.E.C. at 912.

480. It appears that the term “tippee” was coined by Professor Loss in his 1961 treatise. 3 L. Loss, *supra* note 3, at 1450.

481. “The maintenance of fair and honest markets in securities and the prevention of inequitable and unfair practices in such markets are the primary objectives of the federal securities laws.” *Investors Management Co.*, BNA SEC. REG. & L. REP. (August 4, 1971) No. 113 at H-3 (SEC July 29, 1971).

over, to permit tippees to trade where their "tipposrs" are prohibited, merely because of the absence of an "inside relationship" with the corporate issuer, would be to create an obvious loophole in trading regulation—the taint is indistinguishable in both instances.

The conceptual basis of "tippee" liability is the principle that all members of the investing public should be subject to the same market risks. The fruition of this concept requires market disclosure of all material information, regardless of the identity of the possessor.⁴⁸² In view of the fact that "tippees" may possess information of the *Cady, Roberts* variety, and that they may deal with it to the detriment of the investing public, the question arises as to the theories upon which they may be held liable.

The Bases for Tippee Liability—Rule 10b-5

Rule 10b-5 makes unlawful the utilization of manipulative and deceptive devices by "any person."⁴⁸³ Consequently, a "tippee" comes within the prohibitions of the Rule when he trades without disclosing material, non-public information in his possession. However, it must be remembered that one of the two elements in the *Cady, Roberts* test—the existence of a special inside relationship to the corporate issuer—is not met by the "tippee" since he is, by definition, an outsider. Thus, the courts have been confronted with the problem of adapting the *Cady, Roberts* test to various "tippee" situations. Several different theories have been advanced to determine "tippee" liability

1 Professor Loss

Prior to the *Cady, Roberts* decision, Professor Loss advanced the proposition that "tippees" might be held liable under Rule 10b-5 upon a showing that they knew or had reason to know that the insider's tip was a "breach of trust." Professor Loss reasoned that "[t]o hold 'tippees' liable under Rule 10b-5 when they had no reason to suspect

482. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) Congress has also stated: "The concept of a free and open market for securities necessarily implies that the buyer and seller are acting in the exercise of enlightened judgment as to what constitutes a fair price." S. REP. NO. 1455, 73d Cong., 2d Sess. 68 (1934).

And, the Supreme Court has reiterated: "A fundamental purpose, common to [the securities laws], was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963)

483. 17 C.F.R. § 240.10b-5 (1971).

that their informant was an insider might result in an unreasonable entrapment of innocent persons.”⁴⁸⁴ The requirement that the tippee have actual or constructive knowledge that the information was disclosed in “breach of trust” has been criticized,⁴⁸⁵ but it appears that the thrust of Loss’ theory, the necessity of knowledge of a credible, corporate-related source, is vital.

2. *Tippees Are Also Insiders*

In *Ross v. Licht*,⁴⁸⁶ a federal district court in New York was presented with an action by sellers of stock for damages under Rule 10b-5, alleging that buyers purchased on the basis of inside information made available to them by corporate-insider friends. After determining that Rule 10b-5 requires corporate insiders to disclose material, non-public facts known to them by reason of inside positions before purchasing stock, the court went on to hold that the outsider tippees “were insiders also.”⁴⁸⁷ Thus, the court apparently attempted to disclaim any difference between insiders and “tippees” for the purposes of Rule 10b-5. The only problem with this position is the semantical dilemma caused by the fact that *Cady, Roberts* has reduced the term “insider” to a word of art representing one who occupies “a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the benefit of anyone. . . .”⁴⁸⁸ Since a “tippee” is clearly not an insider within this description, the classification of a “tippee” as an insider is unnecessarily confusing. This fact may have been recognized by the *Licht*⁴⁸⁹ court because it offered as alternate bases for liability the theories that defendants “would seem to have been ‘tippees’ . . . and subject to the same duties as insiders,” and that defendants “would be equally liable . . . for aiding and abetting a violation of Rule 10b-5”⁴⁹⁰

3 *Texas Gulf Sulphur and Investors Management Co.*

Dictum in the Second Circuit opinion in *SEC v. Texas Gulf Sulphur*⁴⁹¹ appears to support the alternative holding in *Licht* that “tippee” liability

484. 3 L. Loss, *supra* note 3, at 1451.

485. Note, *supra* note 477. See also A. BROMBERG, *supra* note 3, § 7.5(6)(3).

486. 263 F. Supp. 395 (S.D.N.Y. 1967).

487. *Id.* at 409.

488. *Cady, Roberts and Co.*, 40 S.E.C. 907, 912 (1961).

489. *Ross v. Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

490. *Id.*

491. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968).

is coterminous with insider liability, while recognizing that tippees are not insiders. The court noted that "tippees' conduct is equally violative of the Rule as the conduct of their inside source." ⁴⁹²

The most comprehensive treatment of "tippee" liability to date is the SEC decision in *Investors Management Co* ⁴⁹³ Investment advisers, mutual funds, and investment partnerships received information from Merrill Lynch, Pierce, Fenner & Smith, the prospective underwriter of a new Douglas Aircraft Corp. issue, of substantially reduced Douglas earnings and earnings estimates. Immediately prior to the disclosure, analysts had viewed Douglas' earnings position as favorable, and Douglas itself had forecast earnings of \$8 to \$12 per share for 1967. The new information, which was disclosed to Merrill Lynch on June 20, 1966 indicated no earnings for 1966 and expected only about half the original projection for 1967. This information was leaked by Merrill Lynch to defendants on June 21, 1966 and by June 23 they had sold 133,400 Douglas shares from long positions and 21,200 from short positions for a total in excess of \$13,300,000. Douglas publicly announced the reduced earnings figures on June 24.

After determining that defendant's conduct was violative of Rule 10b-5, the SEC announced four elements necessary for the imposition of responsibility in "tippees" (1.) The information must be material;⁴⁹⁴ (2.) it must be non-public;⁴⁹⁵ (3.) the "tippee," whether he receives the information directly or indirectly, must know or have reason to know that it is non-public and improperly obtained;⁴⁹⁶ and (4.) the informa-

492. *Id.* at 852-53.

493. BNA SEC. REG. & L. REP. (August 4, 1971) No. 113 (SEC July 29, 1971).

494. *Id.* at H-4. "Among the factors to be considered in determining whether information is material under this test are the degree of its specificity, the extent to which it differs from information previously publicly disseminated, and its reliability in light of its nature and source and the circumstances under which it was received." "

Id. Furthermore, the SEC recognized that "the fact that respondents acted immediately or very shortly after receipt of the information to effect sales is in itself evidence of its materiality" *Id.*

495. The fact that rumors had been circulating on June 21 to 23 was found not to constitute public disclosure on three grounds: (1) the rumors were not specific as to figures and projections, (2) they were not attributed to a corporation-informed source, and (3) their circulation was limited. *Id.* at H-4, 5.

496. The SEC stated that the appropriate test was neither a special relationship with the issuer giving access to non-public information, nor actual knowledge. Constructive knowledge was found to be the guideline. The SEC said:

We consider that one who obtains possession of material, non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other in-

tion must be a factor in the "tippee's" decision to effect the transaction.⁴⁹⁷

It is interesting to note that the SEC rejected defendants' argument that their obligations under the anti-fraud provisions were less because they were "remote tippees" who received their information from other "tippees." The SEC commented that: "If [defendants] are viewed as indirect recipients of the Douglas information, the same criteria for finding a violation of the antifraud provisions apply. Although the case of such an indirect recipient may present more questions of factual proof of the requisite knowledge, the need for the protections of those provisions in the tippee area is unaffected."⁴⁹⁸

The SEC similarly disallowed a contention that defendants, as investment advisers, had a fiduciary duty to their clients to sell their Douglas stock upon learning of poor Douglas earnings, commenting that "[t]he obligations of a fiduciary do not include the performing of an illegal act."⁴⁹⁹

In summary, it appears that the SEC has adopted Professor Loss'

vestors, thereby acquires a relationship with respect to that information within the purview and restraints of the anti-fraud provisions. Both elements are here present as they were in the *Cady, Roberts* case. When a recipient of such corporate information, knowing or having reason to know that the corporate information is non-public, nevertheless uses it to effect a transaction in the corporation's securities for his own benefit, we think his conduct cannot be viewed as free of culpability under any sound interpretation or application of the antifraud provisions.

Considerations of both fairness and effective enforcement demand that the standard as to the requisite knowledge be satisfied by proof that the recipient had reason to know of the non-public character of the information, and that it not be necessary to establish actual knowledge of that fact or, as suggested by respondents, of a breach of fiduciary duty. The imposition of responsibility where one has reason to know of the determinative factors in violative conduct is in keeping with the broad remedial design of the securities law and has been applied under other of their provisions as well as the antifraud provisions.

Id. at H-5. In determining "reason to know," the SEC states that it is appropriate to consider the surrounding circumstances, including the nature of the information; the manner in which it was obtained; the facts relating to the informant, including his business or other relation to the recipient and to the source of his information; and the recipient's sophistication and knowledge of related facts. *Id.*

497. "Turning next to the requirement that the information received be a factor in the investment decision, we are of the opinion that where a transaction of the kind indicated by the information (e.g., a sale or short sale upon adverse information) is effected by the recipient prior to its public dissemination, an inference arises that the information was such a factor. The recipient of course may seek to overcome such inference by countervailing evidence." *Id.*

498. *Id.*

499. *Id.* at H-6.

test of constructive knowledge in confirming the Second Circuit view that "tippee" liability is coterminous with insider liability. The *Investors Management Co.* case also illustrates the staggering amounts that can be involved in "tippee" cases—in that case over \$13,300,000.

Additional Tippee Debilities

Since both section 10-b and Rule 10b-5 prohibit the use of material inside information⁵⁰⁰ "by any person,"⁵⁰¹ it is clear that both the "tippor,"⁵⁰² in divulging inside information, and the "tippee,"⁵⁰³ in trading on the basis of such information violate the securities laws. Several interesting questions have arisen as to the ultimate burden of liability in suits involving both tippee and tippor.

1 Contribution

In *Ross v. Licht*,⁵⁰⁴ a suit by defrauded plaintiffs alleging a conspiracy between corporate insider "tippos" and their "tippees," the three tippees were held jointly and severally liable with the tippos. While the precise issue of contribution among defendants was not raised, the policy of the securities acts seems to indicate that contribution among defendants is intended.⁵⁰⁵ Thus, the first debility of the tippee becomes apparent. In a suit joining both a tippee and his tippor as defendants, where both are found to have violated Rule 10b-5, it would appear that

500. Note, *Caveat Tippor*, 33 U. PITT. L. REV. 103 (1971)

501. 17 C.F.R. § 240.10b-5 (1971)

502. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

503. *Investors Management Co.*, BNA SEC. REG. & L. REP. (August 4, 1971) No. 113 (SEC July 29, 1971)

504. 263 F Supp. 395 (S.D.N.Y. 1967)

505. Note, *supra* note 477, at 98. Therein the author points out the securities acts contain three contribution provisions. Section 11(f) of the Securities Act of 1933 contains the statement that: "All or any one or more of the persons specified in subsection (a) shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who became liable was, and the other was not, guilty of fraudulent misrepresentations." Sections 9(e) and 18(b) of the Exchange Act of 1934 provide that: "Every person who becomes liable to make any payment under this subsection may recover contributions as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment." The author notes that in each of these sections, civil liability was expressly provided, and he also comments that the 1933 Act makes the provision for contribution against one who is guilty of no fraudulent misrepresentation. This difference may cause the courts some future difficulty in determining the issue of contribution.

the tippee will be held to an equal degree of liability with the tipper, although the latter's conduct may evince the greater *mens rea*.

2. *In Pari Delicto and Unclean Hands*

At times, tippers have "divulged" false information to tippees, and the tippees, acting on the basis of this information, have purchased or sold securities and thus have sustained losses. In suits by the defrauded "tippees" against their "tippers," the decisions appear to be confused as to whether the defendant tipper may raise, as an absolute defense, the doctrines of *in pari delicto* or "unclean hands."

In *Kuehnert v. Texstar Corp.*,⁵⁰⁶ the court held that plaintiff's status as a "tippee" made the defenses of unclean hands and *in pari delicto* available, but noted that their exercise rests with the discretion of the court, saying: "[T]he question must be one of policy which decision will have the better consequences in promoting the objective of the securities laws by increasing the protection to be afforded the investing public."⁵⁰⁷ In determining that the policy of the securities acts dictates that a "tippee" have no recourse against his "tipper" the court noted:

It is true that if a tippee has no remedy against an insider's private falsehoods, little deterrent against such conduct will exist; the insider may have free rein. But, as against this, there is another danger. If a tippee can sue he has, in effect, an enforceable warranty that secret information is true.

[W]e think it important that tippees, who present the same threat to the investing public as do insiders themselves, should be offered appropriate discouragement. We conclude that the better choice is to leave upon persons believing themselves tippees the restraint arising from the fear of irretrievable loss should they act upon a tip which proves to have been untrue.⁵⁰⁸

A result similar to that in *Kuehnert* was reached in *Wohl v. Blair*⁵⁰⁹ Therein, plaintiff had received a false tip from his broker which encouraged him to buy stock. The court denied plaintiff's motion to strike the defenses of unclean hands and *in pari delicto* on the ground that customers should be forced to deal on the basis of inside information "at their own risk."

506. 412 F.2d 700 (5th Cir. 1969).

507. *Id.* at 704.

508. *Id.* at 705.

509. 50 F.R.D. 89 (S.D.N.Y. 1970).

The decision in *Wohl* was later repudiated in *Nathanson v. Weis, Voism, Canon, Inc.*⁵¹⁰ As in *Kuehnert*, the court viewed the question of whether to allow the defenses of unclean hands and *in pari delicto* in terms of "what policy would best serve to carry out the prime purpose of the securities laws to protect the investing public."⁵¹¹ But the *Nathanson* court concluded that the securities laws were preventative in nature, and that the best way to eliminate the practice of tipping would be to place the ultimate loss upon the tipper, thus discouraging him from making the initial disclosure.⁵¹² In order to best achieve this result, it was concluded that the defenses of unclean hands and *in pari delicto* should be disallowed so as to insure maximum tipper punishment.

It appears that both *Kuehnert* and *Nathanson* agree that the primary purpose of the securities laws is the protection of the investing public. They also implicitly agree that the allowance of the defenses of unclean hands and *in pari delicto* rests in the discretion of the court. It would appear that their only area of disagreement is how, through the exercise of discretion, the court may best promote the purpose of the securities laws. *Kuehnert* maintains that the tipper is sufficiently deterred by way of the *Texas Gulf Sulphur* decision, criminal penalties, etc., and therefore the avaricious tippees should be subjected to similar pressures. *Nathanson* disagrees, preferring to bring full judicial pressure to bear on the tipper, hoping thereby to shut off the flow of inside information.⁵¹³

Conclusion

After observing the judicial activity under Rule 10b-5 in the microcosm of "tippee" liability, it becomes apparent that 10b-5 is being expanded into a universal fraud remedy. A tippee, no matter how far removed from the corporate source of the information, may be liable under Rule 10b-5 for non-disclosure of inside information if the four elements of the *Investors Management* test are satisfied.⁵¹⁴ In addition, if the tippee does disclose the inside information, thus becoming a tipper, and if the information turns out to be false, the *Nathanson* view would allow suit by the defrauded tippee against the tipper. Thus, the

510. 325 F Supp. 50 (S.D.N.Y. 1971).

511. *Id.* at 52-53.

512. *Id.* at 57.

513. The *Nathanson* decision has been criticized in Note, *supra* note 500, with some success.

514. See notes 494-97 *supra* and accompanying text.

tippee will be liable to his buyer or seller for non-disclosure of material, non-public information which is true, and he will also be liable for disclosure of information which is false. Certainly, this is a long judicial step from the original interpretation of Rule 10b-5 as a purely SEC oriented injunction provision.

CONCLUSION

In the years since a private right of action was first implied under Rule 10b-5, the courts have experienced little success in developing a unified approach to the elements of that right of action. Furthermore, the judicially created *Birnbaum* doctrine has imposed a seemingly arbitrary element in determining standing of plaintiffs to sue under Rule 10b-5. The most obvious cause of this disjointed situation is the absence of clear Congressional intent concerning the scope of section 10(b).

It is submitted that a private right of action under 10b-5 is proper and necessary. The other provisions in both securities acts providing for private rights of action fail to cover effectively the spectrum of securities frauds.

The *Birnbaum* doctrine was judicially created, and should be judicially destroyed. This could be accomplished either by limiting that case to its facts, or by restricting its application to those cases involving breaches of fiduciary duties. The resulting expansion of the scope of Rule 10b-5 would be harmonious with the announced purposes of the securities acts. The argument that abolition of the purchaser-seller rule would open wide the doors to a multitude of actions is countered by the fact that the remaining elements of the 10b-5 action such as scienter, materiality, reliance, and causation are sufficient to eliminate frivolous suits.

Therefore, absent a Congressional redraft of the statute, it is apparent that the judiciary must act in concert to clarify the elements of Rule 10b-5.

There has been a great social cost incurred due to the proliferation of litigation under the Rule. Certainty is a mandate in the realm of securities counselling which is no longer possible due to the confusion concerning Rule 10b-5. One of the most effective methods to abate this confusion would be a concerted effort by the Supreme Court to grant certiorari to those cases presenting issues upon which the circuits are in conflict and to deal authoritatively with the problems presented.