1974

Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code

Michigan Law Review

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Litigation Commons, and the Securities Law Commons

Recommended Citation
Available at: https://repository.law.umich.edu/mlr/vol72/iss7/4

This Note is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.
Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code

The nation's largest railroad reached the end of the line on June 21, 1970. On that date the Penn Central Transportation Company filed a petition for reorganization pursuant to section 77 of the Federal Bankruptcy Act. The collapse of the company caught many shareholders by surprise. Although the Penn Central Company on occasion had modified its corporate form, it had not missed paying a dividend for 123 years, and its securities sported prime ratings until the month before the bankruptcy.

Yet, not everyone was injured in the crash. The Securities and Exchange Commission’s (SEC) report to Congress on the collapse of the Penn Central alleges that some corporate insiders dumped their personal holdings of Penn Central securities shortly before news of the company's financial distress reached the investing public. It was also alleged that insiders made these sales without disclosing material information regarding the company’s approaching crisis, and that Penn Central’s management issued unjustifiably optimistic reports to the public. It is not surprising that the “wreck of the Penn Central” has generated considerable private litigation by share-


In 1968 the Pennsylvania Railroad Company merged with the New York Central Railroad, see N.Y. Times, Jan. 16, 1968, at 1, col. 8 (late city ed.), and in 1969 a reorganization plan was consummated that created the Penn Central Transportation Company as a subsidiary (and main asset) of the Penn Central Holding Company. See J. Daughen & P. Binzen, THE WRECK OF THE PENN CENTRAL, facing p. 113 (1971).

3. Wall St. J., Nov. 28, 1969, at 10, col. 3 (eastern ed.).


6. Id. at 248: “Between the time of the formation of the Penn Central Transportation Company in February 1968 and the June 1970 bankruptcy, as management deliberately and increasingly glazed its public reports with distorted optimism, many members of management succeeded in selling many shares of Penn Central stock.” See also In re Penn Cent. Sec. Litigation, 547 F. Supp. 1327, 1332 (E.D. Pa. 1972), modified, 557 F. Supp. 869 (1979), affd., 494 F.2d 529 (3d Cir. 1974).
holders to hold the insiders liable under section 10(b) of the Securities Exchange Act of 1934, as implemented by rule 10b-5. The Penn Central litigation, involving a large, publicly held corporation, illustrates the need to examine the reach of the federal antifraud provisions. This Note discusses the problem of defining the plaintiff class when the number of past and present shareholders who are potential plaintiffs is very great. Attention will center on the methods courts have used to limit the class of investors compensable under rule 10b-5. Also, the effect that enactment of present drafts of the American Law Institute's proposed Federal Securities Code would have on the composition of the plaintiff class in

---


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

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.

10. The idea for a new codification of the federal securities laws originated with the Committee on Federal Regulation of Securities of the Section of Corporation, Banking and Business Law of the American Bar Association. See Hempham, An Overview—Regulation of Securities and the Securities Markets: A Timely Report to the Bar, 28 Bus. LAW. 375 (1973). The American Law Institute accepted the challenge and selected Louis Loss as reporter. Thus far, three tentative drafts have been published. ALI FEDERAL SECURITIES CODE (Tent. Draft No. 1, April 1972) deals with exemptions, issuer registrations, distributions, postregistration provisions, and definitions relating to these areas. ALI FEDERAL SECURITIES CODE (Tent. Draft No. 2, March 1973), the draft relevant to this Note, predominantly covers deceptive and manipulative acts and civil liabilities therefor. ALI FEDERAL SECURITIES CODE (Tent. Draft No. 3, April 1974) also deals with exemptions and distributions, as well as the administration, enforcement, and scope of the Code. For some of the history behind the codification effort see Loss, The Amer-
analogous actions will be discussed. Finally, the Note assesses the viability of the private compensatory remedy in light of the difficulties that plague the limitation of the plaintiff class in rule 10b-5 actions.11

11. For the sake of clarity this Note will assume that the defendant has violated rule 10b-5. It should be recognized, however, that the harshness of the private damage remedy is exacerbated by uncertainty concerning the elements of a violation. For example, it is not clear whether the defendant must have had knowledge of the false representation or misleading nondisclosure to be held liable. See 2 A. Bromberg, Securities Laws §§ 8.4(500)-(590) (Supp. 1971); Epstein, Scienter Requirement in Actions Under Rule 10b-5, 48 N.C. L. REV. 482 (1970); 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. 1266 (1970). Some circuits state that knowledge is not necessary and that negligence suffices. See cases collected in R. Jennings & H. Marsh, Securities Regulation: Cases and Materials 1071 nn.7, 8 (3d ed. 1972). Under the latter standard, it might seem easy for a defendant to stumble into a rule 10b-5 violation, but one commentary is skeptical of the seriousness of the risk. It questions whether "any court would in fact impose a crushing liability upon a corporate officer in favor of thousands of purchasers in the market for simple negligence in the issuance of a press release." Id. at 1072. The Second Circuit would not, finding negligence sufficient to support an injunction under rule 10b-5 but requiring scienter in a damage action. Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971). The Second Circuit has repeatedly affirmed its stand against the sufficiency of mere negligence. See, e.g., Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 489 F.2d 941, 963 (2d Cir. 1973), cert. denied, 414 U.S. 910 (1974); Lanza v. Drexel & Co., 479 F.2d 1277, 1305-06 (2d Cir. 1973); Cohen v. Franchard Corp., 478 F.2d 115, 123-24 (2d Cir.), cert. denied, 414 U.S. 857 (1973); SEC v. Manor Nursing Centers, Inc., 438 F.2d 1092, 1096 n.15 (2d Cir. 1972). Second Circuit decisions have recently influenced district courts in other circuits to come out against a negligence standard. See, e.g., Waldman v. Shearson, Hammill & Co., Inc., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,586 (D.N.J. Jan. 31, 1974); Stewart v. Bennett, 359 F. Supp. 978 (D. Mass. 1973); Golob v. Nauman Vandervoort, Inc., 352 F. Supp. 1264 (N.D. Ohio 1972). In the recent case of Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974), the Fifth Circuit appears to have agreed with the Second Circuit that mere negligence is not sufficient. The Smallwood court held that although it would not "draw the bottom line on the degree of scienter required" in the circuit, some culpability beyond mere negligence is necessary. 489 F.2d at 606. Citing "the difficulties courts have had in trying to fit a wide variety of complex fact situations and relationships within a single standard of scienter," the Ninth Circuit has recently rejected any comprehensive scienter test. White v. Abrams, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,457, at 95,608 (9th Cir. March 15, 1974). Instead the court of appeals proposes to determine the duty that rule 10b-5 imposes on a particular defendant by looking at such factors as the relationship between the plaintiff and the defendant, the defendant's access to information compared to the plaintiff's access, the defendant's benefit from the relationship, the defendant's awareness of the plaintiff's reliance, and the defendant's activity in initiating the securities transaction. CCH Fed. Sec. L. Rep. ¶ 94,457, at 95,609-10. Perhaps the Ninth Circuit would not feel compelled to depart from more traditional state of mind standards if the Code's method of varying the standard with the type of violation, see note 29 infra, were substituted for the single standard used now.
Under present law, the possible reach of section 10(b) and rule 10b-5 is extensive. The rule imposes on corporate insiders not only the duty to make no affirmative misrepresentations “in connection with the purchase or sale of a security,” but also the duty to “disclose material facts which are known to persons with whom they deal and which, if known, would affect their investment judgment.” Courts have left intact the broad sweep of this language. In the leading case of *SEC v. Texas Gulf Sulphur Co.*, for example, it was held that anyone who has access to inside corporate information that a reasonable investor would consider important in making an investment decision may not trade in the securities of that corporation without disclosing the information to the investing public.

Congress has created an impressive array of sanctions against violators of section 10(b) and rule 10b-5, many of which are enforced by the SEC. For insiders of a large corporation, however, the most

Another troubling problem under present law is the requirement that the information undisclosed or misrepresented by the defendant be “material.” Courts have been unable to articulate a clear definition of “materiality.” In *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), for instance, the Second Circuit approved two different formulations, one covering “those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed,” 401 F.2d at 849, quoting Fleisher, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 Va. L. Rev. 1271, 1289 (1965), and the other, less strict, encompassing all facts “which in reasonable and objective contemplation might affect the value of the corporation’s stock or securities...” 401 F.2d at 849, quoting List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965), quoting Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963) (emphasis added by Texas Gulf Sulphur court). Either definition could conceivably cover educated guesses based on the sort of specialized knowledge inevitably acquired by an insider, a result deplored by at least one federal district judge. *SEC v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262, 284 (S.D.N.Y. 1966) (Bonsal, J.), aff’d in part and vacated in part, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

12. Cary, Corporate Standards and Legal Rules, 50 Calif. L. Rev. 468, 415-16 (1962). The traditional rule had been that the affirmative duty of disclosure applied only in face-to-face transactions. See Goodwin v. Agassiz, 283 Mass. 396, 186 N.E. 659 (1935). Reasoning from traditional fiduciary concepts, one common law case expanded the affirmative disclosure duty to include a director’s open market purchase of stock from an existing shareholder. Hotchkiss v. Fischer, 136 Kan. 530, 16 F.2d 581 (1923). However, a distinction between purchases from existing shareholders and sales to nonshareholders was expressly rejected in *Cady*. 40 S.E.C. at 915.


15. Congress has expressly empowered the SEC to conduct investigations of possible past or potential violations and to publish information concerning such violations. 15 U.S.C. §§ 78u(a)-(c) (1970). Some skepticism has been voiced regarding the efficacy of this sanction. See, e.g., Baumhart, *How Ethical Are Businessmen*, 59 Harv. Bus. Rev.
fearsome sanction is the private damage remedy implied by the courts under rule 10b–5. The number of possible plaintiffs is large, and the extent of their loss is potentially as great as the number of outstanding shares multiplied by the drop in price. Penn Central Company, for example, had 24,110,321 shares of common stock outstanding as of December 31, 1971; during the period from 1968 to 1970, the price of its stock fell from 86 1/2 per share to 5 1/2 per share. Those investors who bought or held Penn Central stock in ignorance of the company's financial weakness thus suffered an immense aggregate loss, grossly disproportionate to the savings made by insiders who sold their holdings before news of the bankruptcy reached the public. To require those insiders to reimburse all shareholders for their losses would be unduly harsh, and would also be impossible to effect. If no limitations on the plaintiff class are imposed, those who profit will lack the necessary funds to pay those injured. The result would not be reimbursement but personal bankruptcy.

The proposed Federal Securities Code generally achieves a more reasonable result because in many situations it imposes a ceiling on the possible extent of the defendant's liability. In accord with its objective of rectifying the overlap and "scatteration" of the present

July-Aug. 1961, at 1, 6 (indicating that the business community does not seriously condemn insider trading). However, Texas Gulf Sulphur and its progeny may have produced a less cynical attitude among corporate officials. A new study might be fruitful.


In addition, the SEC may obtain injunctions barring further violations. 15 U.S.C. § 78u(e) (1970). And in SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), cert. denied, 404 U.S. 1005 (1971), the court acknowledged the Commission's authority to seek restitutionary relief to deprive insiders of the fruits of their wrongdoing. 446 F.2d at 1307-08. No specific statutory authority exists for such relief, but the court upheld the authority of a district court to grant restitution as an ancillary remedy in the exercise of its general equity powers. 446 F.2d at 1307. The court stipulated that the SEC might seek "other than injunctive relief in order to effectuate the purposes of the Act, so long as such relief is remedial relief and not a penalty assessment." 446 F.2d at 1308.

16. See, e.g., Janigan v. Taylor, 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); 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). Other cases are collected in 6 L. Loss, Securities Regulation 3871-73 (2d ed. Supp. 1969); Ruder, Civil Liability Under Rule 10b–5: Judicial Revision of Legislative Intent, 57 Nw. U. L. Rev. 627, 687-99 (1963). It has been suggested that the private cause of action implied under rule 10b–5 should extend only to suits brought by sellers, but the idea has won little acceptance. See 1 A. Bromberg, supra note 11, § 2.4(2) (Supp. 1971).


18. Id.

19. See text following note 44 infra and text accompanying notes 161-62 infra.
The Code breaks down and delineates antifraud violations that are now covered in a broad manner by section 10(b) and rule 10b-5, as well as by other provisions and rules. Part XIII (sections 1301 to 1311) groups all of the provisions that prohibit acts of fraud, misrepresentation, or manipulation. Section 1301(a), a principal counterpart to the present section 10(b), makes it unlawful to engage in fraudulent securities transactions, proxy solicitations, or tender requests. Section 1303(a) prohibits trading by insiders if they know a "fact of special significance" that is not generally available. The practice of fraud in connection with filings, records, and publicity is outlawed by section 1304. Other provisions less similar to present actions under rule 10b-5 make it illegal to give fraudulent investment advice (section 1302); to misrepresent Commission approval (section 1305); or to engage in churning (section 1306), touting (section 1307), manipulation (section 1308), or stabilization (section 1309).

20. See ALI FEDERAL SECURITIES CODE, Introductory Memorandum at xv-xvi (Tent. Draft No. 2, March 1973), which lists the principal problems with the present statutes.

21. However, the Code is not intended completely to supersede the growth of the common law in the rule 10b-5 area. Reporter Louis Loss early in the project indicated that he would not "codify the law in that area completely" because in a time of rapid development of a federal corporation law it might not be prudent "to foreclose judicial invention of private rights of action" by making "everything express." Loss, supra note 10, at 34.

22. Churning occurs when a broker who has been granted discretion by a client to trade on his account abuses that discretion by engaging in transactions that are excessive or overfrequent in light of the nature of the account. See R. Jennings & H. Marsh, supra note 11, at 837-38. The Code section on churning would also cover abuses by brokers who have authority for excessive trading in a client's account by reason of the client's willingness to follow the broker's suggestions.

23. This Code provision covers the situation in which a person describes or recommends a security to a second person for consideration from a third person, such as an issuer or broker, who is interested in buying or selling the stock. The first person must disclose the source of consideration. Thus, A cannot receive money from B in consideration for describing B's stock to C unless C knows or is told that A is being paid by B. This provision is a recodification (with minor changes) of section 17(b) of the Securities Act of 1933, 15 U.S.C. § 77q(b) (1970).

24. Manipulation can take a number of forms under the Code. Manipulation by touting is defined in section 1308(a) as the dissemination by a buyer or seller, or prospective buyer or seller, of a security of "information to the effect that the price of a security of the . . . issuer . . . will or is likely to rise or fall because of the market operations of any person conducted for the purpose of raising or depressing the price of the first security." This provision is derived from sections 9(a)(3) and 9(a)(5) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78i(a)(3), (5) (1970). See R. Jennings & H. Marsh, supra note 11, at 924-25.

25. Stabilization, under both present law and under the Code, is a transaction designed to fix or peg the price of a security. See R. Jennings & H. Marsh, supra note 11, at 869-924.
Part XIV (sections 1401 to 1424) establishes civil liabilities for the violation of the provisions of part XIII. Section 1402 provides a private remedy for buyers and sellers victimized by deceptive sales or purchases in violation of sections 1301(a)(1) or 1303(a). Buyers and sellers injured by false publicity prohibited by section 1304(c) have a remedy in section 1406. Other sections of part XIV create civil liabilities for violations of the provisions against manipulation and stabilization (section 1408), churning (section 1410), and fraudulent proxy solicitations and tender requests (section 1412). Liabilities are also created, without reference to part XIII, for false registration statements, offering statements, and annual reports; other false filings; and false distribution statements. In addition, section 1423(a) allows a court to “recognize a private action based on a violation of a provision of this Code or a rule or order thereunder . . . even though it is not expressly created by part XIV.” By creating distinct liability sections with differing elements the Code avoids the blunderbuss approach of the present law under rule 10b-5.


29. The Code would also settle disputes among the circuits over the necessity of scienter. See note 11 supra. First, it expressly defines knowledge: “When reference is made to this section, a misrepresentation is known by a person to be a misrepresentation if he (a) knows or believes that the matter is otherwise than represented, (b) does not have the confidence in its existence or nonexistence that he expresses or implies, or (c) knows that he does not have the basis that he states or implies he has for his belief.” ALI FEDERAL SECURITIES CODE § 251A (Tent. Draft No. 2, April 1973).

Second, the Code makes clear the scienter requirement for each type of violation. Under section 1402, which prohibits insider trading, negligence suffices for liability, and the burden is on the defendant to prove that he was not negligent. Negligence is also sufficient under section 1403, which creates liability for misrepresentations (defined in section 259 to include material omissions) in registration statements, offering statements, and annual reports. If the plaintiff proves that the defendant had actual knowledge as defined in section 251A, however, the limitations on damages imposed by section 1403(g)(2) do not apply. ALI FEDERAL SECURITIES CODE § 251A, Comment (4) (Tent. Draft No. 2, April 1973). (Section 1403(g)(2) limits damages with respect to each defendant to the greater of $100,000, one per cent of the defendant’s gross income for the last fiscal year, or where the violation is based on the defendant’s sale of stock, his profit from later repurchasing the same type of securities at a lower price.) Section 1404, which deals with misrepresentations in filings other than those covered by section 1403, requires proof that the defendant had knowledge. Negligence suffices under section 1405 to establish liability for false distribution statements, but an underwriter without section 251A knowledge is not liable for falsely certifying that he is unaware of any further information that must be disclosed. Liability under section 1406 for false publicity is also predicated on the existence of section 251A knowledge.

The Code would also end some of the confusion surrounding the definition of materiality. See note 11 supra. Section 256(a) states: “A fact is ‘material’ if a reasonable person would attach importance to it under the circumstances in determining his course of action.” Section 259(a) incorporates this concept into the definition of misrepresentation: “Misrepresentation’ means (1) an untrue statement of a material fact, or (2) an omission to state a material fact necessary to prevent the statements made
Perhaps more valuable than the Code's orderly structure of rights and remedies, however, are the methods it employs to limit the plaintiff class in a rule 10b-5-type action. Present judicially developed limitations require privity, a showing that the plaintiff did not merely retain his stock during the period of insider wrongdoing, proof of reliance on the defendant's representations or nondisclosures, and the establishment of a causal connection between the inadequate disclosure and the plaintiff's economic loss. The following analysis compares the Code's limitations with those developed by the courts.

I. PRIVITY

Privity—generally defined as "[m]utual or successive relationship to the same rights of property," was formerly a common requirement in actions based on fraud or misrepresentation. If strictly imposed it would allow a plaintiff to sue only the person from whom he bought or to whom he sold. A rigid privity requirement thus cannot be insisted upon in cases involving stocks sold on an open market.

However, a fairly early case, *Joseph v. Farnsworth Radio & Television Corp.*, required that "a semblance of privity" be established between the defendant-vendor and the plaintiff. In that case the court dismissed a rule 10b-5 suit in part because the insiders' last sale of allegedly overvalued stock occurred weeks before the plaintiffs purchased similar stock. Although the district court admitted that the defendants may have engaged in fraud, it held that there was no fraud on these particular plaintiffs. It refused to rule on the rights of investors who bought their stock during the period of the defendants' sales, thereby implying that the required "sem-

---

31. 2 A. BROMBERG, supra note 11, § 8.5(110).
32. Id.
34. 99 F. Supp. 701 (S.D.N.Y. 1951), affd., 198 F.2d 888 (2d Cir. 1952).
35. 99 F. Supp. at 706.
blance of privity" may exist if the plaintiff and the defendant buy and sell at approximately the same time.

Most courts, however, have abandoned the privity requirement. Plaintiffs even have been allowed to proceed against defendants who engaged in no trading whatsoever. In *Heit v. Weitzen*, for example, the court allowed recovery even though it was unlikely that the defendants—a corporation, several of its directors, and a vice-president—had any concern with the price of the corporation's stock. Their wrongdoing primarily involved overcharges on government contracts, and they engaged in no trading of the securities of the corporation. The stockholder-plaintiffs charged that the defendants had violated rule 10b-5 by their failure to disclose that a substantial part of the corporation's income for fiscal 1964 was derived from these overcharges and by their consequent misstatement of the corporation's assets in press releases and an annual report. The Second Circuit court of appeals held that a cause of action was stated under rule 10b-5 where the deceptive device employed would cause reasonable investors to trade in reliance thereon, whether or not the defendants engaged in contemporaneous trading.

Although a privity requirement has been largely abandoned, courts still occasionally speak in "semblance of privity" terms. In *In re Caesars Palace Securities Litigation* the court stated:

> [N]o court has yet advocated an unconditional abandonment of privity, and it is axiomatic that some legally cognizable relationship, perhaps akin to the "semblance of privity" concept espoused in *Joseph v. Farnsworth Radio & Television Corp.* . . . must be present between the parties before liability may be imposed. . . . If this underlying concept of privity was totally disregarded, a burden out of all proportion to the fault involved might be cast upon anyone who makes false assertions in the marketplace.

---


41. 360 F. Supp. at 376-77.
Caesars Palace plaintiffs, purchasers of debentures of Caesar’s World Inc., were attempting to sue the shareholders, employees, officers, and partners of the corporation and partnership that sold the Caesars Palace Hotel and Casino to Caesar’s World. Caesar’s World and its officers were also defendants. The alleged violations involved dissemination of false and misleading information about the Casino’s financial status and misstatements and omissions in the registration statements and annual report of Caesar’s World. The Caesars Palace defendants moved to dismiss the complaint as to them on several grounds, including lack of privity. Despite the court’s concern for a “semblance of privity,” it refused to dismiss the complaint, finding that “an actionable relationship exist[ed] between the parties.” It did, however, invite the defendants to resubmit the question if, pursuant to discovery, they were able to prove that “a total absence of privity exist[ed].”

Caesars Palace, however, should not be construed as requiring “privity” in the sense that recovery can be had only for those tainted shares that are traced through the market from the defendants to the plaintiffs. The court may well have been troubled by the broader problem that the plaintiffs’ securities were not even issued by the corporation in which the Caesars Palace defendants held an interest. Thus, the “legally cognizable relationship” that the case requires may be more in the nature of an insider-stockholder relationship than a purchaser-seller relationship.

The Federal Securities Code follows the current general practice and does not impose a privity requirement. Professor Loss pointed out that this is not without its disadvantages:

I know it’s fashionable for law professors particularly to pooh-pooh privity as a concept in deceit, and I have done it along with others, but when you abandon the privity concept and make a director or officer liable to everybody who has bought or sold in the market because there is a false press release or a false report, or something of that sort, the potential liability is really quite horrendous in relation to the crime, if it be a crime.

Again, I’m not suggesting that there should never be liability here. I’m simply saying that, when you abandon a basic concept like privity, you must think through the implications . . .

The Code’s policy of limiting excessive liability tempers the effect of its abandonment of the privity requirement. In cases involving false registration statements, offering statements, and reports (section 1403); other false filings (section 1404); false distribution statements (section 1405); and false publicity (section 1406), the Code sets a ceiling on damages for each defendant at the greatest of $100,000, one
per cent (to a maximum of $1,000,000) of the defendant’s gross income for the last fiscal year, or the defendant’s profit from selling and buying or buying and selling securities of the type in question.

Moreover, section 1402, which deals with deceptive sales and purchases, distinguishes between face-to-face and market transactions. Section 1402(a) makes a defendant in a face-to-face transaction liable to only his immediate buyer or seller. In contrast, section 1402(b) provides that when the matching of buyer and seller is “substantially fortuitous,” a defendant is liable to all who buy or sell between the day the defendant unlawfully buys or sells and the day when all material facts become generally available. Although similar to a “semblance of privity” requirement, section 1402(b) more accurately deals with causation-of-loss, since persons not within its time provision would not have been injured by the defendant’s actions. This limitation on plaintiffs pinpoints those injured, rather than those who bought or sold at approximately the same time as the defendant, which was the concern of the *Farnsworth Radio* court.

While a privity requirement would eliminate many plaintiffs in actions such as the Penn Central case, and thus protect some defendants from potentially disproportionate private damage judgments, its passing need not be mourned. It creates an arbitrary distinction in the context of a national market on which the securities of large, publicly held corporations are sold. An investor who trades on a public securities exchange neither knows nor cares whether he purchased his particular shares from a corporate insider. The privity requirement would thus make compensation in rule 10b-5 cases depend on a fortuitous event—whether or not a particular investor engaged in securities trading during approximately the same time period as an insider accused of wrongdoing.

II. THE BIRNBAUM DOCTRINE

Although they have rejected the privity requirement, the courts have sought to replace it with other theories of limitation. One of these theories, the so-called Birnbaum doctrine, disqualifies plaintiffs who merely retain securities during the period of the defendant’s nondisclosure or misrepresentation. This limitation differs from the “semblance of privity” requirement in that the period of defendant’s wrongful representations, not the period of the defendant’s trading, marks the time in which the plaintiffs must buy or sell the securities in question.

The *Birnbaum* requirement arose not from concepts of common law privity but from the legislative history of section 10(b) of the Securities Exchange Act and the language of that section that pro-

45. Of course, an investor might care to know that he is buying while insiders are selling, or vice versa.
hibits the use of manipulative and deceptive devices "in connection with the purchase or sale of any security." 46 Rule 10b-5 also applies only to devices used "in connection with" a securities transaction. 47

In Birnbaum v. Newport Steel Corp. 48 the Second Circuit announced that section 10(b) "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that rule X-10b-5 extended protection only to the defrauded purchaser or seller." 49 Applying this interpretation, the court dismissed a suit brought by minority shareholders charging that the individual defendant had made misrepresentations "in connection with" the sale of his controlling interest in one of the defendant corporations. The sale was made for a substantial premium after the defendant rejected a merger that would have been very profitable to all of the corporation's shareholders, including the plaintiffs. The court rejected the plaintiffs' argument that the defendant's sale of a controlling interest met the requirements of rule 10b-5 and found that the plaintiffs, who had retained their securities, were not "purchasers or sellers" within the meaning of the rule. 50

The Birnbaum case thus derived two requirements from the "in connection with" language of section 10(b) and rule 10b-5. The first distinguishes defendants whose wrongdoing involves trading from those charged with "mere mismanagement"; the second distinguishes plaintiffs who are purchasers and sellers from investors who retain their stock through the period of wrongdoing. 51

The first requirement has a valid rationale. Common law concepts of fiduciary duty have traditionally covered corporate mismanagement, 52 and the Securities Exchange Act of 1934 was designed to protect the integrity of the trading market rather than to oversee internal corporate operations. 53 Ironically, however, it is this requirement that the courts may have diluted. 54 The Supreme Court, in

49. 193 F.2d at 464.
50. 193 F.2d at 463-64.
51. Analytically the two requirements are distinct, although in practice plaintiffs are more likely to be purchasers or sellers in trading than in mismanagement cases. The unsuccessful plaintiffs in Birnbaum subsequently recovered under state law on the theory that the defendant had appropriated a corporate opportunity to his own benefit. Perlman v. Feldman, 219 F.2d 173 (2d Cir. 1955) (diversity jurisdiction).
53. Herpich v. Wallace, 430 F.2d 792, 808 (5th Cir. 1970).
54. A prediction of the demise of Birnbaum should be ventured cautiously. It has been made before and has been proved wrong. Lowenfels, The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5, 54 Va. L. Rev. 268 (1968).
Superintendent of Insurance v. Bankers Life & Casualty Co., had stretched the scope of section 10(b) to cover a situation that, although peripherally involving a sale of securities, was more a case of corporate looting than of abuse of the securities market. The “misrepresentation” in question was that Manhattan, the corporate seller of certain United States Treasury bonds, would receive the proceeds from the sale. In fact the proceeds were used by an individual defendant to purchase Manhattan stock. The Court found the scheme to be “an ‘act’ or ‘practice’ within the meaning of Rule 10b-5 which operated as a ‘fraud or deceit’ on Manhattan . . .” and held that the plaintiff had stated a cause of action under section 10(b).

The Court expressly rejected the Second Circuit’s view that section 10(b) is “limited to preserving the integrity of the securities market.” All that is required for redress under section 10(b), it said, is “a ‘sale’ of a security and . . . fraud . . . used ‘in connection with’ it . . .” Manhattan was protected because it “suffered an injury as a result of deceptive practices touching its sales of securities as an investor,” the securities being the Treasury bonds. The Court’s language seemingly eliminates any requirement as to the defendant other than that he engage in a fraud that in some manner can be connected with a purchase or sale of securities. The connection in Bankers Life seems to have been tenuous indeed. Certainly there

56. One Begole paid for the stock with a check obtained from the Irving Trust Company for which there were no funds on deposit. After Begole acquired the Manhattan stock, Manhattan sold its United States Treasury bonds for $4,854,592.67. The proceeds from this sale, plus enough cash to bring the total to $5,000,000, were transferred to Manhattan’s account at Irving Trust against which the Irving Trust check was then charged. Irving Trust issued a second $5,000,000 check to Manhattan that Manhattan’s new president tendered to the Belgian-American Bank and Trust Company, which issued a $5,000,000 certificate of deposit in the name of Manhattan. The certificate was assigned to the New England Note Corporation and was then endorsed to the Belgian-American Banking Corporation as collateral for a $5,000,000 loan to New England. The proceeds from this loan were used to cover the second Irving Trust check for $5,000,000. The outcome was that Begole had used Manhattan assets to purchase the Manhattan stock from Bankers Life. Manhattan’s books reflected only the sale of its government bonds and the purchase of the certificate of deposit. They did not show that its assets had been used to purchase Manhattan’s shares or assigned to New England and then pledged to Belgian-American. 404 U.S. at 7-9.
57. 404 U.S. at 9.
58. The Superintendent of Insurance sued on behalf of Manhattan but really represented Manhattan’s creditors. The Supreme Court approved this procedure on the ground that controlling stockholders owe fiduciary obligations to their corporations for the benefit of its creditors as well as its minority shareholders. 404 U.S. at 12. Manhattan Casualty Company had no minority shareholders. 404 U.S. at 7.
59. 404 U.S. at 13-14.
61. 404 U.S. at 12.
were contrivances to hide the absence of the appropriated assets. However, the purchases, transfers, and pledge\textsuperscript{63} merely concealed the primary wrongdoing, which was not an abuse of the market process but simple misappropriation. Although cases of purely internal corporate mismanagement in which no defendant trades are not brought within the reach of section 10(b), \textit{Bankers Life} does seem to reject Birnbaum insofar as certain breaches of fiduciary duty are concerned.\textsuperscript{64} Plaintiffs ordinarily should have little trouble satisfying the "touch test" of \textit{Bankers Life},\textsuperscript{65} but the "mere mismanagement" limitation still may be viable in cases in which the alleged wrongdoing is completely divorced from any securities transaction.\textsuperscript{66}

The proposed Code adds little and settles nothing in the area of the "mere mismanagement" distinction drawn by Birnbaum. The Introductory Memorandum points out that one of the principal problems with the present state of the law is that "[i]t has become increasingly difficult to draw the line between violation of Rule 10b–5 in stockholders' derivative actions and the traditional case of corporate mismanagement that merely happens to involve a securities transaction."\textsuperscript{67} Despite their realization of the problem, however, the drafters intentionally chose to leave open "as simply not ripe for codification . . . the delicate question of drawing a line between securities fraud and corporate mismanagement . . . ."\textsuperscript{68} Fearing that any bright line would be too tight or too loose, they concluded that "[t]he Golden Mean will have to be prickled out in the common-law tradition."\textsuperscript{69}

Accordingly, section 1301(a) makes it unlawful to engage in a deceptive act or misrepresentation "in connection with" a security transaction, a proxy solicitation, or a tender request.\textsuperscript{70} By using the

\begin{footnotesize}
\footnote{63. See note 56 supra.}
\footnote{64. Cf. 404 U.S. at 12.}
\footnote{67. ALI FEDERAL SECURITIES CODE, Introductory Memorandum at xvii (Tent. Draft No. 2, March 1973).}
\footnote{68. ALI FEDERAL SECURITIES CODE, Introductory Memorandum at xxi (Tent. Draft No. 2, March 1973).}
\footnote{69. ALI FEDERAL SECURITIES CODE § 1423(a), Comment (6) (Tent. Draft No. 2, March 1973).}
\footnote{70. ALI FEDERAL SECURITIES CODE § 1301(a) (Tent. Draft No. 2, March 1973): It is unlawful for any person to engage in a deceptive act or a misrepresentation in connection with (1) a sale or purchase of a security, an offer to sell or buy a security, or an inducement to hold a security, (2) a proxy solicitation or other circularization of security holders in respect of a security of a registrant,}
\end{footnotesize}
“in connection with” language of section 10(b) and rule 10b–5, the Code incorporates the present case law distinguishing securities cases from mismanagement cases. In addition, section 225\(^1\) prevents blanket inclusion of simple corporate mismanagement cases by defining “a deceptive act” as a fraudulent or deceptive “act, device, scheme, practice, or course of conduct.” However, “[t]he existence of a deceptive act is not precluded by the fact that it constitutes company mismanagement.”\(^2\)

The second limitation imposed by Birnbaum grants standing only to plaintiffs who actually purchase or sell securities during the period of wrongdoing, and it is less reasonable than the “mere mismanagement” distinction. It assumes that Congress intended to withhold protection from investors induced to retain declining securities by an abuse of the market process.

In reaching its conclusion, the Birnbaum court relied heavily on the express intention of the Securities and Exchange Commission in adopting rule 10b–5 “to close [a] ‘... loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.’ ”\(^3\)

Far from closing a loophole, however, the Birnbaum standing requirement carves out a limitation that serves no purpose other than arbitrarily to narrow the plaintiff class in a given case.\(^4\) It eliminates plaintiffs who may well have suffered damage equal to or greater than that suffered by those plaintiffs whose action it allows, for the decision

---

or (3) a tender request or a recommendation to security holders in favor of or opposition to a tender request.

(a) “Deceptive act” includes an act, device, scheme, practice, or course of conduct that (1) is fraudulent, (2) operates or would operate as a fraud, or (3) is likely to deceive regardless of whether deception is intended.
(b) Inaction or silence when there is a duty to act or speak may be a deceptive act.
(c) The existence of a deceptive act is not precluded by the fact that it constitutes company mismanagement.
72. See § 225(c), cited at note 71 supra.
73. 193 F.2d at 463, quoting SEC Release No. 3230 (May 21, 1942). Fraudulent practices by sellers were directly proscribed by section 17(a) of the Securities Act of 1933. 15 U.S.C. § 77q(a) (1970). The failure to mention fraudulent practices by buyers created the “loophole” that rule 10b–5 closed. 193 F.2d at 463. In closing the loophole, however, the court made reference to the fact that section 17(a) “only made it unlawful to defraud purchasers of securities.” 193 F.2d at 463 (emphasis original). Its conclusion that rule 10b–5 meant only to augment the earlier statute led it to adopt a similar limitation.
74. This has been sufficient justification for the few who have put forth any rationale for the standing rule. See Rekant v. Desser, 425 F.2d 872, 877 (5th Cir. 1970); Kellogg, The Inability To Obtain Analytical Precision Where Standing To Sue Under Rule 10b–5 Is Involved, 20 BUFFALO L. REV. 93, 114-16 (1970). But unless some legal theory for precluding suits by mere “holders” of securities is offered, one might just as reasonably preclude suits by persons born on Tuesdays and Thursdays.
not to sell stock is as potentially dangerous as the decision to buy it. The protection afforded a given plaintiff should not depend on whether he actually traded in securities but whether the defendant's fraud affected his decision to trade or retain.†75 Despite its illogic, the Birnbaum standing rule has already been applied in a motion for summary judgment against certain Penn Central investors who neither purchased nor sold Penn Central securities during the period of alleged wrongdoing.†76

Although the Supreme Court has never spoken on the Birnbaum standing requirement, its statement in Bankers Life†77 that "[s]ection 10(b) must be read flexibly, not technically and restrictively"†78 has been relied on by many courts in eroding the rule. In Bankers Life the Court found the plaintiff†79 to be a seller of securities, making it unnecessary to review the validity of the purchaser-seller requirement. However, the case strained the requirement. The plaintiff was a seller only because it was induced to convert an asset—bonds—into a form—cash—that could be appropriated more easily.

Courts often assert the standing requirement to bar a suit that could as easily have been dismissed for failure to complain of more than an ordinary breach of fiduciary duty.†80 On the other hand, the standing requirement has been circumvented by liberal interpretations and exceptions in cases that do not easily fit within it.

For example, in Vine v. Beneficial Finance Co.†81 the Second Circuit gave standing to a plaintiff whose corporation had been subjected to a short form merger,†82 even though he had not yet sold his

75. See W. Painter, supra note 52, at 254.
76. In re Penn Cent. Sec. Litigation, 347 F. Supp. 1327, 1333-36 (E.D. Pa. 1972), modified, 357 F. Supp. 869 (1973), aff'd, 494 F.2d 528 (3d Cir. 1974). The Third Circuit affirmed the district court's decision that the exchange of shares pursuant to the 1969 reorganization of the railroad, see note 1 supra, was not a purchase or sale of securities:

77. Discussed in text accompanying notes 55-66 supra.
78. 404 U.S. at 12.
79. Technically the plaintiff was the Superintendent of Insurance suing on behalf of the creditors of the seller. See note 55 supra.
81. 374 F.2d 627 (2d Cir. 1967), cert. denied, 399 U.S. 970 (1967).
82. The relevant statutory short form merger allowed a corporation owning 95
stock, because his only options were to accept the acquiring corporation's cash offer or to exercise his appraisal rights. Since the plaintiff eventually would receive cash for his shares, the court felt that requiring him to sell as a condition to bringing suit would be a "needless formality."83 This "forced seller" doctrine has also covered plaintiffs forced to sell because of antitrust laws84 or the defendants' control of the market for the stock.85

Courts have found "purchases" and "sales" in mergers,88 exchanges of assets for stock in corporate reorganizations,87 liquidations,88 and the issuance of stock.89 A "forced purchaser" rule has evolved to cover plaintiffs, usually brokers, who buy securities after the period of the wrongdoing because of the defendant's failure to pay for them.90 Courts have relaxed the standing requirement to allow the maintenance of actions by "aborted purchasers or sellers" who would have entered into a securities transaction had it not been for the fraud of the defendant,91 and the requirement has been completely eliminated in suits seeking only injunctive relief.92

In view of the disinclination of courts to apply the Birnbaum standing requirement it is surprising that it is still paid lip service.93

---

83. 374 F.2d at 634.
85. Travis v. Anthes Imperial Ltd., 473 F.2d 515 (6th Cir. 1973).
87. See, e.g., Swanson v. American Consumer Indus., Inc., 415 F.2d 1325 (7th Cir. 1969).
91. Manor Drug Stores v. Blue Chip Stamps, 492 F.2d 136 (9th Cir. 1973) (as modified on denial of rehearing and rehearing en banc). In Manor Drug Stores an antitrust suit against a trading stamp company resulted in a consent decree requiring divestiture by the shareholders of the company of 55 per cent of their interest. This was to be accomplished by merging the company into a new company and offering stock of the new company to those retail users of the stamps who were not shareholders in the old company. The plaintiffs were dissuaded from accepting the offer by a misleading prospectus, and the court ruled that they had standing because the consent decree served as the equivalent of a contractual relationship, thus providing objective evidence that the plaintiffs would have purchased had the transaction not been aborted by the fraud of the defendants. 492 F.2d at 141-42.
93. Many circuits recently have rejected expressly or impliedly the opportunity to
For example, in *Heyman v. Heyman* the court, after making it clear that the *Birnbaum* doctrine would still be followed, granted standing to the beneficiary of a trust that was funded by a fraudulent sale. The court acknowledged that the plaintiff "[did] not fit comfortably within the rubric of 'seller,'" but, since the plaintiff would be the beneficiary of the sale of the stock, the court found that her connection with the sale was sufficiently intimate to bring her within the *Birnbaum* rule. The holding in *International Control Corp. v. Vesco* that a stock dividend was a sale even though there was no consideration prompted the dissenting judge to say "I fear that the decision of the majority may portend the demise of the *Birnbaum* rule."

Dissatisfaction with the *Birnbaum* doctrine in the Seventh Circuit finally lead to its overt rejection. In *Eason v. General Motors Acceptance Corp.* the court observed: "Instead of stating the issue in terms of standing, we think it more useful to ask whether the plaintiffs were members of the class for whose special benefit Rule 10b-5 was adopted." Answering the charge that the rejection of *Birnbaum* would create an unmanageable flood of litigation, the court responded that the number of parties who can satisfy its "special class" test may not differ materially from the number who qualify under the present flexible interpretation of the purchaser-seller requirement. In any event, the court noted, the SEC could overturn the purchaser-seller requirement. See *Smallwood v. Pearl Brewing Co.*, 489 F.2d 979, 989-90 (5th Cir. 1974); *Landy v. FDIC*, 486 F.2d 139, 156-57 (3d Cir. 1973), *cert. denied*, 42 U.S.L.W. 1995 (U.S. April 22, 1974); *James v. Gerber Prods. Co.*, 493 F.2d 944, 947 (6th Cir. 1973); *H.K. Porter Co. v. Nicholson File Co.*, 492 F.2d 421, 425-26 (1st Cir. 1973); *Travis v. Anthes Imperial Ltd.*, 473 F.2d 515, 521 n.9 (8th Cir. 1973); *Mount Clemens Indus., Inc v. Bell*, 464 F.2d 339 (9th Cir. 1973); *Drachman v. Harvey*, 453 F.2d 722, *reved. on rehearing en banc*, 453 F.2d 736, 738 (2d Cir. 1971).

95. 356 F. Supp. at 966.
96. 356 F. Supp. at 965.
97. 490 F.2d 1354 (7th Cir. 1974).
98. The distribution of the stock dividend was part of a scheme by which the defendants transferred the assets of International Controls Corp. (ICC) to other corporations controlled by the defendants, in fraud of investors in ICC. In the dividend transaction, ICC incorporated Fairfield General as a wholly owned subsidiary and subsequently transferred stock that ICC held in Fairfield Aviation, also an ICC subsidiary, to Fairfield General in return for Fairfield General stock. This stock was distributed to ICC shareholders as a dividend. The issuance was held to be a sale. 490 F.2d at 1343-46.
99. 490 F.2d at 1359.
100. 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 42 U.S.L.W. 3595 (U.S. April 22, 1974).
102. 490 F.2d at 669.
amend rule 10b-5 if it became unwieldy. The argument that Birnbaum should be followed for the sake of preserving national consistency was also rejected. The court was skeptical of the consistency of Birnbaum's following at the present time and felt that only the Supreme Court could unify the law in the area.

The Code, surprisingly, does not resolve the purchaser-seller dispute. Part XIII, however, does establish that inducement to hold a security can be an unlawful act. Section 1301(a)(l) makes it unlawful to "engage in a deceptive act or misrepresentation in connection with . . . an inducement to hold a security," and section 1301(b) creates a duty to correct information that is later discovered to be a misrepresentation if it induced a person to hold. Likewise, section 1303(a) prohibits an insider-trader from inducing an investor to hold a security if he knows a fact of special significance that is not generally available. Also, section 1304(c) makes it unlawful to induce the holding of securities by deceptive acts in connection with, or misrepresentations in, a "press release or other form of publicity," and section 1304(d) creates a duty of correction.

Despite the clear intent of part XIII to cover antifraud violations connected with the holding of securities, part XIV does not expressly provide a private right of action for holders. Section 1402(a), which deals with face-to-face transactions, makes a violator of section 1301(a) (l) or 1303(a) liable only to "his buyer or seller." In cases involving a market transaction, section 1402(b) provides that a defendant is liable only "to a person who buys or sells" between the day when he buys or sells and the day when all material facts become generally available.

At first blush the Code seems to codify the Birnbaum standing requirement. Section 1423(a), however, gives courts the power to recognize private actions for violations of Code provisions, even though such actions are not expressly created by part XIV, as long as any new action is not inconsistent with any conditions or restrictions expressly created by the Code. This section leaves the "outer

103. 490 F.2d at 661.
104. 490 F.2d at 661.
105. For the complete text of section 1301(a) see note 70 supra. The definition of deceptive act includes "inaction or silence when there is a duty to act or speak," ALI FEDERAL SECURITIES CODE § 225(b) (Tent. Draft No. 2, March 1973), and the definition of misrepresentation includes "an omission to state a material fact," ALI FEDERAL SECURITIES CODE § 259(a)(2) (Tent. Draft No. 2, March 1973).
106. The "fact of special significance" formulation imposes a strict standard for the materiality of the withheld information. See note 29 supra.
107. A private right of action is also given to buyers or sellers in the provisions for liability for false registration statements, offering statements, and reports (section 1403(c)); false filings generally (section 1404(c)); false distribution statements (section 1405); and false publicity (section 1406(a)).

A court may recognize a private action based on a violation of a provision of
frontiers" of rule 10b–5 to judicial development. Comment (5) to section 1423(a) makes it clear that the drafters intended to allow courts to transcend Birnbaum by specifically mentioning that nothing in the Code is inconsistent with holding that purchaser-seller status is unnecessary if only injunctive relief is sought, that a corporation in a merger not yet consummated is a purchaser, or that only the corporation need be a purchaser in a derivative suit. In Comment (5)(b) the Code's intent is made even more explicit: "The courts are free to grant standing to persons who have been affirmatively induced not to sell.”

Section 1423 may give rise to troublesome questions of uniformity. Does the Code suggest that district courts have the discretion to overrule the opinions of their courts of appeals on matters of standing? It would be anomalous for a district court to reject the Birnbaum doctrine after it had been expressly upheld by the court of appeals of the circuit. It would seem equally anomalous for the circuits to refuse to follow the lead of the Supreme Court if it chose to resolve the standing issue. Presumably, then, the Code simply contemplates judicial development similar to that occurring now. The circuits would experiment among themselves, subject to the occasional intervention of the Supreme Court. In any event, section 1423 would make it more difficult to argue that the need for national consistency requires the application of Birnbaum, as was urged but rejected in Eason.109

The Code also codifies some of the holdings that have expanded the meaning of "sale.”110 Section 293(f)(3) of Tentative Draft No. 1 includes within the definition of "sale" "the issuance of a security pursuant to a merger, consolidation, recapitalization, or transfer of assets for securities.” Comment (2) to sections 1402(a)-(c) makes it clear that "[a] short form merger involves a 'purchase' from the minority," thus incorporating the holding of Vine v. Beneficial Finance Co.111 In general, however, the Birnbaum standing require-

this Code or a rule or order thereunder (other than a rule of a national securities exchange or registered securities association or a rule under [Sec. Ex. Act § 19(b) (10)]) even though it is not expressly created by part XIV, but only if (1) it is not inconsistent with the conditions or restrictions in any of the actions expressly created, (2) the provision, rule, or order is intended to protect a class of persons to which the plaintiff belongs against the kind of harm alleged, (3) the plaintiff satisfies the court that under the circumstances the remedy sought and the deterrent effect of recognizing the action would not be disproportionate to the violation, and (4) in cases comparable to those dealt with in section 1402(l)(2)(B) or 1408(b)(2), any section incorporating either of those sections by reference, or section 1408(b) a comparable limit is imposed on the measure of damages.

109. See text accompanying notes 100–04 supra.
110. See text accompanying notes 86–92 supra.
111. See text accompanying note 81 supra.
ment would be nearly as unsettled under the Code as it is under present law.112

III. RELIANCE

Establishment of a causal relationship between a rule 10b-5 violation and a plaintiff's investment decision requires proof of the plaintiff's reliance on the defendant's misrepresentation, or, in a case involving nondisclosure, proof of reliance on the belief that the concealed events have not occurred.113 Reliance thus provides a "but for" causal link114 between the defendant's wrongdoing and the decision to engage in or refrain from the transaction connected with the plaintiff's economic loss, although the loss itself may have been caused by other factors.115 The test, as announced in List v. Fashion Park, Inc.,116 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."117 As applied to the Penn Central litigation, this test would allow only those shareholders able to prove individual reliance on the defendant's misleading conduct to recover under rule 10b-5.118 Each purchaser would have to prove that he would have refrained from buying if he had known the truth. In addition, assuming that the Birnbaum standing requirement were discarded,119

112. There is one area in which the Code expressly extends a private remedy to nontraders. Under section 1408(e), a person who violates section 1308 (dealing with unlawful manipulation of stock prices) or section 1309 (dealing with unlawful stabilization) "is liable to any person other than a buyer or seller of the security involved for any loss caused by the violation." The comment to section 1408 says that the provision is intended for the case "where an unsuccessful takeover bidder [proves] that the defendants . . . thwarted its bid by manipulating the market."


114. 340 F.2d 457 (2d Cir. 1965).

115. Judge Lord reserved judgment as to whether proof of reliance will be required in the Penn Central case. He permitted the suits to continue as a class action. Proof of individual reliance was to be postponed until after the court had dealt with the elements amenable to proof in a class action. 347 F. Supp. at 1344-45.

116. There is some indication that, where nontrading shareholders can offer the proof of reliance described above, courts may be willing to discard the strict standing requirement of Birnbaum in favor of a causation-of-investment-decision approach in damage as well as injunction cases. In Neuman v. Electronic Specialty Co., [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,591 (N.D. Ill. 1969), the court held that a cause of action was stated under rule 10b-5 by nontrading shareholders of a corporate defendant that allegedly had made misrepresentations with the knowledge and approval of certain individual defendants. The representations were calculated to encourage the plaintiff-shareholders to refuse an advantageous tender offer, thereby allow-
each holder of Penn Central stock would have to prove that he would have closed out his holdings if he had known the truth.

The Supreme Court, however, may have modified the proof standard under the reliance requirement in a way that could expand the class of potential plaintiffs in a given suit. In Affiliated Ute Citizens v. United States the Court rejected the necessity of proof of individual reliance. It held instead that "[a]ll that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of [his] decision [to sell]." The facts of the case, however, must be examined. They may be so unique that more conventional rule 10b-5 actions, such as the Penn Central litigation, must be distinguished.

The plaintiffs in Affiliated Ute Citizens were individual mixed-blood Ute Indians who had sold to non-Indians their shares in the Ute Development Corporation (UDC), a corporation formed to distribute to mixed-bloods their share of tribal assets, including gas, oil, and mineral rights and unadjudicated and unliquidated claims against the United States. Each shareholder’s right to dispose of his stock was subject to first-refusal rights possessed by all members of the tribe. UDC appointed the First Security Bank of Utah as its transfer agent to hold the UDC stock for the shareholders and to issue dividends to them. UDC’s attorney specifically instructed the bank to discourage the sale of stock by any shareholders. In adjudicating a rule 10b-5 claim against employees of the bank, the district court found that the defendants purchased and encouraged the sale of UDC stock.

In Neuman the plaintiffs made telegraphic tenders, which were unacceptable to the offeree. The court indicated that the plaintiffs’ actions evidenced their intent to sell but for the misrepresentations. This result is eminently fair; the alleged misrepresentations in Neuman were designed to cause retention, and only nontrading shareholders could have been injured.

121. 406 U.S. at 153-54.
122. See Cohen v. Franchard Corp., 478 F.2d 115, 124 n.12 (2d Cir.), cert. denied, 414 U.S. 857 (1975). In Cohen the court declined to hold that it was error for the trial court not to have given jury instructions according to the Ute formulation.
123. 406 U.S. at 145-46.
shares without disclosing that they were creating a secondary market for UDC shares among non-Indians and that the price of the stock in the secondary market was higher than that received by the Indians. The employees purchased shares for themselves and received commissions and gratuities, as well as increased deposits, in return for their facilitation of sales to non-Indians. The court found that the defendants had violated rule 10b–5.

The court of appeals reversed the judgment for the plaintiffs on the ground that there was no evidence that the plaintiffs had relied on the representations of the bank's employees. The Supreme Court, however, accepted the trial court's view. By simply requiring "that the facts withheld be material" the Court in essence submerged the reliance requirement into the definition of materiality. The concealment of a fact is apparently deemed to be the cause of a plaintiff's investment decision if the fact is material in that its disclosure could have been expected to influence the decision of a reasonable investor.

One distinguishing feature of Affiliated Ute Citizens, however, is that it involved nondisclosures. Proof of individual reliance is perhaps still necessary in misrepresentation cases. At first glance this is anomalous. One would not wish to give defendants who make affirmative misrepresentations an easier time in court than those who simply remain silent. However, since it is generally more difficult to prove reliance in a nondisclosure case the actual advantage to the defendant who makes affirmative misrepresentations is at best slight. Nevertheless, one case holds that Affiliated Ute Citizens "applies equally to actual misrepresentations," although most courts have applied it only to nondisclosures.

Another distinguishing feature of Affiliated Ute Citizens is that it was not a class action. Potential recovery was limited, perhaps making it feasible to weaken the reliance requirement. On the other hand, insisting on proof of personal reliance in large class actions may make the class action device unworkable. This concern has led at least one court to loosen the reliance requirement in such a case. When the defendants in In re Memorex Security Cases estimated

---

124. 406 U.S. at 146-47.
126. 406 U.S. at 153. See text accompanying note 121 supra.
128. See cases cited in note 124 infra.
that the trial would take sixty years to complete if they were given
the right to depose and cross-examine each of the 60,000 class mem­
ers,\textsuperscript{130} the court concluded that in deciding the reliance question it
was also “deciding the larger question of whether Rule 23(b)(3) is
available in an action alleging securities fraud in the stock exchange
context.”\textsuperscript{131} The court adopted a “causal nexus” test for reliance,
stating:

If it is demonstrated that the Memorex documents materially mis­
represented the financial status of the corporation and that the
market responded thereto in a manner that the stock can be said to
have been “inflated,” and that it was reasonable for an investor to
rely thereon, then a sufficient showing of a causal connection between
the misrepresentations and the purchases by class members will have
been made.\textsuperscript{132}

The general view seems to be that the requirement that reliance
be proved, even if still insisted upon, will not defeat a class action,
although separate trials perhaps may be necessary at some point.\textsuperscript{133}

The third distinguishing feature of \textit{Affiliated Ute Citizens} is
that the misrepresentations were made directly to the plaintiffs. In
face-to-face situations relaxation of the reliance requirement may be
unobjectionable. It is clear that the plaintiffs would have known
the true facts if they had been revealed, and one can reasonably as­
sume that the plaintiffs then would have insisted on the higher re­
turn available in the secondary market. The Penn Central situation
presents a different case. Not all investors in the open market are
aware of or comprehend the importance of a given disclosure; some
investors are more alert to financial news and better able to analyze
factual material than others. Thus, it is not reasonable to assume that
a failure to disclose material information would be the cause-in-fact
of a decision to sell, purchase, or retain made by an uninformed or
unsophisticated investor.

Most courts, however, appear unwilling to limit \textit{Affiliated Ute
Citizens} to the face-to-face situation.\textsuperscript{134} Indeed, one case has expressly

\begin{itemize}
\item \textsuperscript{130} 61 F.R.D. at 97 n.7.
\item \textsuperscript{131} 61 F.R.D. at 98.
\item \textsuperscript{132} 61 F.R.D. at 101. \textit{See also} Siegel v. Realty Equities Corp., 54 F.R.D. 420, 425
\item \textsuperscript{133} \textit{See, e.g.,} Brandt v. Owens-Illinois, Inc., [1973 Transfer Binder] CCH Fed. Sec.
(E.D. Pa. 1973). \textit{See also} note \textsuperscript{118} supra. \textit{But see} Pearson v. Ecological Science Corp.,
which positive misstatements were alleged and the question of reliance was considered
“a highly individual question,” CCH Fed. Sec. L. Rep. ¶ 94,030, at 94,144, that con­
tributed to the denial of class action status.
\item \textsuperscript{134} \textit{E.g.,} Siroti v. Econo-Car Int'l., Inc., 61 F.R.D. 604, 606 (S.D.N.Y. 1974); Jenkins
rejected the argument that *Affiliated Ute Citizens* is distinguishable from a case involving transactions on the open market, holding that application of the *Affiliated Ute Citizens* causation rule “is dependent not upon the character of the transaction—face-to-face versus national securities exchange—but rather upon whether the defendant is obligated to disclose the inside information.”136 Although limiting the relaxation of the reliance requirement to face-to-face transactions would protect defendants from exorbitant liability, the courts seem unwilling to draw this line.

If the courts abandon proof of reliance as an element of the plaintiff’s case, a question remains whether the defendant can assume the burden and prove that the plaintiff did not actually rely on the misrepresentation. The holding of the Second Circuit in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*,136 that proof of materiality raises a “presumption” that the plaintiff relied on the deception137 imposes on a defendant the burden of proving that the plaintiff would not have learned of the material facts or appreciated their significance even if disclosure had been made.138 This interpretation has gained acceptance in the Third139 and Fifth Circuits.140

The proposed Federal Securities Code continues the trend away from a reliance requirement, insisting instead upon proof of causation of loss (legal cause). The emphasis is not on the causal connection between the fraudulent deception and the plaintiff’s investment decision. Instead, the Code emphasizes the causal link between the defendant’s conduct and the plaintiff’s loss. Professor Loss explains the difference:

A buyer can have *relied* on a seller’s misstatement of a material fact in deciding to buy; but, if the general market drops precipitately the next day on news of a political assassination or an invasion in some part of the world, the buyer’s loss is caused not by the misstate-

---


138. Judge Gurfein argued in his partial concurrence that the rationale behind the reduced reliance standard was the elimination of the impractical task of discovering “how many votes or decisions to tender were affected.” In his view materiality implicates reliance as a matter of law, rather than merely raising a presumption. 480 F.2d at 400.


ment (except in the "but for" or post hoc propter hoc sense) but by the disastrous political news.\footnote{141}

Proof of inducement of an investment decision thus has no general significance as a separate element in antifraud actions under the Code. One exception is found in section 1403(d)(1), which disallows the defense of correction to a defendant guilty of filing a false registration statement, offering statement, or annual report if the plaintiff "justifiably relied on the misrepresentation or omission."\footnote{142} Comment (8)(b) to section 1403 indicates that the List definition of reliance is intended.\footnote{143} The Affiliated Ute Citizens formulation—that materiality proves reliance—would make section 1403(d)(1) superfluous, because materiality is already required for a section 1403 violation. Section 1404(d), which deals with other false filings, also requires proof of reliance.

A reliance requirement of sorts also appears in section 256(b), which elaborates on the definition of materiality in the face-to-face situation: "When a person is communicating with a small number of other persons, ... (2) a fact is not 'material,' notwithstanding section 256(a), with regard to a recipient of the communication who is known by the maker of the communication not to regard or to be likely to regard the fact as important in determining his course of action although a reasonable investor would so regard it." This is similar to a reliance requirement because it focuses on the causal link between the defendant's acts and the plaintiff's investment decision. Whereas Affiliated Ute Citizens found reliance from materiality, however, the Code equates nonreliance with nonmateriality in face-to-face situations. Ironically, under present law reliance may be less significant in face-to-face situations than in market transactions, as a result of the Supreme Court's decision in Affiliated Ute Citizens.\footnote{144}

IV. CAUSATION OF LOSS

"Reliance" establishes a causal connection between the deception and the plaintiff's investment decision. Another causal connection—between the actions of the defendant that induced the investment

\footnote{141. ALI FEDERAL SECURITIES CODE § 215A, Comment (4)(c) (Tent. Draft No. 2, March 1973) (emphasis original).}
\footnote{142. At present such situations arise under section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1970).}
\footnote{143. Section 1403(d)(2) states: "Reliance on an omission is proved by proof of reliance on the particular filing or document and ignorance of the omission; but reliance on either a misrepresentation or an omission may be proved without proof that the plaintiff read a particular filing or document." The Comment observes: "If reliance is to be required at all ... the text language, which comes from List, seems sound."}
\footnote{144. See text following note 133 supra.}
decision and the plaintiff's loss—may be required by section 28(a) of
the Securities Exchange Act of 1934, which provides that "no person
permitted to maintain a suit for damages under [the Act] . . . shall
recover . . . a total amount in excess of his actual damages on account
of the act complained of." 145 Section 28(a) bars recovery by plaintiffs
who would not have avoided economic loss even if the defendants had
been completely candid.

Such a causation requirement is well conceived; it approximates
the results achieved by the Birnbaum standing rule without incor-
porating the latter's weaknesses. Mutual Shares Corp. v. Genesco146
illustrates the effect of the causation requirement. A corporation's
minority shareholders charged that the controlling shareholders had
manipulated the market price of the corporation's stock by reducing
dividends in order to acquire shares at a depressed price. The Second
Circuit held that the plaintiffs stated a cause of action for injunctive
relief under rule 10b-5, even though they did not satisfy the Birn-
baum standing requirement because they had purchased their stock
before the defendant's wrongdoing and had not yet sold it at the time
of the suit. The court affirmed the dismissal of plaintiff's damages
claims, however, because "[o]n this aspect of the case, the only trans-
actions in securities that plaintiffs could refer to would be defendants' 
purchases of stock from other . . . shareholders at depressed prices;
. . . the causal connection between these and any alleged existing
damage to plaintiffs is slim indeed." 147 The court observed that while
the claim for damages was deficient with regard to "proof of loss and
the causal connection with the alleged violation of the Rule; . . . the
claim for injunctive relief largely avoids these issues . . . ." 148

This observation is important. In Genesco the market price of
the plaintiffs' stock presumably rose to its original level once the de-
ception was exposed, so that the stockholders who retained their stock
suffered no actual damage. Only those who already sold their stock
at artificially depressed prices could prove permanent damage. Injunc-
tive relief, however, was properly granted. Stockholders who re-
tain their shares certainly have an interest in preventing future
manipulations.149

The effect of the causation requirement in Genesco was to bar
from recovery those plaintiffs who merely retained their shares, the
same result that would have been obtained under Birnbaum. Under the
Birnbaum rule, however, defrauded investors who retain de-

146. 384 F.2d 540 (2d Cir. 1967); accord, Britt v. Cyril Bath Co., 417 F.2d 433, 436-37
(6th Cir. 1969). See also Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971).
147. 384 F.2d at 546.
148. 384 F.2d at 547.
149. 384 F.2d at 547.
valued securities up to the time of suit are denied standing, \textsuperscript{150} but those who sell their securities upon discovering the fraud can sue, \textsuperscript{151} even though the investment loss in both cases is caused by a decision to retain stock in reliance on a misrepresentation. Thus, \textit{Birnbaum} makes a distinction between two investors who suffer an identical drop in the value of their stock as its price hits bottom.

Since an investor may be injured as much by a decision to retain securities as by a decision to sell or purchase, the requirement that plaintiffs sell at some time before bringing suit is unreasonable.

One may, however, in some circumstances make a valid distinction between purchasers or sellers and mere holders of stock by focusing on the causal connection between the fraudulently induced investment decision and the plaintiff's damages. Purchasers and sellers are more likely to be able to prove causation. For example, if an insider is to trade without violating rule 10b–5 he must disclose all material facts and allow time for their assimilation by the public. \textsuperscript{162} If he discloses discouraging information, the market price of the securities involved will drop, indirectly communicating the information to even the least alert members of the investing public. Nonshareholders would refrain from purchasing or would purchase at prices reflecting the stock's true value. "But for" the withholding of material information, purchasers injured by a nondisclosure would not have purchased, or at least would have paid a fair price, and would have sustained no economic loss.

Mere "holders," who purchased their stock before occurrence of the concealed events, occupy a different position. Many would have suffered at least some loss even if the insider had made a complete and immediate disclosure, for the price of their shares would have fallen as soon as the adverse information was released, and most sales would thus be made at depressed prices.

If a shareholder planned to sell while he and most other shareholders were ignorant of facts that foretold a decline in the market value of the stock, but he is dissuaded from selling because an insider makes affirmative misrepresentations, a causal connection would exist both between the misrepresentation and the decision not to sell and between the retention of the stock and the economic loss. Accordingly, a requirement that a plaintiff who merely held stock demonstrate that but for the misrepresentation he would have sold while other investors held might seem appropriate. \textsuperscript{153}


\textsuperscript{153} Stockwell v. Reynolds & Co., 252 F. Supp. 215 (S.D.N.Y. 1965), may have been
Although this rule might work where the misrepresentation occurs in a face-to-face situation, it would present insurmountable proof problems where the misrepresentations are directed to the general public. In a case like *Penn Central*, the complete concealment of the company's weakened financial condition equalizes the market awareness of outside shareholders; sophisticated analysts are as ignorant as naïve investors. The former might justly claim that they could have saved themselves if the facts had been revealed as soon as they became known to the insiders. But it seems impossible after the fact to separate those who might have saved themselves from their less alert brethren. Therefore the proof problem described above remains: If the truth were made known to the public the price would drop whether the disclosure was made sooner or later, and all holders would suffer loss. Because mere holders cannot sustain the burden of proof with regard to causation, they should be denied recovery under rule 10b–5.

It may appear that this approach merely reinstates the *Birnbaum* standing requirement criticized at length above.154 However, an analysis based on causation limits the plaintiff class in a way that is both more analytically precise and more flexible, allowing for recovery in cases in which misrepresentations are personally addressed to a few investors who can prove that they might have traded while others held.

The Federal Securities Code adopts a different approach. It begins by defining causation in section 215A: “A loss is ‘caused’ by specified conduct to the extent that the conduct (a) was a substantial factor in producing the loss and (b) might reasonably have been expected to result in loss of the kind suffered.” “But for” causation does not suffice under this definition. The comments give the example of a market decline after the published rectification of a false earnings statement that was used in the sale of an electronics stock. A buyer of the stock may satisfy clause (a) (“but for” causation defined in “substantial factor” terms) but would not satisfy clause (b) (“legal cause”) to the extent that the market slide resulted from an unconnected event, such as “the sudden death of the corporation’s president or a softening of the market in all electronics stocks.”155

Part XIV of the Code defines the situations in which causation is relevant to civil liability. The causation requirement for section 1402(b), which creates liability for market transactions violating such a case. The court refused to dismiss the claims of investors who alleged that they were dissuaded from selling stock by their broker's misrepresentations as to the issuer's financial health.

154. See text following note 72 supra.
sections 1301(a)(1) or 1303(a) is found in section 1402(f)(2). That section imposes the burden of proving lack of causation on the defendant: "For purposes of section 1402(b), the measure of damages... is (A) reduced to the extent (which may be complete) that the defendant proves that the violation did not cause the loss." The comments label this concept "comparative causation." If the insiders cannot prove causation, the measure of damages will be that prescribed by section 1402(f)(1). For a buyer of Penn Central stock, for instance, damages would be the difference between the purchase price and the value of the securities at the time all of the previously undisclosed facts became available.

Section 1402(f)(2)(B) mitigates the potential harshness of the shift in the causation burden by placing a ceiling on liability. By limiting damages "to the extent of the securities that the defendant sold or bought" the provision protects insider-traders from civil

---

156. Section 1301(a)(1) is set out in note 70 supra.
   It is unlawful for an insider to sell, buy, or induce the holding of a security of the issuer, if he knows a fact of special significance with respect to the issuer or the security that is not generally available, unless (1) the insider believes, and has reasonable ground to believe, that the fact is generally available or (2), if the buyer, seller, or holder (or his agent in the transaction) is identified, (A) the insider believes, and has reasonable ground to believe, that that person knows it, or (B) that person in fact knows it from the insider or otherwise.
158. Lack of causation is also a defense or a mitigating factor in § 1408(g)(1)(A) (false registration statements, etc.), § 1404(e) (false filings generally), § 1405 (false publicity), and § 1408(c)(1) (manipulation and stabilization).
   The measure of damages (subject to the limitations in paragraph (2)) is
   (A), if the plaintiff is a buyer, the difference between the amount that he paid and the value of the security determined as of the time specified in section 1402(e)(1) [the time all material facts became generally available], except that
   (i), to the extent that the plaintiff sold a security of the class and series after his purchase and before the time specified in section 1402(e)(1) realizing less than he paid, "measure of damages" means the difference between the amount that he paid and the amount that he received on sale, and
   (ii), to the extent that the defendant bought a security of the class and series after his sale on which the action is based and before the time specified in section 1402(e)(1) at a profit (compared with his purchase price to the plaintiff) greater than the measure of damages as defined in the foregoing portion of this subparagraph (A), "measure of damages" means that profit; and
   (B), if the plaintiff is a seller, the difference between the amount that he received and the value of the security, determined as of the time specified in section 1402(e)(1), except that
   (i), to the extent that the plaintiff bought a security of the class and series after his sale and before the time specified in section 1402(e)(1), paying more than he received, "measure of damages" means the difference between the amount that he paid on purchase and the amount that he received, and
   (ii), to the extent that the defendant sold a security of the class and series after his purchase on which the action is based and before the time specified in section 1402(e)(1) at a profit (compared with his purchase price from the plaintiff) greater than the measure of damages as defined in the foregoing portion of this subparagraph (B), "measure of damages" means that profit.
liabilities grossly out of proportion to their gain.161 Thus a Penn Central insider who sold 1,000 shares immediately before the market dropped 80 points would be liable at most for $80,000 (1,000 shares × $80 per share).162

As discussed above,163 however, section 1402 expressly creates a right of action only in buyers and sellers. Mere holders of securities must depend on a judicially created action under section 1423(a).164 If a court does use section 1423(a), a question may arise whether the shift in burden of proof and the damage limitations of section 1402 apply. Since the new action would still be based on violation of the insider trading restrictions of section 1303(a), arguably the damage and causation rules of section 1402 are grafted onto the new action.

This would be true at least with respect to the damage ceiling. Clause (4) of section 1423(a) allows a new action only if “in cases comparable to those dealt with in section 1402(f)(2)(B) . . . a comparable limit is imposed on the measure of damages.” Whether a court may shift the burden of proving causation back to the plaintiffs to compensate for extending standing to mere holders, however, is less clear. Section 1423(a) provides that a new action may be recognized only if “the plaintiff satisfies the court that under the circumstances the remedy sought and the deterrent effect of recognizing the action would not be disproportionate to the violation.” This clause supports the view that the court can adjust the elements of the action. It expresses a concern that the remedy be commensurate with the violation, and the court may feel that the remedy would be disproportionate unless the burden of proving causation is on the plaintiff.

Section 1423(a) allows recognition of a new action only “if it is not inconsistent with the conditions or restrictions in any of the actions expressly created.” A plaintiff may thus argue that the burden of causation must be left with the defendant, as required by section 1402(f)(2)(A). However, the effect of section 1423(a) would be very limited by so narrow a construction of “inconsistent.” The better interpretation is simply that a court may not, on the pretense of recognizing a new action, refuse to enforce restrictions expressly created by the Code. Thus, the example of an inconsistent action given in the comments165 is one that allows a market buyer to recover for negligently false reports or press releases even though sections

161. Such protection is not afforded under present law. See text accompanying notes 16-18 supra.
162. Defendants are also protected by the artificial ceiling on damages discussed at text following note 44 supra.
163. See text preceding note 107 supra.
164. Section 1423(a) is set out in note 108 supra.
1404 and 1406 require scienter in such cases. Such an action would be little more than the nullification of a statutory provision. 169

V. CONCLUSION

Although under present law the causation of loss requirement may distinguish rationally among plaintiffs, the potential scope of the plaintiff class when a large, publicly held corporation is involved would still be vast, especially if Affiliated Ute Citizens is followed literally. This may indicate that a private compensatory remedy is an unworkable sanction for violations of rule 10b-5.

Moreover, private compensatory remedies do not further the goals of section 10(b) and rule 10b-5. Both are essentially prohibitory and designed to maintain an atmosphere of fair dealing in the securities marketplace. They do not demand disclosure of material facts when concealment serves a corporate purpose; rather, they demand that those who conceal confidential corporate information refrain from trading. 167 It is the insider's concealment, however, and not his trading that causes the losses suffered by other investors. 168 The insider's trading on the basis of confidential information causes damage only to those with whom he is directly in privity, and that relationship is purely fortuitous. The defendant's real offense is his abuse of the market. By using private information for personal gain wrongdoers decrease public confidence in the securities market and discourage potential investors. 169

In short, the primary thrust of rule 10b-5 should be the deterrence of insider misconduct, rather than compensation of investors. A variety of noncompensatory sanctions exist through which deterrence can be achieved, including SEC investigations and criminal sanctions. 170 Perhaps the best solution is to deprive wrongdoers of

166. Similar problems may arise if section 1423(a) is used to create a private action for plaintiffs induced to hold their securities by the defendant's misrepresentations in a face-to-face transaction. Section 1402(a), which creates a remedy for purchasers and sellers who are misled in nonmarket transactions, does not contain a damage ceiling and does not shift the burden of proof of causation to the defendant. Whether a court could impose a ceiling or shift the burden under section 1423(a) is unclear.


169. The Penn Central case lends no support to Professor Manne's much-discussed suggestion that insiders be permitted to trade on the basis of confidential information as a reward for entrepreneurial services. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 135-41, 147-89 (1966). Insider trading in the Penn Central context would reward not the innovative but the inept who presided over the collapse of the enterprise.

170. See note 15 supra.

This does not mean that private investors must be left at the mercy of insiders.
their unjust enrichment through either an SEC restitutionary action\(^{171}\) or a simple private derivative suit.\(^{172}\) Criminal sanctions\(^{173}\) and punitive damages\(^{174}\) could be imposed in egregious cases, ensuring that the insider will always be left with something to lose by attempting fraud. These options would provide a flexibility not now available in compensatory damage cases.

The proposed Federal Securities Code does not limit the possibility of vast insider liability by narrowing the plaintiff class. Instead, it places a ceiling on the damages each defendant must pay. Such a scheme is itself an indication that full compensation of investors injured in open market situations is unfeasible and of secondary importance; the recoveries of individual plaintiffs are likely to be insignificant.

Damage and restitutionary remedies are available when a plaintiff can prove that he was the victim of a common law fraud in his dealings with a corporate insider. The plaintiff, however, must show that he was damaged by his justifiable reliance on a material misrepresentation made with intent to deceive by one who knew of the falsity. See W. Prosser, Handboook of the Law of Torts §§ 105, 107-08 (4th ed. 1971). He may not have a cause of action if he relied on nondisclosure rather than affirmative misrepresentation. See note 12 supra. But see W. Prosser, supra, § 106, at 906-09.

A rescission action grounded in federal law is also a possibility. The Securities Exchange Act expressly provides in section 29(b) that contracts made in violation of the Act or any rule of the Commission thereunder shall be void as regards the rights of any violator or of persons who acquired rights under the contract knowing of the facts resulting in the violation. 15 U.S.C. § 78cc(b) (1970). (Section 1423(b) of the Code is to the same effect.) Section 29(b) contemplates rescission of the contract and restitution of the injured party's consideration. Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) (alternative holding); Geismar v. Bond & Goodwin, Inc., 40 F. Supp. 876, 878 (S.D.N.Y. 1941). Kardon and Geismar involved suits by defrauded sellers.

The voidability provision would seem by definition to apply only when privity of contract exists between the litigants. See § 3 L. Loss, supra note 16, at 1759 (2d ed. 1961). This, coupled with a short statute of limitations (suit must be brought within one year after discovery that the violation was involved in the sale and within three years of the violation), may make the section less attractive to plaintiffs than the implied private remedy under rule 10b-5.

Rescission has also been granted under the general equitable powers of courts under section 22(a) of the Securities Act of 1933, 15 U.S.C. § 77v (1970). See Deckert v. Independence Shares Corp., 311 U.S. 282, 288-89 (1940) (suit by a buyer induced to purchase by violation of the 1933 Act). Such a remedy may avoid the statute of limitations problem, but privity of contract probably would still be required.


\(^{172}\) In Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969), the state court sustained the sufficiency of a derivative suit complaint that sought to recover profits made by insiders trading on the basis of confidential corporate information. The corporate officers allegedly sold their personal holdings without disclosing an approaching drastic reduction in the company's earnings. The court saw no merit in the argument that the corporation could not complain because it had suffered no direct damage. 24 N.Y.2d at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 81. See also Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973), vacated, 42 U.S.L.W. 4603 (U.S. April 29, 1974).


Moreover, individual plaintiffs may be bypassed completely. Section 1409 sets up a proration mechanism to consolidate actions against the same defendant and to spread the damages over the entire plaintiff class. If the trial court does not feel that “the expense of making the proration is warranted in relation to the amounts that would be awarded to individual plaintiffs,” section 1409(j) allows the recovery to be turned over to the issuer (if it is not a defendant), provided that the action is not for a false filing or statement and an award to the issuer would not be inequitable. Alternatively the recovery may be awarded to the Securities Investor Protection Corporation.\textsuperscript{175}

The theory of the scheme “is compensation if practicable but in any event deterrence and avoidance of unjust enrichment.”\textsuperscript{176} The integrated and consistent civil liability proposals of Tentative Draft No. 2 of the Federal Securities Code deserve serious consideration as a method of rectifying the inequities and unrealities of present rule 10b–5 actions. Unless similar limitations on liability are enacted, private federal damage remedies should be discontinued.
