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Securities Regulation-Fraud in Securities Transactions and Rule 10b-5 -- A Survey of Selected Current Problems

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cause the primary burden of implementation must be borne by the medical profession, continual scrutiny should be given to attitudes and developments within that profession which may demand amendments or additions to the law, in order to maintain its alignment with standard medical opinion and practice.

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Securities Regulation—Fraud in Securities Transactions and Rule 10b-5—A Survey of Selected Current Problems

Contents

It is not uncommon to turn to the financial pages of any daily paper and find that more than ten million shares were traded the preceding day on the New York Stock Exchange. This volume is staggering and the monetery value of these transactions would be in the realm of 508 million dollars. However, this is only a partial picture because other stock exchanges and over-the-counter markets contribute to the total daily volume of securities transactions.

The need for governmental regulations to insure a market free of fraudulent, deceptive, and manipulative devices was recognized by Congress shortly after the depression. This recognition led to the passage of the Securities Exchange Act of 1933[1] and, its companion, the Securities Exchange Act of 1934.[2] Contained within the Exchange Act are several anti-fraud provisions.[3] Section 10(b)[4] prohibits any person, by means of any instrumentality of interstate commerce or by the use of a national securities exchange, from employing any manipulative or deceptive devices or contrivances violative of the rules and regulations that the Securities and Exchange Commission[5] may prescribe. This section is operative only if implemented by rules and regulations of the Securities Exchange Commission [hereinafter referred to as the SEC], the agency created in 1934 to administer the growing body of federal securities statutes.

Acting under the authority of section 10(b) of the Exchange Act, the SEC adopted rule 10b-5[6] which is a general anti-fraud provision couched in language that is not noteworthy for its clarity or precision. From this broad rule a body of federal anti-fraud law has developed and proved itself as an adaptable and effective weapon to prevent and rectify fraudulent dealings in interstate securities transactions.

This comment will examine the expansive treatment accorded section 10(b) and rule 10b-5, attempt to articulate the present requirements to maintain a successful rule 10b-5 cause of action under current court interpretation, and hopefully afford insight into the current trends of rule 10b-5 development and some idea of its outer limits.

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[1] Securities Act of 1933, 48 Stat. 74, *as amended,* 15 U.S.C. §§ 77 a-aa (1958).

[2] Securities Act of 1934, 48 Stat. 881, *as amended,* 15 U.S.C. §§ 78 a-jj (1958) [hereinafter cited as the Exchange Act].

[3] *E.g.* § 17(a), § 15(c)(i), § 10(b).

[4] 15 U.S.C. § 78j(b) (1964).

[5] Hereinafter cited as the SEC.

[6] 17 C.F.R. § 240.10b-5 (1967).

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

(1) to employ any device, scheme, or artifice to defraud,

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

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

I. The Parties to a Section 10(b) and Rule 10b-5 Action

The maintenance of a section 10(b) and rule 10b-5 cause of action for fraudulent securities activity has been liberally allowed as to who may qualify as a party plaintiff and against whom the action can be brought. The rule itself declares that the suit may be brought against "any person" who engages in the prohibited conduct; and even though the rule is notably silent in this regard, the courts have placed few restrictions on who may bring the action.

A. *The Rule 10b-5 Plaintiff*

It is well settled that the Securities Exchange Commission, a corporation,[7] and a private individual[8] may bring a rule 10b-5 action if they have been defrauded by or through the use of any means or instrumentality of interstate commerce, the mails, or a national securities exchange in connection with the purchase or sale of any security. The rule 10b-5 plaintiff is further required to prove that the fraud is "in connection with the purchase or sale of any security." This phrase has been interpreted to require that the plaintiff must either be a purchaser or a seller in a securities transaction affected by the fraud.[9] This limitation—imposed by judicial interpretation—seems inconsistent with the words of rule 10b-5 (3) which prohibit engaging "in any act, practice, or course of business which operates or would operate on a fraud or deceit upon any person, in connection with the purchase or sale of any security." Here the rule refers to a fraud on "any person" rather than a purchaser or seller. However, the remaining words, "in connection with the purchase or sale of any

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[7] A stockholder's derivative action initiated on behalf of a defrauded corporation in connection with the purchase or sale of a security has been judicially allowed. *See, e.g.,* Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964); McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir. 1961); Hooper v. Mountain States Securities Corp., 282 F.2d 195 (5th Cir. 1960).

[8] It has never been decided by the Supreme Court that a private right of action exists under section 10(b) and rule 10b-5, but, with the ever increasing mass of case law allowing such an action, it should be a moot question. *See, e.g.,* 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), *modified,* 73 F. Supp. 798 (E.D. Pa. 1947).

[9] *E.g.* Birnbaum v. Newport Steel Co., 193 F.2d 461 (2d Cir. 1952) (individual plaintiff ruled neither purchaser nor seller); Pacific Insurance Co. of N.Y. v. Blot, 267 F. Supp. 956 (S.D.N.Y. 1967) (corporate plaintiff ruled neither purchaser nor seller); Cohen v. Colvin, 266 F. Supp. 677 (S.D.N.Y. 1967).

security," when read in connection with the legislative history referring specifically to those persons who purchase or sell,[10] seem to support this limitation.

The purchaser-seller requirement seems justified where a corporation or an individual is seeking damages, because to allow a non-purchaser or a non-seller to collect damages suffered by another would unjustly enrich the undamaged claimant.[11] It should be noted that a few cases and commentators in this area have argued to abolish the requirement that plaintiff always be a purchaser or seller, especially in suits seeking injunctive relief from a violation or a threatened violation of rule 10b-5.[12] The argument for relaxation is particularly strong in the case of a corporate issuer of the securities who wishes to prevent manipulation and fraudulent transfers of its stock and to protect its shareholders from this fraudulent activity.[13] Here, without relaxation of the purchaser or seller rule, the corporation must stand by and watch its shareholders damaged by the results of the previously threatened activity. The dubious danger that may result from relaxing the purchaser or seller requirement is the threat of injunctive suits designed only to harass the threatening group or only to preserve the control of a certain faction. Thus the purchaser or seller requirement seems to assure that the plaintiff was in close proximity to the alleged fraud, has actually suffered damages, and is seeking damages in general good faith.[14]

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[10] Furthermore, if an invester has suffered loss by reason of illicit practices, it is equitable that he be allowed to recover damages from the guilty party. With these considerations in view, the bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statements.

Sen. Rep. No. 792, 73rd Cong., 2nd Sess. 12 (1934).

[11] This contention is well expressed in Defiance Indus., Inc. v. Galdi, 256 F. Supp. 170 (S.D.N.Y. 1964).

[12] *See, e.g.* Mutual Shares Corp. v. Genesco, Inc., C.C.H., Fed. Sec. L. Rep., ¶ 91,983 (2d Cir. 1967); Note, *Private Enforcement under Rule 10b-5: An Injunction for Corporate Issurer?,* 115 U. PA. L. REV. 618 (1967). It is also noteworthy that in the injunctive suit the "Congressional intent" support for limiting plaintiffs to purchasers and sellers is lacking because this support referred only to an action for damages. See Footnote *10* and accompanying text.

[13] Defiance Industries, Inc. v. Galdi 256 F. Supp. 170 (S.D.N.Y. 1964) is an example of this fact situation arising.

[14] See in this regard Note, *Private Enforcement Under Rule 10b-5: An Injunction for a Corporate Issuer?,* 115 U. PA. L. REV. 618 (1967).

(1) Who is a Purchaser or a Seller?

There are of course the simple clear cut cases of a person who sells (exchanging securities for money or other valuable consideration) or purchases (obtain securities by paying a price or other valuable consideration) securities in the usual sense of the word. However, some recent cases have gone beyond the usual meaning attached to "purchaser" or "seller" in four significant ways. One example is found in the "aborted seller" cases which hold that a person prevented from selling due to fraud practiced upon him can maintain a 10b-5 action.[15] This theory was recently extended to the "aborted purchaser" in *Goodman v. Hentz*[16] where the court said that the rule 10b-5 language ("in connection with the purchase and sale of securities") was not limited to completed purchases or sales, but applied to transactions in which the plaintiff would have been a purchaser or seller but for the fraud.[17]

Secondly, the category of rule 10b-5 plaintiffs has been extended by the doctrine of the "constructive sale" and the "involuntary seller." In *Voege v. American Sumatra Tobacco Company,*[18] the plaintiff was classed as a defrauded seller when his stock in a corporation was converted following a fraudulent merger. The court held that the merger was a "constructive sale" of plaintiff's stock. In a similar fact situation the court in *Vine v. Beneficial Finance Company*[19] held that plaintiff was an "involuntary seller" when he was forced to convert his shares because of a fraudulent short-form merger.

A third expansion has occurred where the plaintiff is considered a type of third-party beneficiary seller. In one such case the beneficiaries of a trust were deemed to be sellers of securities sold by the trustee and were thus allowed to bring a rule 10b-5 action.[20]

Finally, the cases hold that if a corporation is defrauded into

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[15] *See* Stockwell v. Reynolds & Co., 252 F. Supp. 215 (S.D.N.Y. 1965); M. L. Lee & Co. v. American Cardboard & Packing Corp., 36 F.R.D. 27 (E.D. Pa. 1954) (where purchaser breached a contract to buy for fraudulent purposes and the court held that the "aborted seller" could maintain an action). The Exchange act was amended in 1964 to include a "Contract to Sell" in its definition of a "sale." 15 U.S.C. § 78c(a)(14) (1964).

[16] 265 F. Supp. 440 (N.D. Ill. 1967).

[17] *Id.* at 444.

[18] 241 F. Supp. 369 (D. Del. 1965).

[19] 374 F.2d 627 (2d Cir. 1967).

[20] Rippley v. Denver Nat'l Bank, 260 F. Supp. 704 (D. Colo. 1966).

issuing securities it can maintain a rule 10b-5 cause of action, if otherwise qualified, as a defrauded seller.[21] This fourth development, one which has probably had the greatest impact, has resulted in opening the courts to a sizeable, heretofore denied, class—the corporate plaintiff. In addition these cases, holding that a corporate issuer of securities is a seller and that a corporation purchasing stock is a purchaser,[22] settled the previously unanswered question of whether the purchaser or seller also had to be considered an investor in securities. These cases clearly held that at least where the corporation was the plaintiff it did not also have to be an investor. The recent case of *A.T. Brod & Company v. Perlow*[23] held that an individual plaintiff need not be classified as an "investor." Here a broker who purchased stock for an account at his customer's direction was deemed a purchaser (in this case he could also have been an "aborted seller") and thus able to bring a rule 10b-5 cause of action even though he clearly was not an investor.

Dicta in the *Vine* and *Brod* cases may have significant future impact on the purchaser or seller requirement. In both, the SEC submitted an amicus curiae brief attacking as too narrow the limitation of rule 10b-5 plaintiffs to "sellers" and "purchasers," *i.e.* direct victims of the fraud. The court in *Vine* responded:

> (T)he Commission advances the alternative argument that the plaintiff need not even be a selling stockholder to sue under 10b-5, so long as the Rule has been violated and plaintiff's stock has lost value as a result. . . . In view of our disposition of this case, it is unnecessary to deal with this interesting contention.[24]

In neither *Vine* nor *Brod* did the court adopt the SEC's interpretation but found that the plaintiff was a purchaser or seller. There is, however, some judicial support for the SEC's position in the recent case of *Entel v. Allen*.[25] Here defendants' motion for summary

[21] *E.g.* Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964); Hooper v. Mountain States Securities Corp., 282 F.2d 195 (5th Cir. 1960); Globus, Inc. V. Jaroff, 266 F. Supp. 524 (S.D.N.Y. 1967); Cohen v. Colvin, 266 F. Supp. 677 (S.D.N.Y. 1967).

[22] *E.g.* New Park Mining Co. v. Cramer, 225 F. Supp. 261 (S.D.N.Y. 1963); Kremer v. Selheimer, 215 F. Supp. 549 (E.D. Pa. 1963).

[23] 375 F.2d 393 (2d Cir. 1967). *See also* note 43 *infra* and accompanying text.

[24] 374 F.2d at 636.

[25] 270 F. Supp. 60 (S.D.N.Y. 1967).

judgment was denied although plaintiff was clearly neither a purchaser nor seller. The court stated:

> In view of *Vine* and *Brod* and the position taken by the S.E.C. it may well be that the purchaser-or-seller requirement of *Birnbaum* will not be followed when the question is next presented to the Court of Appeals.[26]

B. *The Rule 10b-5 Defendant*

Both section 10(b) and rule 10b-5 expressly state that "It will be unlawful for any person"[27] by certain means to engage in the prohibited conduct in connection with the purchase or sale of any security. This language is broad enough to preclude any attempt to limit its scope as was done judicially in regard to the requirement for the rule 10b-5 plaintiff.[28] However, early interpretations of the rule required that a 10b-5 defendant be in privity of contract with the plaintiff. This requirement apparently stemmed from a forced interpretation of the language of the rule itself. The rule makes it unlawful for "any person" to engage in any act which would operate as a fraud on any person "in connection with the purchase or sale of any security." The courts apparently thought "in connection with the purchase or sale" meant that the defendant had to be in contractual privity or on the other side of the transaction from the plaintiff.[29] This concept grew more and more unpopular as it became obvious that the privity-of-contract limitations should be relaxed to protect the public in an expanding securities market.

The first judicial departure was the "conspiracy doctrine" subjecting "fringe" defendants (not in direct privity with the plaintiff) to rule 10b-5 sanctions. Under this doctrine, if the person could be shown to have conspired against the plaintiff in violation of rule 10b-5, he could be made a defendant provided that the plaintiff and any one of the co-conspirators were in privity.[30]

The move away from the privity of contract requirement has

[26] *Id.* at 70.

[27] 15 U.S.C. § 78j(b) (1964); 17 C.F.R. § 240.10b-5 (1967).

[28] As has been seen the defrauded or deceived "any person" has been construed to mean a person who is either a purchaser or a seller. See footnotes 9 and 10, *supra,* and accompanying text.

[29] Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd,* 198 F.2d 883 (2d Cir. 1952); Donovan v. Taylor, 136 F. Supp. 552 (N.D. Cal. 1955).

[30] Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955).

progressed to such an extent that today the requirement has been practically abolished[31] and the rule 10b-5 defendant can be literally "any person."

II. The Substantive Requirements of a Section 10(b) and a Rule 10b-5 Cause of Action

Since rule 10b-5 is an anti-fraud provision, it is not surprising that its interpretation and application have been influenced by the requirements of common law fraud and deceit. Thus, any study of the substantive elements of a rule 10b-5 cause of action has to begin with an examination of these common law requirements and an inquiry into which of these have been eliminated, retained, or modified in their application to a rule 10b-5 cause of action.

A. *Common Law Elements for Proof of Fraud and Deceit*

There are five common law elements usually required for proof of fraud or deceit: (1) a false representation (2) of a material fact (3) made with knowledge (scienter) of the falsity for the purpose of inducing the plaintiff to rely on it, and (4) the plaintiff must have relied on it (5) to his detriment.[32] While it is generally accepted that a rule 10b-5 plaintiff need not prove all the elements, the courts have been faced with the problem of determining precisely which are and which are not necessary elements.[33] To some extent the answer may depend upon the nature of the defendants conduct and how the rule itself expresses its prohibition against a particular practice.

B. *The Rule 10b-5 Anti-Fraud Provisions: Scope and Use*

It is, of course, settled that the plaintiff must allege and prove that defendant has engaged in one of the actions or omissions prescribed by the rule. Rule 10b-5(1) makes it unlawful for anyone "to employ any device, scheme, or artifice to defraud."[34] Rule

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[31] *E.g.* Mutual Shares Corp. v. Genesco, Inc., C.C.H., Fed. Sec. L. Rep., ¶ 91,983 (2d Cir. 1967); Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); Lorenz v. Watson 258 (F. Supp. 724 (E.D. Pa. 1966); Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962).

[32] 3 Loss, Securities Regulation 1431 (2d ed. 1961) [hereinafter cited as Loss].

[33] Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966).

[34] 17 C.F.R. § 240.10b-5(1).

10b-5 (2) forbids one "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."[35] Thus subsection (2) prohibits not only the outright lie but, more importantly, it prohibits the half-truth which is literally true as far as it goes but must be qualified or expanded to avoid being misleading. An example would be a statement, made in order to make the stock attractive, that the corporation had just finished drilling ten oil wells without disclosing that all ten were dry. Subsection (2) requires the speaker to make certain that no present or subsequent outside circumstances render what has been said false and misleading. It should be noted that the only affirmative duty to speak under subsection (2) is to clear up a misleading statement already made. Thus, where one maintains complete silence there seems to be no general duty to disclose and no liability under rule 10b-5 (2); but this is subject to the developments to be discussed below.

Rule 10b-5 (3) makes it unlawful to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. Subsection (3) covers fraud in the form of non-verbal acts such as reducing a corporation's dividends to drive down the price of the stock in order to purchase it more cheaply. This subsection and to some degree subsection (1) have provided the basis for an interesting development in fraud under rule 10b-5. The common law imposed liability in deceit for complete non-disclosure (as distinguished from half-truths) only if the nondisclosure was of a material fact and utilized by a person in a position of trust or fiduciary obligation to the injured party.[36] Through subsections (1) and (3) a foundation has been laid for an analgous action under section 10b and rule 10b-5. Since these subsections deal with non-verbal behavior[37] they are relied upon to prohibit total silence where this silence would be misleading or operate as a fraud. However, the common law qualifications to this action were also carried over into the action under rule 10b-5; the nondisclosure must be of a material fact and the nondisclosing person must be under a duty to disclose. Thus, the affirmative duty to disclose material facts, as distinguished from the general duty to speak

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[35] 17 C.F.R. § 240.10b-5(2).
[36] 3 Loss 1434-5; Strong v. Repide 213 U.S. 419 (1909).
[37] Subsection (2) requires some verbal statement in its operation.

the truth if one speaks at all, has been imposed only on persons who under the rule could be considered in the position of an "insider." This cause of action subjects this select group to liability because of their position of trust and the recognized disparity in knowledge and bargaining position between the "insider" and an outsider.[38] The necessity for incorporating a cause of action against insiders for nondisclosure into rule 10b-5 was urged on the courts on the basis of strong public policy foundation and the need to cover the many impersonal exchange and over-the-counter transactions where the parties are more vulnerable to fraud by omission.[39]

As mentioned above, the acts which constitute rule 10b-5 fraud are not restricted to the strict requirements of common law deceit but are being expanded to carry out more effectively the purposes of the anti-fraud provision. Until very recently cases held that rule 10b-5 fraud was limited to those types of fraudulent practices usually associated with the purchase or sale of securities; in so holding those cases exempted from rule 10b-5 coverage acts which could be classified primarily under state law as breaches of general fiduciary duty, fraudulent mismanagement of corporate affairs, and simple breach of contract.[40] This limiting definition of rule 10b-5 fraud now seems completely overridden by several cases. SEC Chairman Cary, in *Cady, Roberts & Company*[41] stated that "these anti-fraud provisions are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others."[42]

The enlargement of rule 10b-5 coverage beyond the usual and common place fraudulent securities transactions is illustrated in *A.T. Brod & Co. v. Perlow.*[43] Here a stockbroker brought a rule 10b-5 action against one of his customers who allegedly intended only to pay for ordered securities if the price went up by the payment date. The court said that rule 10b-5 was designed to reach not

[38] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965); SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966).

[39] List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965).

[40] *E.g.* O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952).

[41] 40 S.E.C. 907 (1961).

[42] *Id.* at

[43] 375 F.2d 393 (2d Cir. 1967).

only frauds usually associated with the purchase or sale of securities and relating to the investment value of the securities but also to "prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether artifices employed involve a garden type variety of fraud or present a unique form of deception."[44] In *Glickman v. Schweickart & Co.*[45] the court similarly held that the rule was not limited to misrepresentations relating to the subject matter of the purchase but also included misrepresentations concerning the means of financing the purchase.

Ruckle v. Roto American Corporation[46] exemplifies the application of rule 10b-5 sanctions in the traditional state law area of breach of fiduciary duty. Here a minority director was allowed to bring a derivative action under rule 10b-5 against the majority directors who had concealed a material fact at a directors' meeting at which sufficient shares were issued to the president of the corporation to permit him to maintain his control. The corporation was held to be a defrauded seller within the meaning of rule 10b-5.[47] In the recent case of *Entel v. Allen*[48] the court stated:

> If an undisclosed scheme to breach State contract law is encompassed by Section 10(b) and Rule 10b-5, then an undisclosed scheme to breach a state corporate fiduciary law must also be covered.[49]

The limits upon the use of rule 10b-5 as a general remedy, to enforce state law fiduciary duties may be gathered from recent case law, although it must be stressed that these limits are in flux and are still evolving. In *Carliner v. Fairlanes, Incorporated,*[50] and in *O'Neill v. Maytag,*[51] for instance, the courts held that many state law actions for breach of fiduciary obligations do not involve any deception; for a breach of fiduciary duty to violate rule 10b-5, however, some deception must be present. *McClure v. Borne Chemical Company,*[52] on the other hand, articulates the broadest ground

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[44] *Id.* at 397.
[45] 242 F. Supp. 670, 674 (S.D.N.Y. 1965).
[46] 339 F.2d 24 (2d Cir. 1964).
[47] To similar effect see McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir. 1961); Hooper v. Mountain States Securities Corp., 282 F.2d 195 (5th Cir. 1960).
[48] 270 F. Supp. 60 (S.D.N.Y. 1967).
[49] *Id.* at 70.
[50] 244 F. Supp. 25 (D. Md. 1965).
[51] 339 F.2d 764 (2d Cir. 1964).
[52] 292 F.2d 824 (3d Cir. 1961).

for using rule 10b-5 as a general remedy for breach of fiduciary duties. In the Third Circuit's view, the Exchange Act of 1934

> deals with the protection of investors, primarily stockholders. It creates many managerial duties and liabilities unknown to the common law. It expresses federal interest in management-stockholder relationships which heretofore have been almost exclusively the concern of the state. Section 10(b) imposes broad fiduciary duties on management vis-a-vis the corporation and its individual stockholders. As implemented by Rule 10b-5 and Section 29(b), Section 10(b) provides stockholders with a potent weapon for the enforcement of many fiduciary duties.[53]

McClure's sweeping interpretation of rule 10b-5 as a general and virtually unlimited federal remedy for breaches of fiduciary duty has not met with judicial acceptance. Thus, in *Entel v. Allen*[54] plaintiff alleged that dominant shareholders and insiders caused the corporation to sell its stock at less than its fair market value. The court said that the issue "posed by this case is whether it is sufficient for an action under rule 10b-5 to allege a breach of one of these general fiduciary duties where breach does not involve deception."[55] In answer to this question the court, citing *Brod,* held that rule 10b-5 would

> prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from securities laws.[56]

In summary, the great weight of authority is that a cause of action under rule 10b-5 is not limited to those frauds usually associated with the purchase or sale of securities but can be used to

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[53] *Id.* at 834.

[54] 270 F. Supp. 60 (S.D.N.Y. 1967).

[55] *Id.* at 69.

[56] *Id.* at 70. The support which the *Entel* case gives to the proposition that rule 10b-5 can only be relied upon to enforce a state law breach of fiduciary duty when the breach involves deception is somewhat obscured by the facts and determination of the case. In *Entel* the plaintiff was suing both privately and derivatively. The court found there was no deception practiced upon Atlas for whom plaintiff was suing derivatively, but it denied defendant's motion for summary judgment without distinguishing between plaintiff's private rule 10b-5 claim which involved deception and his derivative claim which did not. Thus, it appears that the courts reference is only to plaintiff's private claim where deception was present since the court made it clear that it considered the element of deception necessary to enforcement of a breach of fiduciary duty under rule 10b-5.

police all fraudulent schemes in connection with the purchase or sale of securities regardless of how unique or uncommon the fraud or deception might be. Under this expanded concept of coverage rule 10b-5 is increasingly available to attack breaches of fiduciary duty involving fraud or deception in connection with the purchase or sale of any security;[57] but the limitations that may inhibit recourse to rule 10b-5 have not yet been fully determined.

C. *The Duty of Affirmative Disclosure*

It has been noted that rule 10b-5 makes it unlawful for "any person" to engage in any prohibited act set forth in the rule,[58] and it is clear that "any person" could include the corporate director or the corner grocer. Although the prohibitions of rule 10b-5 in general apply equally to any person there is one notable exception. Rule 10b-5 has been interpreted to impose the special duty of affirmative disclosure of material information only upon a limited class of persons[59]—those generally classified as "insiders." This affirmative disclosure requirement is probably the single most important weapon in the anti-fraud arsenal provided under section 10(b) and rule 10b-5.

The affirmative duty to disclose imposed on insiders derives both from judicial interpretation of rule 10b-5 and from the recognition that corporate insiders, as fiduciaries, enjoy a privileged position of access to special knowledge about the affairs of their corporation. Under this approach, rule 10b-5 enforces a policy of fair play by nullifying any unfair advantage the insider has over the uninformed outsider or minority shareholder.[60]

The development of the "insider's" duty of disclosure reached

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[57] *See, e.g.*, Cohen v. Colvin, 266 F. Supp. 677, 682 (S.D.N.Y. 1967).

[58] *See* notes 27-31, *supra*, and accompanying text.

[59] This duty of affirmative disclosure is distinguished from the duty imposed by rule 10b-5(2) which does not require disclosure but requires only that an actor who elects to speak must speak the truth. See Trussell v. United Underwriters, Ltd., 228 F. Supp. 767 (D. Colo. 1964).

[60] Corporate insiders are also subject to a common law liability for fraud and deceit when purchasing or selling securities. This common law liability extends to innocent misrepresentation through half truths as well as falsehoods. In some cases under the common law an insider has been held liable for nondisclosure when by reason of special facts a duty of disclosure existed. See Strong v. Repide, 213 U.S. 419 (1909). Although some common law protection exists, rule 10b-5 is broader in its coverage, requires less proof, affords better venue and broader service of process, and provides a federal forum.

its maturity in the case of *In re Cady, Roberts & Company.*[61] The court established that non-disclosure by insiders was an "act, practice or course of business which operates or would operate as a fraud or deceit upon any person" and applied the rule to securities transactions occurring over the exchanges as well as to face-to-face transactions.

(1) Who is an Insider?

In imposing rule 10b-5 liabilities on insiders, including the duty of affirmative disclosure, the *Cady Roberts* case stressed

> the existance of a relationship giving access directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved when a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.[62]

Examination of this pronouncement discloses two basic facts which must be present in order to invoke the affirmative duty to disclose: first, the presence of the special relationship in which the defendant is privy to the internal affairs of the corporation, and second, the defendant's use of this position and information for personal benefit.

"Insiders" meeting the *Cady Roberts* test are not limited to the obvious officers and directors of a corporation. In *Cady Roberts* the SEC held that a corporate director's business partner who received information of a dividend reduction from the director knowing it had not been released to the public was in a special relationship and privy to the internal affairs of the corporation through the director. Thus, the court held the partner liable as an insider who had failed in his duty to disclose and had used the information for his own benefit.[63] This test was expanded in the celebrated *Texas Gulf Sulphur* case[64] where the court extended the label of "insider" to employees in positions of responsibility within the corporation; and in *Ross v. Licht*[65] the court found that close friends of insiders could themselves be insiders when they utilized information fed to them from a director in purchasing securities from outsiders without

[61] 40 S.E.C. 907 (1961).
[62] *Id.* at 912.
[63] A more recent court has held to similar effect in List v. Fashion Park, 340 F.2d 457 (2d Cir. 1965).
[64] SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966).
[65] 263 F. Supp. 395 (S.D.N.Y. 1967).

disclosing that there was to be a public offering of the corporate stock which was certain to increase its value.

Ross v. Licht[66] went further and pointed out that even if all the elements were not present to hold these close friends insiders they could be held liable as "tippees," *i.e.,* persons who have knowingly received information from insiders in breach of the insider's duty of trust and as such would be subject to the same duty of disclosure as insiders.[67] *Licht* went still further and said that "in any event. . . . [the friends] would be equally liable with the other defendants for aiding and abetting a violation of Rule 10b-5."[68]

Both the *Cady Roberts* test for an "insider" and the "tippee" and "aider and abetter" tests presented in the *Licht* case extend the special duty of disclosure to an ever increasing class of persons. Under these tests it would seem very likely that even the wife and family of an insider or persons who pick up material information in the course of business negotiations with a corporation will be treated as insiders themselves and subject to the duty of disclosure. Cases have held that a broker who purchases on behalf of an insider on information furnished by the insider is subject to the duty of disclosure[69] as is a corporation dealing in its own securities.[70] Under the *Licht* and *Cady Roberts* tests, it would seem that if an outsider overheard several directors in the next booth at a restaurant speak of the development of a revolutionary manufacturing process, he would not be considered an insider. This is because the inside material information was not gained from any special relationship giving the outsider access to corporate affairs. However, suppose an outsider wire-taps the director's conference room, or, with an intent to gather privileged information, follows the directors to the restaurant and obtains material information which he attempts to use to his advantage without disclosure. Here, the outsider would probably have an affirmative duty to disclose or be completely barred from using this ill-gotten information on the grounds that he could not cure

[66] *Id.*

[67] *Id.* at 410. See also in this regard 3 Loss 1450-51.

[68] 263 F. Supp. at 410. Other cases have held defendants liable for violation of rule 10b-5 on grounds of aiding and abetting a rule 10b-5 violation. *E.g.,* Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 676-681 (N.D. Ind. 1966); Pettit v. American Stock Exchange, 217 F. Supp. 21, 28 (S.D.N.Y. 1963).

[69] List v. Fashion Park, Inc., 340 F.2d 457, 461 (2d Cir. 1965).

[70] SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966); 3 Loss 1453.

wrongful acquisition of material information by mere disclosure. Because of this element of conscious wrong-doing courts could impose the duty of disclosure on the outsider by holding that the outsider has placed himself in a special relationship with the corporation or in the position of an insider or forced "tippee."

However, despite this apparent trend toward expanding the definition of "insiders," two similar cases have taken an extremely narrow and unrealistic position. In both, an outsider seeking control of a corporation sent out tender offers to the corporation's shareholders. In *Mills v. Sarjen Corporation,*[71] the potential purchaser did not disclose to the shareholders that on gaining control he planned to sell the assets of the corporation at a large profit. In *Mutual Shares Corporation v. Genesco,*[72] the purchasers failed to disclose the true value of the corporation's real estate which they knew to be undervalued. In both cases the courts refused the plaintiffs' rule 10b-5 complaint on the grounds that the defendant was technically an outsider and as such did not have a duty of disclosure. In each case the defendant was successful in gaining control of the corporation. It would seem that the first share an outsider purchases under a continuing program to gain control is just as important to his effort as the share that puts him into control or into the position of an insider. The seller who sold to this individual, technically an outsider at the time, seems to be in just as great a need of knowledge of the true facts as the sellers to this purchaser after the program progresses to the degree that the purchaser is a technical insider. The duty to disclose should relate back to those who were the first to trade with this purchaser under the continuing program of acquisition even though he was then a technical outsider. In *Sarjen* the court said that the duty to disclose only relates to information obtained by virtue of an inside position as distinguished from that information taken from an outside position into an inside position. This reasoning is subject to attack in that when any corporation is incorporated or reincorporated all the immediate information available to it has been generated from outside positions. No court would hold his information nonprivileged and exempt from the duty to disclose by those who are now insiders.

The inherent unfairness to the early sellers in the above situation

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[71] 133 F. Supp. 753 (D.N.J. 1955).
[72] CCH Fed. Sec. L. Rep., ¶ 91,983 (2d Cir. 1967).

and the wide opportunity for fraud that it presents has evoked the drafting of the Tender Offer Disclosure Act[73] which passed the Senate on 30 August 1967. This Act would establish a duty of disclosure in regard to tender offers and in essence treat the technical outsider or, more correctly, the insider candidate as a true insider during his bid for control.

The *Cady Roberts* test for an insider has a second required element which consists of proof of the use of inside information to the benefit or economic gain of the insider.[74] In *Cochran v. Channing Corporation,*[75] Judge Dawson pointed out that non-disclosure by an insider was not enough but had to be accompanied by defendant's use of the information. The same was required by the court in *SEC v. Texas Gulf Sulphur Company.*[76] In this case the SEC alleged that defendant Texas Gulf Sulphur should be held liable for non-disclosure of material information in connection with the purchase of securities. The court pointed out that the defendant corporation did not utilize the information to its own advantage or to the advantage of its officers or directors.[77]

There appears to be one notable exception to this rule. Several cases hold the defendant liable for non-disclosure of material information on the basis of aiding and abetting. In *Pettit v. American Stock Exchange*[78] the plaintiff alleged a conspiracy among all defen-Exchange and its officers aided, abetted and assisted the illegal dis-

[73] Tender Offer Disclosure Act of 1967, S.510, Aug. 30, 1967. *See* CCH Fed. Sec. Law Rep., No. 164, Sept. 7, 1967.

[74] Kohler v. Kohler Co., 319 F.2d. 634 (7th Cir. 1963).

[75] 211 F. Supp. 239 (S.D.N.Y. 1962).

[76] 258 F. Supp. 262, 293-4 (S.D.N.Y. 1966).

[77] It is interesting to note that the courts in interpreting rule 10b-5 in regard to a corporate defendant's non-disclosure of material information have found no liability when the information was not used by the corporation to its advantage. By doing so, the courts are applying the same standards applied to individual insiders even though the corporation is clearly in a different position. Corporations, in general, have a duty under state law, regardless of any corporate trading, to disseminate material corporate information to the public and its shareholders. The individual insider has no such state law duty. The reason this state law duty has not been carried over into the requirements under rule 10b-5 is probably due to federal recognition of the "business judgment rule" used by state courts as an exception to the corporation's broad duty to disseminate corporate information. This rule imports to corporate decisions (in this case the decision not to disclose) a legitimate purpose and puts them above reproach unless some ulterior profit seeking motive is demonstrated. See Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962).

[78] 217 F. Supp. 21 (S.D.N.Y. 1963).

dants and specifically alleged that members of the American Stock tribution of stock by failing to take the necessary disciplinary action against known breaches by insiders of the obligation imposed by rule 10b-5 of disclosure. The court said:

> Since knowing assistance of or participation in a fraudulent scheme under Section 10(b) gives rise to liability equal to that of the perpetrators themselves, the facts alleged by the trustees, if proven, would permit recovery under Section 10(b).[79]

On the other hand, members of an accounting firm who knowingly prepared false financial statements and failed to disclose this knowledge were not held liable as "insiders" because plaintiff failed to prove that they had either used the information to their own advantage or were aiders and abettors to those who had utilized the undisclosed information.[80]

In summary, the use of the aiding and abetting basis for liability will subject borderline defendants to liability without the necessity of the proof of their own utilization of the non-disclosed information. If the theory of liability is based on their being "insiders" or "tippees" it will require the further proof of a personal utilization of the non-disclosed information to their advantage.

(2) Implementation of the Duty to Disclose

The "insider's" duty to disclose rule presents several practical problems in its implementation.[81] One is the dilemma of the insider who wishes to trade in the securities of his corporation but possesses material information which should not be disclosed for the good of his corporation. In this situation the insider must either stay out of the market in order to remain safely mute or disclose the information in order legally to trade in his corporation's securities. The only real alternative for this insider is the former for only then can he honor the duty of non-disclosure owed to his corporation and at the same time avoid any breach of his duty running to those with whom he might trade.[82] In situations where there are no legitimate business reasons requiring a period of non-disclosure of material in-

[79] *Id.* at 28.

[80] Fisher v. Kletz, 266 F. Supp. 180, 195-6 (S.D.N.Y. 1967).

[81] This duty has been said to apply "regardless of the sophistication or naivete of the person with whom they are dealing" List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965).

[82] This dilemma is discussed in List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965) and *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

formation the insider is not under the influence of the conflicting duties presented above. Here the insider may actively trade in his corporation's securities as long as he makes full disclosure of all material information or waits until the information is released through regular corporate channels.

The insider who wishes to trade faces the additional problem of *how* to disclose. It is evident that in face-to-face transactions direct disclosure is available; but since this duty also applies when an insider trades on a national exchange,[83] the insider must in essence disclose to the public at large since it is impossible to determine whose securities are involved when the insider is buying or who is the purchaser if the insider is selling. Chairman Cary, in the *Cady Roberts* case, dealt directly with this problem and said that:

> the New York Stock Exchange has recognized that prompt disclosure of important corporate developments . . . is essential for the benefit of stockholders and the investing public and has established explicit requirements and recommended procedures for the immediate public release of dividend information by issuers whose securities are listed on the Exchange.[84]

In the *Cady Roberts* case public disclosure was accomplished by means of the Dow Jones News Ticker Service, Wall Street Journal and by telegram to the New York Stock Exchange, in the *Texas Gulf Sulphur* case, however, disclosure was accomplished (to the satisfaction of the court) by mere presentation of the information at a gathering of representatives of appropriate national news media. It seems that any method reasonably calculated to reach the public at large will be deemed sufficient disclosure.

While disclosure of the material information by appropriate means satisfies the insider's duty and will enable him to enter into securities transactions, the question of when the disclosure becomes effective remains. In *Cady Roberts* the defendant insider sold his shares at 11:15 a.m. and 11:18 a.m.—after the telegram of disclosure was sent to the New York Stock Exchange but before it was received by the Exchange and before it went out on the ticker across the country. Chairman Cary said that the insider must "keep out of the market until the established procedures for public re-

[83] See note 61, *supra,* and accompanying text; List v. Fashion Park, Inc. 340 F.2d 457 (2d Cir. 1965); Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960).

[84] *In re* Cady, Roberts & Co., 40 S.E.C. 907, 915 (1961).

lease are carried out instead of hastening to execute transactions in advance of, and in frustration of the release."[85] This apparently establishes a "time-to-absorb" rule which requires the insider to wait until the effect of the news has reached the public and has been absorbed by it.[86] The *Texas Gulf Sulphur* case supports a less strict "announcement" rule which allows insiders to trade safely once the material information has been announced in the channels of public dissemination. The court in the *Texas Gulf Sulphur* case rejected the urging of the SEC to adopt the "time-to-absorb" rule and to establish a reasonable waiting period. The court pointed out that a rule requiring an insider to wait a certain time until the public absorbed the information would not prevent a representative of the news media or a wire service employee from using this information during this "time-to-absorb" period. Emphasising the difficulty of applying such a rule involving an uncertain standard,[87] the court adopted the "announcement" rule as the easiest to enforce and the clearest to interpret by both court and insider.

There is no apparent majority following for either of these rules. Perhaps the only safe course is the voluntary imposition of the "time-to-absorb" rule.

D. *Materiality and Rule 10b-5*

Both the general obligation to make material information truthful when voluntarily disclosed by any party to a securities transaction under rule 10b-5(2), and the additional duty of affirmative disclosure imposed on an insider—discussed in detail in the preceding section—under 10b-5(3), turn on the presence or absence of a *material* fact. The definition of materiality will be the subject of this section.

In *Cady Roberts* the court held that a planned future dividend cut was clearly a material fact since it had a direct effect on the market value of the securities and on the judgment of the investor.[88] Judge Bonsal in the *Texas Gulf Sulphur* case declared that an extraordinary mineral discovery was a material fact. From

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[85] *Id.* at 915.

[86] The "time-to-absorb" rule discussed in *Insider Trading in Stocks,* 21 Bus. Law. 1009 (1966); Fleischer, *Securities Trading and Corporate Information Practices; The Implications of the Texas Gulf Sulphur Proceeding,* 51 Va. L. Rev. 1271 (1965).

[87] SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 289 (S.D.N.Y. 1966).

[88] 40 S.E.C. at 911.

these two examples it can be safely predicted that information concerning an increase in future dividends, a radical increase or decrease in current earnings, an important product discovery, or an unexpected depletion of resources would receive similar treatment. Except in these obvious cases, however, the classification of facts as material or immaterial merely on the basis of their similarity to a previously adjudicated set of circumstances is at best pure speculation.

The courts as well as the SEC have attempted to establish general guidelines, applicable to all information, to determine materiality. Rule 405 promulgated by the SEC under the 1933 Securities Exchange Act says that the term "material" means "the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered."[89] Similar to the SEC's definition is that used in the opinion of several leading cases in this area[90] which refer to a material fact as one that would materially affect the judgment of a reasonable man in the transaction. It is significant that these two tests tie "materiality" to the reasonable man as distinguished from the individual plaintiff. Some recent cases have departed from the above definitions to a more restrictive test of those facts "which in reasonable and objective contemplation might affect the value of the corporations stock or securities."[91] The court in *Texas Gulf Sulphur,* in adopting the "affecting market value" test rather than the broader "affecting judgment test," made the following statement:

> It is appropriate that management's duty to disclose under rule 10b-5 be limited to 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 disclosed. A more rigorous standard would impose an unreasonable burden on management in its securities trading.[92]

The two tests are similar in that generally those factors which would affect the judgment of the average investor will, if disclosed,

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[89] 17 C.F.R. § 230.405(k)(1) (1956).

[90] Rogen v. Ilikon Corp., 361 F.2d 260, 266 (2d Cir. 1966); Ross v. Licht, 263 F. Supp. 395, 408 (S.D.N.Y. 1967); Kardon v. National Gypsum Corp., 73 F. Supp. 798 (E.D. Pa. 1946).

[91] List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965); Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963); S.E.C. v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 280 (S.D.N.Y. 1966).

[92] 258 F. Supp. at 280.

affect the market value of the security as well. But there are obvious examples where a nondisclosure will be deemed material under the "affecting judgment" test and not material under the "affecting market price" test.[93] The latter test has been criticized as unreliable and irrelevant in determining materiality, a criticism was well expressed in *Rogen v. Ilikon Corporation,*[94] where the court in rejected that test:

> It is not at all unlikely that rumors of the discussions between Ilikon and Reynolds did, indeed, affect the price of the stock but that is not controlling. I can take judicial notice of the fact that the stock market not infrequently reacts even to entirely unfounded rumors. Accordingly, I rule, as a matter of law, that Reynolds' negotiations were not material and there was no duty to disclose them to the plaintiff.[95]

The "affecting market value" test is markedly more advantageous to the insider than the "affecting judgment" test since it provides a clearer guideline for him to follow and appears not to be as restrictive of insider trading. Efforts have been made to modify the "affecting the market value" test to eliminate the weakness exposed in the *Rogen* case. In order to insulate the reliability of this test from the normal fluxuations and unjustified reactions of the market, the *Texas Gulf Sulphur* court added to this test two additional factors: (1) the undisclosed information must be "extraordinary in nature" and (2) must have a "substantial effect on the market price."[96]

The test of materiality applicable in rule 10b-5 causes of action

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[93] *E.g.* A. T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967). In this case the defendant, outsider invester, was found in violation of rule 10b-5 for ordering stock from the broker-plaintiff under a fraudulent and undisclosed scheme to pay only for the shares if the price went up by payment date. While this case predicated defendant's liability on section 10(b) and rule 10b-5 (1) which make it unlawful "to employ any device, scheme, or artifice to defraud" in connection with the sale or purchase of any security, the court made the general statement that neither section 10(b) nor rule 10b-5 "contains any language which would indicate that those provisions were intended to deal only with fraud as to the 'investment value' of securities. . . ." 375 F.2d at 396-7. Although the court here was dealing with the materiality of facts involved in a scheme to defraud practiced by an outsider and found liability under rule 10b-5 (1), this case is an example of circumstances where there would have been no finding of materiality in the scheme to defraud if the "affecting market value" test had been used.

[94] 250 F. Supp. 112 (D. Mass. 1966).

[95] *Id.* at 116.

[96] 258 F. Supp. at 280.

is evidently in a state of flux. Any prediction as to which test a specific court would use might have to be based on the prevalent test used in the particular circuit and the personal sentiments of the judge involved. If the balance of the judge's sentiments lean toward the protection of the unknowledgeable investor above all he is likely to apply the "affecting the judgment of the reasonable investor" test. On the otherhand, if the judge fears placing too great a restraint on insider trading he will probably choose to utilize the "affecting market value" test.

Under rule 10b-5 the information involved must be a "fact" as well as material. Facts are generally considered to be things done, existing, and real. The untrue statement of a material fact or the non-disclosure by an insider of a material fact will, under the proper circumstances, incur liability under rule 10b-5. In *Goodwin v. Agassiz*[97] the court said that a "theory" as to the possible existence of copper deposits on the corporation's property was not a "fact" because the theory lacked the certainty of a clear strike or discovery of ore. Similarly, in the recent *Texas Gulf Sulphur* case the court said that trading on "hopes" that the drill hole might lead to a copper mine was not a material fact.[98]

In any discussion of "material fact" it must be recognized that the two words support each other and thus cannot be easily separated. This is evident in the "opinion" and "speculation" areas. When an individual has an opinion it is usually based on some existing "fact," *e.g.*, the corporation is currently buying up certain land. If from this obvious fact the individual speculates that the corporation may have made an important discovery of ore, his subsequent trading in the corporation's stock is based merely on personal opinion or speculation. In the above example, the opinion was not based on a material fact because the fact was too remote to have influenced the market or the reasonable investor.[99] It has also been held that information of a "possible opportunity to sell" corporate assets, revealed to an insider during the course of preliminary negotiations, are facts that are "too remote to have influenced the

[97] 283 Mass. 358, 186 N.E. 659 (1933).

[98] 258 F. Supp. at 283.

[99] This was the exact situation presented in the Texas Gulf Sulphur case (258 F. Supp. at 283). Union Pacific R.R. Co. v. Chicago & N.W. Ry. Co., 226 F. Supp. 400 (N.D. Ill. 1964) also holds that "opinions" are not to be considered as a material fact.

conduct of a reasonable investor."[100] However, if the directors of two corporations have reached an agreement on a merger, then certainly this is a fact and is material; but

> where negotiations have just commenced and the parties have established no operating guidelines, such as a favorable rate of exchange for the stock of one company, it can be argued that insiders should still be able to trade. Under these circumstances, the insider is not in possession of any information which clearly places him in a position superior to that of the average investor, and he would seem to be incurring the normal market risks.[101]

Cases are also consistent in holding that the desire to sell, plans to sell, and even resolutions to sell corporate assets are not material facts until a final decision has been made.[102]

The interplay between what is material and what is a fact for purposes of rule 10b-5 appears to explain the seemingly arbitrary April 9th date set in the *Texas Gulf Sulphur* case as a line separating information that was not a material fact from information that was. Prior to April 9th there were rumors that Texas Gulf Sulphur had made an enormous copper strike. This information, if true, would have significantly affected the market value of the stock or an average investor's judgment; it would thus have been deemed "material." The character of the information was at all times "material" but it was only on April 9th that this "material" rumor was changed from rumor to fact. The materiality of the information remained the same but when the rumor was confirmed by results of tests it became a material "fact."

In connection with the *Texas Gulf Sulphur* ruling as to what constituted a material fact, the court distinguished a "material fact" from an "educated guess." The question was presented to the court as to "whether information which may have a special significance to an insider because of his professional background, is material"[103] to him when it would not be material to an unknowledgeable person. The court agreed that because of specialized knowledge and ability a person may be able to make an "educated guess" that would

[100] List v. Fashion Park, Inc., 340 F.2d 457, 464 (2d Cir. 1965).

[101] Cohen v. Colvin, 266 F. Supp. 677, 682 (S.D.N.Y. 1967).

[102] *E.g.* List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965); James Blackstone Memorial Library Ass'n v. Gulf, Mobile & Ohio R.R. Co., 264 F.2d. 445 (7th Cir. 1959); Rogen v. Ilikon Corp., 250 F. Supp. 112 (D. Mass. 1966).

[103] 258 F. Supp. at 283.

be more reliable than an uneducated guess. But the court stressed that until the information became material to the public so as to have a substantial effect on the market value of the securities it would not be material for anyone. If the court had accepted the proposed exception to the general rule of what constitutes a material fact it would have, in essence, punished an individual for superior intellectual ability and background. Furthermore it would have discouraged these educated persons from investing in their own corporation by subjecting them to a duty to disclose their educated guesses which, if, ultimately wrong would possibly subject them to rule 10b-5 liability. Thus the question posed in the *Texas Gulf Sulphur* case—whether special knowledge in an area will change normally irrelevant information into material information—was answered in the negative.[104]

E. *Scienter and Rule 10b-5*

Although the strict requirements of common law fraud and deceit have not been incorporated into section 10(b) and rule 10b-5, the courts are still preoccupied with them. There is, for instance, disagreement over a possible requirement that the defendant must have knowingly or intentionally violated the rule, *i.e.,* that scienter is an element of 10b-5 action.

Those courts requiring scienter have generally based their contention on the presence of the words "defraud," "fraud," and "deceit" used in clauses (1) and (3) of rule 10b-5. It is said that the common law origin and requirements of these words must be considered when interpreting their meaning under the rule. The absence of any of these words in clause (2) would seem to dispense with any requirement of scienter in its application; but these courts have rebutted this argument, probably for the sake of consistency, by pointing out a similarity between rule 10b-5(2) and section 12(2).[105] Section 12(2) provides a remedy specifically for a buyer against a seller for untrue statements and misleading omissions, but allows the defendant-seller to defeat the section 12(2) cause of action if he proves he did not know or could not have reasonably known the falsity of his statements. These courts hold that since section 12(2) and rule 10b-5(2) are both designed to prohibit

[104] The same result was reached in List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965).
[105] 15 U.S.C. § 77l(2) (1969).

virtually the same type of fraud and since the element of scienter is incorporated into section 12(2), it is also necessary to read scienter into the cause of action based on rule 10b-5(2). The courts point out that without such an interpretation there would be no practical need for section 12(2) and it would be rendered mere surplusage.[106]

The courts which hold that scienter is not required in a rule 10b-5 cause of action base their reasoning on the abandonment of the strict common law elements of proof in rule 10b-5 actions, the purpose of the anti-fraud provisions, the literal wording of the rule itself which does not specifically call for such a requirement, and the wording of clause (2) which does not even refer to fraud or deceit.[107] Support for this view may have been taken from *SEC v. Capital Gains Research Bureau, Incorporated*[108] which was heard by the Supreme Court and involved the Investment Advisor's Act of 1940. In this case Justice Goldberg emphasized that

> Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit' upon a client, did not intend to require proof of intent to injure and actual injury to the client. Congress intended the Investment Advisors Act of 1940 to be construed like other securities legislation 'enacted for the purposes of avoiding frauds', not technically and restrictively, but rather flexibly to effectuate its remedial purposes.[109]

It must be recognized that the *Capital Gains* case not only dealt with another act but involved an action instituted by the SEC. Many courts take the position that the requirements of proof and the elements of a cause of action should be less stringent in SEC-initiated actions under 10b-5 than in suits brought by individuals under the implied private 10b-5 cause of action. This distinction was made in the recent *Texas Gulf Sulphur* case where the court, after recognizing the possible scienter requirement imposed on the defendant in private enforcement suits, specifically stated:

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[106] *See, e.g.*, Weber v. C.M.P. Corp., 242 F. Supp. 321 (S.D.N.Y. 1965); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Col. 1964). Note, 63 MICH. L. REV. 1070 (1965).

[107] Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Dack v. Shanman 227 F. Supp. 26 (S.D.N.Y. 1964); Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14 (W.D. Ky. 1960).

[108] 375 U.S. 180 (1963).

[109] *Id.* at 186. Given the close similarity of the language of section 202 of the Investment Advisor's Act and that of rule 10b-5, this decision is significant for the possible similar treatment the Court might afford rule 10b-5 and the element of scienter.

> In this proceeding by the Commission it is immaterial whether Clayton [the defendant] intended to deceive or to defraud anyone or whether he knew at the time that his purchase would violate Section 10(b) and Rule 10b-5.[110]

The conflict has not been settled. Professor Loss in his authoritative work in this area[111] supports the view that the courts should read into the rule a requirement of scienter in private suits[112] and recent cases seem to lean in this direction.[113] However, even if proof of scienter is required in private suits it does not necessarily follow that proof of actual intent to defraud will be required. The concept of scienter has been expanded to include imputed knowledge where the defendant has acted in a reckless manner in failing to keep himself informed.[114] This "watering-down" of the doctrine of scienter seems to ease what might otherwise be an impossible burden of proof on the plaintiff and appears to be an acceptable compromise between the two absolute and divergent extremes.

F. *Reliance and Causation under Rule 10b-5*

(1) Reliance

Under the common law a plaintiff bringing a cause of action for fraud or deceit was required to prove that the alleged fraud or deceit had been relied upon and was the cause of plaintiff's alleged harm.[115] The rule 10b-5 cause of action is not founded on these common law elements; thus, the extent to which proof of reliance and/or causation is required for a 10b-5 action is dependent upon judicial interpretation of the rule. The elements of reliance and causation are independent: there can be situations where the defendant's misconduct is relied upon but is not the legal cause of the plaintiff's injury and situations where defendant's misconduct was not relied upon by the plaintiff but is clearly the cause of plaintiff's injury.

From analysis it appears that causation (the defendant's mis-

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[110] 258 F. Supp. at 286.

[111] See note 32 *supra*.

[112] 3 Loss 1766. However, Loss was writing prior to the *Capital Gains* case.

[113] *E.g.*, O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); Richland v. Crandall, 262 F. Supp. 538 (S.D.N.Y. 1967); Parker v. Baltimore Paint and Chem. Co., 244 F. Supp. 267 (D. Col. 1965); Weber v. C.M.P. Corp., 242 F. Supp. 321 (S.D.N.Y. 1965).

[114] *See* Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Col. 1964); 3 Loss 1440-1.

[115] *See* note 32, *supra*, and accompanying text.

conduct in fact causing the plaintiff's injury) should be the key to plaintiff's recovery and the controlling element in a rule 10b-5 cause of action. The element of reliance by the plaintiff seems to play only a supporting role. The presence of reliance will always go to prove that the plaintiff's actions (active or passive) were prompted by the defendant's fraud, but it will not absolutely prove that any subsequent injury to the plaintiff was in fact caused by the defendant's fraud or wrongdoing. This "supporting role" theory was adopted in *List v. Fashion Park, Incorporated,*[116] where the court said:

> the test of reliance is whether the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss. The reason for this requirement, as explained by the authorities cited, is to certify that the conduct of the defendant actually caused the plaintiff's injury.[117]

Similarly, in *West v. Zurhorst,*[118] reliance was held to be a requirement because the plaintiff's loss must be proximately caused by the defendant's fraudulent scheme. These cases also point out the dispensability of reliance when the defendant's wrongdoing forces plaintiff into a position of harm or where the plaintiff's conduct would be irrelevant to proof of causation in fact. This latter situation was well illustrated in *Vine v. Beneficial Finance Company,*[119] where plaintiff-shareholder was held to be a defrauded seller because misrepresentations of the defendant made to other members of the class of shareholders caused a forced sale of plaintiff's shares. The court in granting relief said:

> What ever need there may to show reliance in other situations . . . we regard it as unnecessary in the limited instance when no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoer.[120]

In *Voege v. American Sumatra Tobacco Corporation*[121] the majority shareholders of two companies brought about a merger by use of fraudulent and deceptive devices and caused a forced sale of plaintiff's stock at a price below its true value. In plaintiff's rule

[116] 340 F.2d 457 (2d Cir. 1965).
[117] *Id.* at 462.
[118] C.C.H. Fed. Sec. L. Rep. ¶ 91,968 (S.D.N.Y. 1967).
[119] 374 F.2d 627 (2d Cir. 1967).
[120] *Id.* at 635.
[121] 241 F. Supp. 369 (D. Del. 1965).

10b-5 action the court was faced with the defense that plaintiff had failed to allege reliance on the deceptions; it answered that causation was clearly present and that in this situation reliance would be inferred from the fact that when plaintiff purchased her shares, she did so relying on the good faith and honesty of the defendants in their present and future dealings with her under her contract as a shareholder. Thus, it is apparent that reliance either is not required at all or in some instances is imputed where it would not help in determining whether the defendant's fraud in fact caused plaintiff's injury. In other words, the courts do not require reliance where the defendant's fraud would injure the plaintiff and render him utterly defenseless to prevent injury by any course of conduct.

Although reliance may be dispensable when the plaintiff's conduct is irrelevant to his injury, it may prove to be indispensable where plaintiff is prompted into action or inaction by the defendant's wrongdoing. This would be the case where the defendant in an effort to gain control induces the plaintiff to sell his shares by misrepresentations of material facts indicating that it was a seller's market when in fact it was not. However, the plaintiff may disregard this misrepresentation, rely on his own knowledge and research, and decide to sell to the defendant. In this case if the plaintiff suffers a loss it will not be due to the defendant's efforts. Thus, there would be no liability due to the absence of a causal relationship between plaintiff's injury (here self-induced) and defendant's wrongdoing. Only by demonstrating that the fraud of the defendant prompted the action, could the plaintiff maintain a rule 10b-5 action.

Many cases simply state that reliance is necessary without giving their reasoning. In *Freed v. Szabo Food Service, Incorporated*[122] the plaintiff purchased securities at an unwarranted high price that resulted from deceptive publicity sent out by the defendant-seller. The court held that all that was necessary for a rule 10b-5 suit was that plaintiff allege reliance on the misrepresentations of the defendant, the purchase of securities, and resulting injury. In the majority of cases which require plaintiff's allegation of reliance without qualification, the facts are usually such that the plaintiff could control his own conduct which led to his injury.[123]

Rule 10b-5 causes of action based on breach of an insider's duty

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[122] C.C.H. Fed. Sec. L. Rep. ¶ 91,317 (N.D. Ill. 1964).

[123] This would not be the case had the defendant's wrongdoing involved manipulation of the value of the stock itself.

of disclosure present unique reliance situations because there is no outward manifestation of the defendant's conduct upon which plaintiff can be said to have relied. Courts requiring a showing of reliance in non-disclosure cases generally agree that the test of reliance here is not whether the defendant's misconduct was a substantial factor in determining the plaintiff's conduct but "whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact."[124] It is noteworthy that this test is a subjective, personalized one that looks to each individual plaintiff rather than the reasonable man. This allows the defendant to engage in personality studies in order to rebut any alleged effect that the disclosure might have had on the plaintiff. The right to rebut the alleged likelihood of reliance would be valuable if the defendant can show that the plaintiff is a sophisticated and self-reliant purchaser or seller.[125] Thus, while the insider has the duty to inform outsiders with whom he is dealing of all material facts regardless of their "sophistication or naivete," he may save himself from liability by proof that the individual plaintiff would not have acted differently had the information been properly disclosed. Obviously then, the experience and self-reliance of the outsider may contribute greatly to the defendant's success in meeting his burden of proof; a knowledgeable plaintiff can be said to rely more on his own knowledge and business judgment or upon the advice of a service than the advice or disclosure of the other party to the securities transaction.[126]

Defending against reliance, however, is not as easy as it may appear, especially in cases dealing with breach of an insider's duty of disclosure.[127] An insider stands in a fiduciary position to the defrauded outsider and the very nature of the fiduciary position implies reliance by the outsider upon the insider's fair dealing and

[124] Ross v. Litch, 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

[125] This was the case in List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965).

[126] *See* Rogen v. Ilikon, Corp., 361 F.2d 260 (1st Cir. 1966). In this case the court recognized the knowledge of the plaintiff as a possible ground on which the defendant could rely to rebut the allegation of reliance.

[127] This was most evident in Rogen v. Ilikon Corp., 361 F.2d 260, 265 (1st Cir. 1966) where the insider had procured a written waiver of reliance from the outsider. The court distinguished this from a "waiver of compliance" allowed by section 29(a) of the Securities Act of 1934, 15 U.S.C. § 78cc(a) (1964), and held that the waiver of reliance did not constitute non-reliance as a matter of law and would not support a motion for summary judgment.

honesty. In practice, proving reliance on an insider's breach of his duty of disclosure is often accomplished by the mere allegation of the breach. Implied reliance can easily be found where an outsider is personally dealing with an insider with the trust and confidence normally assumed in face-to-face dealings with fiduciaries. However, the implication of reliance is noticeably absent when the outsider is dealing through a national exchange. Here the outsider cannot be said to look to his opposite in the transaction for protection. Nor can it be said that there is any implied representation by his fiduciary to protect his interest in the exchange transaction. However, there has been court insistance upon the implication of reliance even where the sale was not face-to-face. In *In re Cady Roberts & Company,*[128] the defendant insiders sold securities on a national exchange without disclosure of material information. The defendants claimed they had no duty to disclose when they were trading on a national exchange as distinguished from face-to-face transactions. The court said:

> We reject this suggestion. It would be anomalous indeed if the protection afforded by the anti-fraud provisions were withdrawn from transactions effected on exchanges, primary markets for securities transactions. If purchasers on an exchange had available material information known by a selling insider, we may assume that their investment judgments would be affected and their decision whether to buy might accordingly be modified.[129]

Here the SEC was prosecuting in behalf of the public and the court inferred reliance on the part of the purchasing public, i.e., the Commission assumed that disclosure would have affected the investment judgment of the public, and thus that there was reliance. This case extends the strong implication of reliance present in face-to-face dealings between an outsider and an insider to their dealings over a national securities exchange and at the same time reaffirms the necessity of reliance in non-disclosure situations even if it is supplied by implication.

Relance has thus far been discussed in relation to misrepresentation and complete non-disclosure. There are instances where the defendant's wrongdoing consists of market manipulation which may cause the price of the security to rise or fall. If a plaintiff purchases or sells in a market that reflects this manipulation and as a result

[128] 40 S.E.C. 907 (1961).
[129] *Id.* at 914.

suffers loss due to the manipulation, it appears difficult to deny that plaintiff has relied on the defendant's wrongdoing. In this situation the plaintiff has the defendant's wrongdoing forced upon him and as a result has suffered injury directly caused by the defendant's acts. Thus, where the defendant-insider wrongfully manipulates a drop in the price of his corporation's securities and the plaintiff sells his shares because of the outwardly poor prospects of the corporation evidenced by the drop in value of the stock, the plaintiff clearly has relied on the wrongdoing of the defendant to his detriment. Had the true facts been known, plaintiff would have acted differently.

Proof of reliance is not the end of the inquiry. The plaintiff must also prove that the reliance was justified or reasonable, such proof necessitating a reference back to the test of reliance. This test is "whether the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss."[130] In the application of this test it has been seen that what is important for reliance is that the defendant's wrongdoing actually affected the individual plaintiff's action without inquiry whether a reasonable man would have relied. Thus, in *Freed v. Szabo Food Service, Incorporated,*[131] the court recognized that the defendants might be able to take advantage of "individual gullibility" if the court applied the reasonable man test of plaintiff's reliance. It is unclear, however, how far the courts would allow a knowledgeable plaintiff to plead reliance on a scheme that would fool only the completely uninformed. Such reliance would indicate almost gross negligence on the plaintiff's part. Thus, while the courts say they do not require reliance to be reasonable, what they mean apparently is that they will not use the "reasonable man would have relied" test but will apply a reasonableness test gauged to the individual plaintiff's level of sophistication. This requires that the gullible plaintiff be no less than reasonably gullible. It may be that without this modification the role that reliance plays in assuring the court that the defendant has in fact caused the plaintiff's action or inaction and consequent injury could be all but nullified by the plaintiff's mere failure to inform himself of the obvious, thus setting up a sort of blind reliance which would meet the test no matter how unjustified.

[130] See note 117, *supra,* and accompanying text.
[131] C.C.H. Fed. Sec. L. Rep. ¶ 91,317 (N.D. Ill. 1964).

(2) Causation

The necessity of causation or a causal relationship between the defendant's fraud and the plaintiff's injury in a rule 10b-5 action is probably one of the most settled areas in section 10(b) and rule 10b-5 litigation. However, in private causes of action under the rule there is a general dispute over the procedural requirements for alleging and proving causation.

The case of *Voege v. American Sumatra Tobacco Corporation*[132] involved a private action based on rule 10b-5 by a shareholder against his corporation and its directors for bringing about a fraudulent merger. The merger required plaintiff to surrender his stock in the merged corporation for a price grossly below its real value. In finding for the plaintiff, the court pointed out the necessity for showing a causal relationship between the alleged fraud and the claimed injury. The court found the relationship present in that the:

> frauds alleged culminated in the merger between Old Company and New Company under which plaintiff became obligated to sell her stock. . . . This could not have occured in the absence of the frauds.[133]

The court in *Voege* uses what is in essence a "but for" test to establish causation. Proof of causation also played a controlling role in *Hoover v. Allen,*[134] where the court adopted a "proximate cause" test. It pointed out that even if defendants violated rule 10b-5 by fraudulently acquiring corporate control, the fact that subsequent damage due to corporate waste resulted from the actions of those who gained control does not show the damage was a proximate result of the alleged fraud. Thus the court, holding for the defendants, found that corporate waste was not proximately caused by the fraudulent acquisition of corporate assets. This holding, in effect, rejects the broad "but for" test used in *Voege* and adopts a stricter proximate cause test. The latter test is probably used by the majority of courts.

It must be noted that proving causation and alleging it are two distinct things. Some recent cases have held without explanation that the allegation of causation is an essential element to plaintiff's

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132 241 F. Supp. 369 (D. Del. 1965).
133 *Id.* at 375-6.
134 241 F. Supp. 213 (S.D.N.Y. 1965).

complaint.[135] These cases fail to establish whether the requirement of allegation is satisfied only by formal words alleging causation or whether the requirement is satisfied by merely alleging facts from which a causal connection may be reasonably implied. This problem was expressly dealt with in the case of *Globus, Inc. v. Jaroff,*[136] where the court held that:

> the defendants may not require that such causation be proved on the face of the complaint itself. Causation is a matter to be developed and proved at trial. What the defendants may require, however, is that the facts alleged in the complaint are not on their face inconsistent with any alleged or implied causation. If causation may be reasonably inferred from the facts alleged, the complaint may not be rejected on the proffered ground.[137]

This approach, which allows causation to be implied as long as the complaint does not rebut an implied causal relationship, seems to be realistic and it has been supported by numerous other authorities.[138] However, in preparing a complaint it would appear to be wise formally to allege the causal connection between the alleged fraud and the damaged suffered by the plaintiff.

Several recent cases involve the somewhat unique causation situation where fraudulent means are used to achieve a certain result which arguably could have been achieved without the use of such means. In *Barnett v. Anaconda Company,*[139] a corporation with seventy-three percent ownership in a subsidiary acquired all of the subsidiary's assets. A minority shareholder of the subsidiary alleged that the proxy statement sent to him was false and misleading and in violation of rule 10b-5. The court dismissed the action on the ground that even if there had been full and honest disclosure by the defendant the allegations of the plaintiff showed that the defendant owned enough (seventy-three percent) stock to have accomplished the same result. Thus the requisite causal connection between the defendant's alleged fraud and plaintiff's injury was

[135] Vine v. Beneficial Finance Co., 374 F.2d 627, 635 (2d Cir. 1967); Miller v. Steinbach, 268 F. Supp. 255, 279 (S.D.N.Y. 1967); Cohen v. Colvin, 266 F. Supp. 677, 683 (S.D.N.Y. 1967).

[136] 266 F. Supp. 524 (S.D.N.Y. 1967).

[137] *Id.* at 530.

[138] *See* J. I. Case Co. v. Borak, 377 U.S. 426, 431 (1964); Vine v. Beneficial Finance, Co., 374 F.2d 627, 635 (2d Cir. 1967); Heilbrunn v. Hanover Equities Corp., 259 F. Supp. 936, 938 (S.D.N.Y. 1966); Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D.N.Y. 1965).

[139] 238 F. Supp. 766 (S.D.N.Y. 1965).

lacking. It was also pointed out that there were no internal procedures available to minority shareholders under state law to block the transaction. Shortly after *Barnett* came the case of *Hoover v. Allen*.[140] In this case the plaintiff alleged that false statements in a proxy facilitated the passage of a charter amendment authorizing the corporation to operate an investment company, a development that resulted in injury to the plaintiff. The court held that the false statement in the proxy had no causal connection with the passage of the amendment because the dominant shareholder who advocated passage owned two-thirds of the outstanding stock necessary for its passage; thus, regardless of the truth or falsity of the proxy statement, the amendment would have passed. The court seemed to assume that there were no means by which state law could have prevented the action taken by the defendants had the truth been known.

Although the results in *Barnett* and *Hoover* are much the same, there seems to be a distinction between the two cases. In *Barnett,* the court pointed out that there were no "internal procedures" which the minority shareholders could have used to stop the fraudulent transaction had the truth been known; in the *Hoover* case, on the other hand, the court said there was no cause of action at all available under state law to prevent the situation had the truth been known. The possibility in *Barnett* that the plaintiff might have obtained an injunction based on the unfairness of the proposed action or that the Stock Exchange might not have approved the purchase of assets had the truth been known would seem to indicate some causal connection between the alleged fraud and the injury. In other words, "but for" the fraud the plaintiff might have been able to prevent the injury by injunctive relief or other available state or exchange remedy. Thus, the court's assumption that the fraud had no useful purpose in the transaction is suspect. The *Hoover* case does not present this possible causal element. The common basis of these two decisions, however, is that in both cases the court viewed the solicitation of proxies which contained the objectionable material as a nonessential step in the ultimate passage of the proposals. This position was taken to task in the recent case of *Laurenzano v. Einbender,*[141] where minority shareholders contended that false proxy material was issued in violation of rule 10b-5 by de-

[140] 241 F. Supp. 213 (S.D.N.Y. 1965).
[141] 264 F. Supp. 356 (E.D.N.Y. 1966).

fendants in solicitation of a vote of shareholders to authorize the corporate purchase of its own stock at allegedly inflated costs. The defendants, in their motion to dismiss, contended that approval of the transaction was obtained not by the misleading proxy material but by their sheer voting power (sixty-five percent of the stock at the meeting). In denying the defendants' motion to dismiss for lack of causation the court pointed out that any time proxies are solicited, whether by election or because of a formal requirement, it could not be assumed that because the result was within the control of the soliciting faction the proxies had no purpose and were a legally inert act. The court stressed the fact that an unfavorable vote by the minority might have affected the majority position and caused it to modify or reconsider its position. Judge Dooling went further to state that

> The misleading proxy material deprives the meeting, and the majority stockholder, of the expressions of view and the votes that would have ensued upon truthful disclosure; it is not legally possible to decide what legal consequences flow from the informational defects in the meeting by asserting that the meeting would have ended in the same resolutions no matter what the views or votes of the minority. That is not necessarily the fact and it cannot be the resolving principal of law.[142]

The *Laurenzano* case is noteworthy in that it is not only established a rational ground for causation in a situation that seemed at first blush to deny any causal connection; it also established this causal relationship without relying on the presence or absence of a cause of action or basis for relief under state law by which the shareholder might have gotten relief had he known the truth. The *Laurenzano* court called the presence or absence of a possible state court remedy "essentially collateral" and stated that the "misstatements and their effects, it would appear, should be related to the corporate context in which proxy material functions as such and not the outer range of their effect on the resort to legal remedies."[143] The more recent case of *Weber v. Bartle*[144] rejected as contrary to public policy defendants' contention that there was no causal relationship between their fraud and plaintiff's injury because the minority would have been outvoted even if the truth had been told. However, unlike *Laurenzano,* this holding does not supply a basis for

[142] *Id.* at 362.
[143] *Id.* at 361.
[144] 272 F. Supp. 201 (S.D.N.Y. 1967).

finding causation but only prevents the defendant from alleging lack of causation.

It is evident from the *Laurenzano* and *Weber* cases that allegations of strict causation are not required. These cases are examples of a general trend away from a requirement of a formal allegation of causation. This trend was well supported by the case of *Globus, Incorporated v. Jaroff*[145] where the court held that as long as the facts alleged were not inconsistent with any alleged or implied causation the complaint would be sufficient.[146]

The allegation and proof of causation, as has been seen, is a general requirement for the maintenance of a section 10(b) and a rule 10b-5 cause of action, with the shady area being in the detailed requirements of allegation and proof. However, there are two areas where this general requirement has been questioned in regard to rule 10b-5. The first area is in suits brought by the SEC. Even though the abolition of causation was proposed in the *Texas Gulf Sulphur* case[147] in actions brought by the SEC, the element of causation is still required in these cases but to a lesser degree than in private rule 10b-5 actions. The second area in which the requirement of causation is relaxed is in actions which seek injunctive relief rather than damages. This relaxation is necessary in most injunctive relief cases because the damage or injury is only threatened and has not yet materialized. Thus, the courts will ignore the element of causation and look to the imminence of the threat posed by defendant's fraud and the adequacy of the legal remedy. Such relaxation is well illustrated in *Mutual Shares Corp. v. Genesco, Incorporated.*[148] Here the court denied plaintiff's action for damages based on a violation of rule 10b-5 on the grounds that plaintiff had failed to prove any loss and thus also any causal connection between the defendant's alleged fraud and injury or damages. However, in regard to plaintiff's claim for injunctive relief the court said:

> [T]he claim for damages . . . founders both on proof of loss and the causal connection with the alleged violation of the Rule; on the other hand, the claim for injunctive relief largely avoids these issues, may cure harm suffered by continuing shareholders, and would afford complete relief against the Rule 10b-5 violation for

[145] 266 F. Supp. 524 (S.D.N.Y. 1967) (Fact situation similar to *Laurenzano*).
[146] *See* note 136, *supra,* and accompanying text.
[147] 258 F. Supp. 262, 277 (S.D.N.Y. 1966).
[148] C.C.H. Fed. Sec. L. Rep. ¶ 91,983 (2d Cir. 1967).

> the future. "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages." We, of course do not know whether plaintiffs can prove their allegations. However, we hold that they have stated a claim under the Act and Rule 10b-5 for injunctive relief to prevent defendants from depressing the price of Kress stock by market manipulation or otherwise. . . .[149]

III. Conclusion

In today's economy it is apparent that wealth is shifting from land to intangible property interests. The ownership of securities by the average citizen is now commonplace and the context within which we find transfers of their ownership is as broad as the individual circumstances in which each owner or potential owner finds himself; and more often than not these transfers involve an instrumentality of interstate commerce or a national securities exchange.

This comment has attempted to present the current state of the law regarding the successful maintenance of a rule 10b-5 suit involving fraud in a securities transaction, and to present in some degree the trends in rule 10b-5 development. However, due to the infancy of the law in this area and the daily expansion of the scope of rule 10b-5 by courts seeking to keep pace with the times and satisfy the public demand for a securities market free of manipulation and deception, it can only be recommended that this comment be used as a stepping stone from which the attorney can proceed to examine the most current judicial interpretation.

Algernon L. Butler, Jr.

[149] *Id.* at 96,345.