Fridrich v. Bradford and the Scope of Insider Trading Liability Under SEC Rule 10b-5: A Commentary

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Adopted in 1942 pursuant to the authority prescribed in section 10(b) of the Securities Exchange Act of 1934,[1] SEC rule 10b-5[2] affords protection to buyers and sellers of securities against fraudulent practices. Since the existence of an implied private right of action under the rule for defrauded purchasers and sellers was recognized three decades ago,[3] the provision, which one distinguished court of appeals has referred to as being "plain, concise and unambiguous,"[4] has surely become the most litigated provision among all of the federal securities laws. It has commanded the energies and creative talents of lawyers, jurists, and legal scholars to a degree not experienced elsewhere in the law.

The development of the body of federal law under rule 10b-5 has branched in many directions, touching a wide-ranging gamut of abusive practices in the corporate and securities milieu. Expansionist applications of rule 10b-5, however, have not come without criticism, and in recent important determinations the omnidirectional tentacles of the rule have experienced no small amount of trimming.[5] In *Fridrich v. Bradford*[6] the United States Court of Appeals for the Sixth Circuit imposed a further restriction on the scope of rule 10b-5 liability, this time in the familiar area of "insider trading." In so doing, the

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1. 15 U.S.C. § 78j(b) (1970) [hereinafter cited as the Exchange Act].

2. 17 C.F.R. § 240.10b-5 (1976):

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 security exchange,

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

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

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

3. *See* Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). For general consideration and discussion of the bases for implication of private rights of action under provisions of the federal securities laws, see Rapp, *An Implied Private Right of Action under Section 16(a) of the Securities Exchange Act of 1934*, 1972 SEC. L. REV. 159.

4. Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971).

5. *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (reaffirmation of the strict purchaser-seller rule for standing under rule 10b-5); Ernst & Ernst v. Hochfelder, 425 U.S. 185, (1976) (high degree of scienter required under rule 10b-5).

6. 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 97 S.Ct. 767 (1977).

court has confronted head-on the established notions of rule 10b-5 liability in the open-market setting which have their roots in the landmark *SEC v. Texas Gulf Sulphur Co.*[7] litigation, as applied to a private action for damages in *Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*[8]

Fridrich held that no private action for damages under rule 10b-5 will lie in favor of open-market purchasers or sellers of securities against those persons having material inside information who transact in those securities without disclosing that information to the marketplace, *unless the plaintiff can demonstrate a direct causal relationship or connection between the insider's trading and the injury suffered.*[9] The holding of the court is in direct conflict with the earlier Second Circuit position in *Shapiro* that liability for damages under rule 10b-5 will be imposed upon one who, without disclosing inside information, buys or sells securities in the open market—that liability running to all persons who during the same period purchased or sold the securities in the open market without knowledge of the inside information.

The decision in *Fridrich* has far-reaching implications, not only from the precise holding, but also from the reasoning that the court employed to reach it. In addition to directly attacking the correctness of the Second Circuit position in *Shapiro*, the court focused not only on the important substantive question under rule 10b-5 of what element of "causation" will be required to impose civil liability for damages, but also upon important and heretofore untouched policy considerations concerning the place of the private right of action under rule 10b-5 in the entire federal securities regulatory scheme. In all of these respects it is a case of extraordinary significance in its approach and result.

This article will analyze and comment on the Sixth Circuit pronouncement in *Fridrich* and its implications. Necessary to an effective consideration and understanding of the case and the situation that it creates, however, is some reflection on the legal environment in which it was decided. Thus, section I below focuses upon the development of the scope of rule 10b-5 liability for "insider trading" from *Texas Gulf Sulphur* to *Shapiro*, and in that light discussion of *Fridrich* follows in section II. Section III will critically analyze *Fridrich*, and section IV will develop what is submitted to be the proper approach to liability for damages under rule 10b-5 for insider trading violations.

7. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).
8. 495 F.2d 228 (2d Cir. 1974).
9. 542 F.2d at 318-19.

I. INSIDER TRADING LIABILITY FROM *Texas Gulf Sulphur* TO *Shapiro*: BREACH OF DUTY AND CAUSATION IN FACT

A. *The Developing Principles*

To the extent that one might suggest a notion as being axiomatic under rule 10b-5, it would have to be that the purpose of the rule is to prevent inequitable practices and to insure fairness in securities transactions, whether conducted face to face, over the counter, or on a national exchange.[10] Through the operation of the rule investors may have the justifiable expectation that they will all have equal access to all material information in their transactions. This principle was expressed by Judge Waterman in the landmark decision in *Texas Gulf Sulphur* as follows:

> The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone' may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' *i.e.*, the investing public. . . . Insiders, as directors or management officers are, of course, by this Rule precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an 'insider' within the meaning of Sec. 16(b) of the Act. . . . Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[11]

Texas Gulf Sulphur involved, among other things, the "tipping" of material inside information, and subsequent trading on that inside information by the people so tipped, prior to disclosure to the marketplace as a whole.[12] In holding that, in an injunctive action by the

10. Section 10(b) of the Exchange Act, under which rule 10b-5 was promulgated, applies to "any security registered on a national securities exchange or any security not so registered," and thus on its face is all inclusive. Significantly, the landmark case of Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), in which a private right of action under rule 10b-5 was first implied, arose in the context of a transaction among only four individuals in shares of a closely held corporation. Early suggestions that section 10(b) and rule 10b-5 ought to be limited only to trading in the organized markets were uniformly rejected by the courts. *See, e.g.*, Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N.D. Ill. 1952); Robinson v. Difford, 92 F. Supp. 145 (E.D. Pa. 1950).

11. 401 F.2d at 848 (citations omitted).

12. The case actually had two principal aspects. The first involved insider trading and the "tipping" of inside information concerning the impressive results of certain exploratory drilling by the company. The focus there was on the liability of those insiders who tipped the information as well as those who had traded on the basis of it. The other, and perhaps even more familiar aspect of the case, centered on the public dissemination by the corporation of misleading information concerning drilling progress. The principal issue there was whether or not the corporation could be held to have violated rule 10b-5 by issuing a misleading press release in the absence of any trading by it, *i.e.*, whether the violation occured "in connection with" the purchase or sale of a security. *See* note 16 *infra*.

SEC, an insider-"tipper" is liable under rule 10b-5 for the profitable trading in securities by his "tippees," the court gave rise to the now familiar "disclose or abstain" rule, which requires, under penalty of a rule 10b-5 violation, that one in possession of material, undisclosed information either publicly disclose it or refrain from buying or selling the security. The duty that this "rule" creates runs in favor of the person with whom the insider is dealing, which, in the open-market setting, as the court points out in the passage quoted above, means the investing public. By designating an *entire market*, and all of those buying and selling in it at the time, as victims of the insider trading—or more precisely of the informational imbalance that it presupposes—the court protects the integrity of securities markets by assuring that all participants have equal access to material information.[13]

But *Texas Gulf Sulphur* did no more than establish the operative principle for insider trading liability. Since it was an injunctive action brought by the SEC, it did not decide whether an insider trading violation could render the insider liable in a civil action for damages, and if so, the extent of that liability. Early cases before *Texas Gulf Sulphur*, such as *Joseph v. Farnsworth Radio & Television Corp.*,[14] had required something analogous to contractual privity between plaintiff and defendant to establish liability for damages under rule 10b-5. In *Joseph*, plaintiffs had purchased over an exchange shares of a corporation that was, unknown to them, in serious financial condition. Defendants were directors and officers of the corporation who had unloaded their shares onto the market without disclosing the true condition of the company to the market, during a period ending

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13. Speaking for the court, Judge Waterman addressed the point as follows:

> The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks,—which market risks include, of course the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital. The insiders here were not trading on an equal footing with the outside investors. They alone were in a position to evaluate the probability and magnitude of what seemed from the outset to be a major ore strike; they alone could invest safely, secure in the expectation that the price of TGS stock would rise substantially in the event such a major strike should materialize, but would decline little, if at all, in the event of failure, for the public, ignorant at the outset of the favorable probabilities would likewise be unaware of the unproductive exploration, and the additional exploration costs would not significantly affect TGS market prices. Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.

401 F.2d at 851-52.

Well before the Second Circuit's analysis in *Texas Gulf Sulphur*, the SEC had expressed its similar view that the status of a corporate insider carries with it fiduciary responsibilities to the trading markets and those outsiders participating in them. *See In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

14. 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952).

before plaintiffs had purchased their shares. To the plaintiffs' contention that defendants were liable for failure to disclose, the district court responded:

> Nothing in the history of the Act or the Rule permits the far-reaching effect sought herein by plaintiffs. A semblance of privity between the vendor and purchaser of the security in connection with which the improper act, practice or course of business was invoked seems to be requisite and it is entirely lacking here.[15]

This restrictive notion of privity as an element of 10b-5 liability was discarded by subsequent decisions, commencing with *Texas Gulf Sulphur*. In an aspect of the case not involving insider trading the SEC alleged that the corporate defendant had violated rule 10b-5 by disseminating false or misleading information to the public. In defense, the corporation alleged that the violation charged did not occur "in connection with the purchase or sale" of securities as required by the Rule.[16] Thus, the court was called upon to interpret the meaning of the "in connection with" requirement as it relates to the impersonal open-market setting. Judge Waterman declared:

> The dominant congressional purposes underlying the Securities Exchange Act of 1934 were to promote free and open public securities markets and to protect the investing public from suffering inequities in trading, including, specifically, inequities that follow from trading that has been stimulated by the publication of false or misleading corporate information releases.
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> Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase 'in connection with the purchase or sale of any security' intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities.
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> . . . Accordingly, we hold that Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to in-

15. 99 F. Supp. at 706. The decision was affirmed by a divided court on the basis of the district judge's reasoning and the intervening decision by the Second Circuit in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952). *Birnbaum*, of course, established the fundamental standing rule for actions under rule 10b-5—that a 10b-5 plaintiff be an actual purchaser or seller of a security—which was recently affirmed by the Supreme Court in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

Judge Frank rendered a strong dissent in *Joseph* based upon his view that common law limitations, including strict privity, were not intended to be applied under section 10(b) and rule 10b-5.

16. The rule proscribes fraudulent or deceptive practices that occur "in connection with" the purchase or sale of a security. *Texas Gulf Sulphur* represented the first real consideration of the meaning of the "in connection with" language in the rule, and represented a prime situation in which to analyze it in the open-market situation. The logical inquiry focused on the extent to which the making of a false or misleading statement for public dissemination could subject the corporation to liability in the absence of any trading on its part.

> fluence the investing public . . . if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes.[17]

Thus, the court looked to the impact of a 10b-5 proscribed act on a generalized market and those members of the investing public who suffer from that act "in connection with" *their* trading in that market. This is the root of the so-called "fraud on the market" theory of 10b-5 liability that achieved considerable prominence following *Texas Gulf Sulphur.*[18]

In *Heit v. Weitzen,*[19] decided by the same court just a short time later, a class action was brought on behalf of purchasers of securities of Belock Instrument Corporation who alleged, *inter alia*, that the corporation had failed to disclose material facts regarding income in its annual report, press releases, and SEC filings. Plaintiffs alleged that they had purchased their securities in the open market at prices that they contended were artificially inflated by reason of the false or misleading information that had been disseminated by the company. None of the defendants in the case had purchased or sold securities themselves, and the district court had granted their motion to dismiss upon grounds that the "in connection with" element of rule 10b-5 could not be satisfied. In light of *Texas Gulf Sulphur*, however, the Second Circuit reversed. Now confronted with a damage action counterpart to *Texas Gulf Sulphur*, Judge Medina observed:

> Judge Waterman writing for the court in *Texas Gulf Sulphur* construed the 'in connection with' requirement broadly and held that the clause was satisfied whenever a device was employed 'of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities,' SEC v. Texas Gulf Sulphur Co., at 860. There is no necessity for contemporaneous trading in securities by insiders or by the corporation itself. 'Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media . . . , if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes.' SEC v. Texas Gulf Sulphur Co., at 861.
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> Applying this rule, and accepting at face value plaintiffs' well pleaded allegations, as we must on a motion to dismiss for failure to

17. 401 F.2d at 858-862.

18. The *Texas Gulf Sulphur* concept of "connection" was further developed in later cases, including Superintendent of Ins. v. Bankers Life & Cas. Co., in which the Supreme Court, although speaking in a non-open-market setting, declared that the suffering of an injury by an investor as a result of deceptive practices "touching" the transaction would satisfy the "in connection with" requirement. 404 U.S. 6, 12 (1971); *see also* Leasco Data Processing Equipment Corp. v. Maxwell [1973-1974 Transfer Binder] FED. SEC. L REP. (CCH) ¶ 94,403, at 95,377-79 (S.D.N.Y. 1974).

19. 402 F.2d 909 (2d Cir. 1968).

> state a claim, we conclude that plaintiffs have met the requirements of the 'in connection with' clause. It is reasonable to assume that investors may very well rely on the material contained in false corporate financial statements which have been disseminated in the market place, and in so relying may subsequently purchase securities of the corporation. The 'ulterior motive' present in the instant case—the concealment of the fraud from the government—is irrelevant, since the false information was circulated to a large segment of the investing public. It is impossible to isolate the particular 'fraudulent' acts and consider them as directed toward the government alone.[20]

Thus, the court found sufficient "connection" to withstand a motion to dismiss.[21]

Although neither *Texas Gulf Sulphur* nor *Heit v. Weitzen* addressed the issue of the scope of rule 10b-5 liability for damages of those who trade on inside information to a class of open market purchasers and sellers,[22] taken together they establish that a rule 10b-5 violation may relate to an entire marketplace and affect all purchases and sales in that marketplace. They found sufficient "connection" to exist between such a violative act and the transactions of market traders to give rise to a right of recovery by open-market buyers and sellers. Most importantly, the cases made it clear that in the open-market setting contractual privity is not an element of a rule 10b-5 action in determining who is protected by the rule, and thus who is able to sue for recovery in the face of its violation. This represented a departure from the restrictive tone that had been set in the early 1950's in *Joseph*, which had required a "semblance of privity" as an element of an action based on a failure to disclose. As stated by the Tenth Circuit in *Mitchell v. Texas Gulf Sulphur*, "the common law requirement of privity has all but vanished from 10b-5 proceedings."[23] Yet it is interesting to note that in *Fridrich v. Bradford* the Sixth Circuit reached back to *Joseph* to support its rejection of the *Shapiro* insider-trading rule.

This is not to imply that *Texas Gulf Sulphur*, as applied in private

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20. *Id.* at 913.

21. The same result obtained in Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971), in which the Tenth Circuit evaluated the *SEC v. Texas Gulf Sulphur Co.* and *Heit v. Weitzen* view of requisite "connection" as the "forward looking view." The court further observed that "[p]erhaps the first step is to realize that the common law requirement of privity has all but vanished from 10b-5 proceedings while the distinguishable 'connection' element is retained." 446 F.2d at 101.

22. The *Texas Gulf Sulphur/Heit v. Weitzen* approach to 10b-5 open-market liability engendered serious inquiry into the limitation on the extent of an inside trader's liability for damages. For example, in the district court opinion in Financial Indus. Fund v. McDonnell Douglas Corp., [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,004 at 90,702 (D. Colo. 1971), *rev'd*, 474 F.2d 514 (10th Cir. 1973), *cert. denied*, 414 U.S. 874 (1973), the court observed: "We are a long way from holding that the TGS official who used inside information to buy 600 shares the day that 440,000 traded is liable to all the sellers. The mechanism which will measure and channel his liability is not yet forged."

23. 446 F.2d 90, 101 (10th Cir. 1971).

damage actions by *Heit v. Weitzen* and subsequent decisions, removed all actual or potential boundaries on the scope of rule 10b-5 civil liability in the open-market setting. Notwithstanding the fact that the restrictive *Joseph* notion of privity was discarded, the development of meaningful limitations on the scope of potential liability for a rule 10b-5 violation continued to command attention. But it did so with a different perspective. Instead of looking to a privity or quasi-privity relationship between a 10b-5 violator and a purchaser or seller of the security, the inquiry came to focus upon a different type of causative relation or nexus between a securities transaction and the claimed violation.

In cases dealing with the dissemination of false or misleading information, such as *Texas Gulf Sulphur* (as it relates to the corporate defendant), *Heit v. Weitzen*, and *Mitchell*, the courts found a sufficient nexus to satisfy the "connection" requirement in that investors in the marketplace were injured by misleading material statements that were made in a manner reasonably calculated to influence the investing public. It is necessary to keep in mind, however, that while *Mitchell* and its predecessors spoke of a broad notion of "connection" in the open-market setting, they also suggested that some element of reliance was an element of the action. When the *Texas Gulf Sulphur* court addressed the inequities of a securities market tainted by informational imbalance, it also talked of "connection" in terms of something being disseminated to that market which is "reasonably calculated to influence."[24] And in *Mitchell*, while the court rejected any suggestion that privity should be an element of rule 10b-5, it did observe that "connection" requires "reliance" by allegedly injured buyers and sellers.[25]

B. *Nondisclosure Cases Prior to* Shapiro

The problem with using reliance (or the foreseeability of it) as a limiting factor on the scope of rule 10b-5 liability is, of course, that it does not work in the nondisclosure setting, which is where the typical insider trading case arises—there is simply nothing for the market to rely on. Recognizing this shortcoming as early as 1965, the Second Circuit delcared in *List v. Fashion Park Inc.* that, in a nondisclosure setting, the proper test is not reliance, but rather "whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact."[26]

That decision was amplified by the Second Circuit's later deci-

24. 401 F.2d at 862.
25. 446 F.2d at 101-02.
26. 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

sion in *Chasins v. Smith, Barney & Co.*[27] There a customer sued his broker-dealer under rule 10b-5 for his failure to disclose that the firm had a market-making role in the securities which it had sold to the plaintiff on a principal basis. The broker-dealer asserted that it could not be held civilly liable to the plaintiff in the absence of a showing that the plaintiff had actually relied on the firm's recommendation to purchase the stock.[28] But the court rejected this contention on the ground that in a nondisclosure setting the proper test for determining the scope of 10b-5 liability was not reliance, but rather "causation in fact."[29] The court clearly indicated, consistent with what the *Texas Gulf Sulphur/Heit* line of cases had established in the open market setting, that the purchase made without disclosure of the material fact coupled with the subsequent loss would suffice to impose liability.[30] Causation-in-fact had been sufficiently shown, the court held, and this was all that was required to establish the requisite connection between the violation and the occurrence of the transaction which led to the loss.

This developing notion of causation-in-fact as satisfying the "connection" requirement was further expanded by the Supreme Court in *Mills v. Electric Auto-Lite Co.*,[31] a decision arising under section 14(a) of the Exchange Act and rule 14a-9, which prohibits misstatements and omissions of material facts in proxy material. In *Mills* the court held:

> Where there has been a finding of materiality, a shareholder has made a sufficient showing of casual relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction.[32]

Thus, materiality was held to be the only element necessary to establish causation under rule 14a-9.[33]

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27. 438 F.2d 1167 (2d Cir. 1970).
28. *See id.* at 1172.
29. *Id.*
30. The court addressed the point as follows:

> To the extent that reliance is necessary for a finding of a 10b-5 violation in a non-disclosure case such as this, the test is properly one of tort 'causation in fact.' . . . Chasins relied upon Smith, Barney's recommendations of purchase made without the disclosure of a material fact, purchased the securities recommended, and suffered a loss in their resale. Causation in fact or adequate reliance was sufficiently shown by Chasins.

Id. (citation omitted).

31. 396 U.S. 375 (1970).
32. 396 U.S. at 385.
33. *Mills* was an action by shareholders seeking to set aside a merger accomplished through the use of a misleading proxy statement. The allegation was based upon an inadequate disclosure of the relationship of members of one board of directors to the other party in the merger.

After receiving indirect judicial recognition in rule 10b-5 actions,[34] the *Mills* reasoning was applied directly to a 10b-5 case by the Supreme Court in *Affiliated Ute Citizens v. United States.*[35] That case involved a sale of shares by the plaintiffs through employees of a bank at a price significantly below their market value, benefiting the bank employees who were able to realize the gain for themselves. The rule 10b-5 allegation focused upon the failure of the bank employees to disclose the fact that the plaintiffs could sell their shares at a better price elsewhere, and that the employees were in a position to gain financially from the sales through them. The Court held:

> Under the circumstances of this case involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of [his investment] decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.[36]

Thus, the use of reliance as a limiting factor in a nondisclosure setting was ruled out by *Affiliated Ute*, whose rationale may well extend to positive information dissemination settings as well.[37]

A principal issue was whether any causal connection existed between the nondisclosure and the merger, and as noted in the text the court found that materiality of the undisclosed fact was sufficient to show that causal connection.

34. *See* Kohn v. American Metal Climax, Inc., 458 F.2d 255, 269 (3d Cir. 1972); Kahan v. Rosenstiel, 424 F.2d 161, 173-74 (3d Cir. 1970).

35. 406 U.S. 128 (1972).

36. 406 U.S. at 153-54. The case has generally been regarded as establishing what is in effect a presumption of reliance in nondisclosure cases. *See, e.g.*, Titan Group, Inc. v. Faggen, 513 F.2d 234, 238-39 (2d Cir. 1975); Carras v. Burns, 516 F.2d 251, 257 (4th Cir. 1975). It should be noted, however, that the Sixth Circuit has challenged this general presumption in Chelsea Assocs. v. Rapanos, 527 F.2d 1266 (6th Cir. 1975). In that case the court declared that the *Affiliated Ute* "presumption," and thus the causation-in-fact principle, is not conclusive, and that where it is found that a plaintiff would *not have relied upon an undisclosed fact* had it been disclosed a dismissal is appropriate. The impact of the decision is the rejection of a strict adherence to an *Affiliated Ute* causation/materiality analysis.

More recently the Supreme Court has reaffirmed the holding in *Affiliated Ute* that reliance need not be alleged or proven in a nondisclosure case. Ernst & Ernst v. Hochfelder, 425 U.S. 185, (1976). *See also* Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975) ("[a]s a matter of law, the district court erred in its determination that plaintiff could not prevail unless it could prove direct reliance" because *Affiliated Ute* rejected such a restrictive reading of rule 10b-5 and that "the test is properly one of tort 'causation in fact' "); Zipkin v. Genesco, Inc. [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,409 (S.D.N.Y. 1976).

37. *See* Note, *The Nature and Scope of the Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 24 CASE WES. RES. L. REV. 363, 385-86 (1973). Even before *Mills* and *Affiliated Ute*, plaintiffs had been permitted to establish that the defendants' actions caused injury to them without any showing of reliance when the injury resulted from the impact of the defendants' misrepresentation upon others. For example, in Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967) a plaintiff successfully claimed injury after having been forced to dispose of stock in a short-form merger after the defendant had, by means of misrepresentations, acquired sufficient shares to cause the merger transaction. And in Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970), the court held that it was not required that a plaintiff whose tender offer had been

C. *The* Shapiro *Case*

Applying the causation-in-fact analysis of *Affiliated Ute* and *Mills* to the insider-trading context, one may properly posit that when an insider is in possession of undisclosed material information and uses that information to his personal trading advantage, in violation of the disclose or abstain rule, and another individual buys or sells in the marketplace without that information and suffers injury thereby, there is a sufficient causal link between the failure to disclose and the damage suffered by the outsider to permit a rule 10b-5 recovery. There is, in other words, causation-in-fact, and with the rejection of any requirement of privity or reliance, this is all that is necessary.

This was, of course, precisely the analysis of *Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith.*[38] *Shapiro* affirmed the imposition of rule 10b-5 liability against insiders who had tipped material inside information to certain outside traders, who were then able to dispose of securities profitably in advance of a serious decline in market price following public disclosure of the adverse information.[39] Liability was extended to benefit every purchaser of Douglas Aircraft Corporation stock on the New York Stock Exchange from the time of the "tippee" trading up to the public disclosure of the adverse information by the company.

Since *Shapiro* was an open-market case, there was obviously no way to match buyers with inside sellers. Moreover, if the court required plaintiffs to match particular purchases and sales, liability could only result for defendants whose sales could be traced to particular open-market buyers. While the argument for requiring such matching was made at the district court level in *Shapiro*, Judge Tenney rejected it out of hand. To accept it, he said, would be to reduce the private right of recovery under rule 10b-5 to "a game of roulette."[40]

The Second Circuit also rejected the contention that insider trading liability for damages should be extended only to those situations where transactions by insiders and outsiders could be directly matched. First the court held that the duty imposed by *Texas Gulf Sulphur* extended to the entire market:

> We also reject defendants' second asserted ground for distinguishing *Texas Gulf*—that our 'disclose or abstain' rule is not applicable here because the only duty owed by defendants was to purchasers of the specific shares of Douglas stock sold by defendants and the transactions here involved were not face-to-face sales to plaintiffs. This argument

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thwarted by fraudulent conduct of a competing tender offeror demonstrate reliance upon defendant's misrepresentations since the success of the fraud depended upon the volitional acts of the tender offerees.

38. 495 F.2d 228 (2d Cir. 1974).

39. *See id.* at 238-241.

40. 353 F. Supp. 264, 278 (S.D.N.Y. 1972).

totally misconstrues our *Texas Gulf* rule. . . . It also ignores the fact that these transactions occurred on an anonymous national securities exchange where as a practical matter it would be impossible to identify a particular defendant's sale with a particular plaintiff's purchase. And it would make a mockery of the 'disclose or abstain' rule if we were to permit the fortuitous matching of buy and sell orders to determine whether a duty to disclose had been violated. . . . To hold that Section 10(b) and Rule 10b-5 impose a duty to disclose material inside information only in face-to-face transactions or to the actual purchasers or sellers on an anonymous public stock exchange, would be to frustrate a major purpose of the antifraud provisions of the securities laws: to insure the integrity and efficiency of the securities markets. . . . We decline defendants' invitation to sanction a result which Section 10(b) and Rule 10b-5 clearly were intended to foreclose. . . . We hold that defendants owed a duty—for the breach of which they may be held liable in this private action for damages—not only to the purchasers of the actual shares sold by the defendants (in the unlikely event they can be identified) but to all persons who during the same period purchased Douglas stock in the open market without knowledge of the material inside information which was in possession of the defendants.[41]

Having determined that defendants owed a duty under the principle of *Texas Gulf Sulphur* to the entire open market, the Second Circuit disposed of defendants' further contention that causation-in-fact had not been established between the defendants' rule 10b-5 violations and the losses suffered by the open-market purchasers. *Texas Gulf Sulphur* and its progeny, while establishing the basis for finding a rule 10b-5 violation, did not clearly supply the requisite nexus between that violation and the open-market trading in a nondisclosure setting so as to permit private recovery, although Judge Bonsal in *Astor v. Texas Gulf Sulphur*[42] had indicated that liability for damages could be imposed for insider trading in the open-market setting by ruling against the insiders' motion for summary judgment. The missing nexus, however, was supplied by the Supreme Court's holding in *Affiliated Ute* that proof of the materiality of an undisclosed fact, if there exists a duty to disclose it, establishes causation-in-fact:[43]

41. 495 F.2d at 236-37.

42. 306 F. Supp. 1333 (S.D.N.Y. 1969). This was a consolidation of some sixty separate civil actions arising out of the *Texas Gulf Sulphur* circumstances. Former shareholders of the company sought money damages against multiple defendants, including those who had engaged in insider trading. All of the defendants moved for summary judgment on the plaintiffs' claims, and in particular those defendants from whom damages were sought on the basis of insider trading. Those particular defendants urged "that they had no duty to disclose the information to the TGS shareholders and that their transactions do not give rise to private actions for damages against them." 306 F. Supp. at 1339. But on the basis of the Second Circuit's decision in *Texas Gulf Sulphur*, Judge Bonsal refused to dismiss the claims against these insiders, and in so doing rejected the notion that any traditional privity relationship must exist between insiders and outside traders, saying instead that "the question is whether the plaintiffs or any of them would have been influenced to act differently than they did if they had known the material information at the time of [their] sale, and if they would, whether they were damaged by defendants' conduct." 306 F. Supp. at 1342.

43. 406 U.S. at 153-54. The pertinent language is quoted in the text accompanying note 36, *supra*.

> [T]his holding in *Affiliated Ute* surely warrants our conclusion that the requisite element of causation in fact has been established by the admitted withholding by defendants of material inside information which they were under an obligation to disclose, such information clearly material in the sense that plaintiffs as reasonable investors might have considered it important in making their decision to purchase Douglas stock.[44]

In subsequent consideration of *Shapiro* at the district court level[45] Judge Tenney addressed the question of the *extent* of the duty posited by the Second Circuit in the course of determining the boundaries of the plaintiff class. Judge Tenney initially noted:

> The duty is imposed on both non-trading tippers and trading tippees . . . and extends to all purchasers trading *contemporaneously with defendants' wrongdoing,* that is, 'while such inside information remains undisclosed.' . . . Given the nature of this duty and the nature of its breach, logic compels the conclusion that liability be coterminous with the duty breached by the wrongdoer.[46]

Plaintiffs urged that the class should include all persons who purchased in the open market without the benefit of the inside information from the time of the first illegal sale by a defendant (June 21, 1966) through the date of the first public announcement of the information (June 24, 1966). Defendants, on the other hand, contended that the outer parameter of the class should be limited to the period of insider trading rather than extending to the time of the initial public disclosure of information, a period approximately one day shorter than that sought by plaintiffs.

On the basis of the passage quoted above, which determined the period of wrongdoing to be the time during which an informational imbalance in the market existed, Judge Tenney rejected the defendants' position. He found that the breach of defendants' rule 10b-5 duty continued from the time of the first insider trade until the time at which the informational imbalance was corrected, regardless of whether insider trading continued to occur throughout that entire period of time:

> Upon full public disclosure of the material facts the information loses its confidential inside character. Once the public is restored to its position of equal access by circulation of the material information, the duty to abstain or disclose is abrogated. The breach which occurred with the first disobedient sale likewise terminates. To hold that the duty ceases before the opportunity for effective public discovery would contravene the compensatory and deterrent purposes of 10b-5 liability.

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44. 495 F.2d at 240.

45. [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,377, at 98,875 (S.D.N.Y. 1975).

46. *Id.* at 98,878 (citations omitted, italics in original).

In a private civil action the wrongdoer remains liable until his unlawful conduct is corrected.[47]

Thus, the duty imposed by the *Texas Gulf Sulphur* "disclose or abstain" rule was held to extend to all open-market traders, and the breach of that duty was connected by causation-in-fact analysis to all open-market activity from the date of the first trade until the disclosure of the material information to the marketplace. The results reached in *Shapiro* at both the district and appellate court levels represented extensive and carefully reasoned applications of well established and largely unchallenged principles. In *Fridrich v. Bradford*, however, the Sixth Circuit confronted not only *Shapiro*, but all that underlies it as well.

II. *Fridrich v. Bradford*: An Open Assault on *Shapiro*

Fridrich arose out of the purchase on April 27, 1972, by J.C. Bradford, Jr. of 1,225 shares of the common stock of Old Line Life Insurance Company.[48] The shares of Old Line were traded in the over-the-counter market and particular shares purchased by Bradford were acquired through J.C. Bradford & Co., a Nashville broker-dealer of which Bradford and his father were the managing partners. Bradford's shares were purchased after he had received a tip from his father concerning the commencement of negotiations for the acquisition of Old Line on extremely favorable terms.[49] After learning of the negotiations, Bradford purchased his shares in the open market at $37.00 per share. Subsequent to his purchase, and following public disclosure of an agreement to merge Old Line with U.S. Life Corporation, Old Line shares increased substantially in value and Bradford sold at a handsome profit. Patterns of trading by others in possession of the inside information followed that of Bradford.

47. *Id.* (emphasis added).

48. While principal focus was placed on the activities of J.C. Bradford, Jr., he was only one of five defendants in the case. Others named were J.C. Bradford, Sr., J.C. Bradford and Co., J.C. Bradford & Co., Inc., and Life Stock Research Corp. J.C. Bradford & Co., Inc., a corporation, was wholly owned by the partners of J.C. Bradford and Co. Life Stock Research Corp. was an investment company of which controlling interest was owned by J.C. Bradford & Co., Inc. Among the five defendants, the court characterized the activities of J.C. Bradford, Sr. as being dominant in the sense that it was he who "put together a syndicate to purchase a controlling block of Old Line stock" and subsequently participated directly in merger negotiations. It was the senior Bradford who tipped the inside information to his son, who then became the central figure in the litigation. 542 F.2d at 308-09.

49. The senior Bradford had been directly involved in negotiations for the acquisition of Old Line. J.C. Bradford and Co. had been the principal market maker in Old Line Stock since 1961, and during a period in which Old Line was viewed as a target for merger or acquisition efforts, Bradford, Sr. was often approached. In 1972 Bradford set out to negotiate the acquisition by U.S. Life Corp., and ultimately arranged favorable terms. It was after the commencement of those negotiations in April 1972 that Bradford, Sr. began purchasing Old Line shares for the account of his wife and of Life Stock Research Corp. He also informed his son of the negotiations, thus leading to those purchases.

Following consummation of the Old Line/U.S. Life merger, the Securities and Exchange Commission commenced an investigation into the circumstances of trading prior to the first public announcement of the merger negotiations. The investigation led to the commencement of an injunctive action in November 1972 in which the Commission charged that Bradford and others had violated rule 10b-5 in connection with the purchase and sale of Old Line common stock.[50] The proceedings were terminated by a consent decree, which as to Bradford required the disgorgement of the profit realized on his purchase and sale of Old Line shares, permanently enjoined him from further violations of section 10(b) and rule 10b-5, and suspended his performance of any business activities as a broker-dealer for twenty days. The consent judgment also provided for a mechanism by which persons who had sold Old Line shares to J.C. Bradford & Co. during pertinent periods of time could recover from that firm the difference between the price at which they sold and forty dollars per share.[51]

In April 1973 the civil action by Fridrich and others was commenced in the United States District Court for the Middle District of Tennessee.[52] The complaint charged defendants with violation of section 10(b) and rule 10b-5 by reason of their trading in Old Line stock while in possession of material undisclosed information.[53] None

50. SEC v. Bradford, No. 72-Civ.-4776 (S.D.N.Y. 1972)

51. The mechanism, an escrow fund, was not something specifically sought by the Commission in its injunctive action. Rather, after the SEC complaint was filed on November 10, 1972, the two Bradfords and Life Stock Research Corp. entered into an escrow agreement under which they agreed to deposit with a Nashville bank funds that could be disbursed to claimants "found to be entitled thereto under any judgment entered against these defendants." 542 F.2d, at 311 n.11. In consenting to an SEC injunction, the defendants acknowledged, and the court ordered, that the fund be held and disbursed to persons who filed claims to it as either of the following: (1) noncustomers who sold to J.C. Bradford & Co. from April 21, 1972 to April 27, 1972; and (2) customers who sold to J.C. Bradford & Co. from April 21, 1972 to June 29, 1972. The court noted that a total of $127,567.94 was ultimately paid out of the fund to claimants.

52. [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,723, at 96,392 (M.D. Tenn. 1974). The complaint filed in the district court alleged that the plaintiffs sold approximately 14,000 shares of Old Line stock on June 13, 14, and 15, 1972 and that their sales would not have been made had they known of the impending merger. Plaintiffs alleged that the defendants were in possession of undisclosed material information about the merger during the period from April 19, 1972 until November 20, 1972, and that insider trading took place during that period. Damages were sought in the amount of the difference between the price received for plaintiffs' stock in their June 1972 sales and the highest bid price reached during the period up to November 20, 1972.

53. Additional allegations were stated under SEC rule 10b-6, 17 C.F.R. § 240.10b-6. Rule 10b-6 prohibits certain activities by participants in a distribution of securities. The essential prohibition of the rule is that one participating in a distribution may not bid for or purchase any security that is the subject of the distribution until that participation is completed. An application of rule 10b-6 was sought in *Fridrich* by reason of the market-maker status of J.C. Bradford & Co. and the fact that, as the district court found, an acquisition of a company's securities in exchange for securities of another company constitutes a distribution of those securities with respect to which the rule 10b-6 proscription would be operative. Thus, the district court found that rule 10b-6 would be violated "during the period when the terms of the acquisition agreement are being established and put into effect; and any broker-dealer participating in

of the *Fridrich* plaintiffs were entitled to recovery from J.C. Bradford & Co. under the mechanism established in connection with the SEC proceedings, since these plaintiffs' transactions did not involve Bradford or any of his associates.[54]

On stipulations of fact and other evidence submitted, including deposition testimony taken in the course of the prior SEC investigation, the district court found that the defendants had violated rule 10b-5 by trading while in possession of material inside information. On the basis of *Shapiro*, liability was found to extend to the "investing public" trading in the same market. As to the extent of recovery, the court held:

> Each plaintiff sold Old Line stock during the period of nondisclosure and is therefore entitled to damages as a result of defendants' nondisclosure in violation of rule 10b-5. . . . The measure of damages is the difference between the price each plaintiff received for his shares sold during the period of nondisclosure . . . and the highest value reached by Old Line stock within a reasonable time after the tortious conduct was discovered and disclosure made of the information wrongfully withheld.[55]

Interestingly, the key date used by the district court as the starting point for looking to "highest value" reached after discovery and disclosure was not the date of a press release in June 1972 respecting merger negotiations, but rather was determined to be November 10, 1972, the date of the SEC consent decree. The court found that the highest value reached during a period of twenty days following that judgment was fifty-eight dollars per share, and on this basis assessed damages against defendants in an aggregate sum of $361,186.75. This calculation and the key date on which it is based, rather clearly leads to the conclusion that at least in the eyes of the district court the "period of nondisclosure" did not end with public disclosure of the merger negotations on June 29, 1972. While there was some suggestion by the court that nondisclosure of at least one fact did continue,[56] it would appear that *Shapiro* was being stretched by such an expansive recovery, and that fact likely contributed to the extremely restrictive position adopted by the Sixth Circuit on appeal. Indeed,

negotiation of the terms of such an acquisition . . . trades in the securities being acquired." [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,723, at 96,405. In its consideration of this alternative holding of the district court, the Sixth Circuit rejected it summarily with the simple observation that its conclusion on the major rule 10b-5 point that the defendants' conduct in no way caused any loss to plaintiffs "is equally applicable to a theory of liability under Rule 10b-6." 542 F.2d at 323.

54. The plaintiffs' shares were not sold to J.C. Bradford & Co.; rather, their transactions were effected through an unrelated broker who testified that he had no knowledge of the proposed merger at the time of plaintiffs' sales.

55. [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,723, at 96,406-07.

56. The court found that facts regarding a "finders fee" to be paid to Bradford, Sr. as part of the merger transaction were not fully disclosed prior to the actual merger. *Id.* at 96,406.

the court of appeals set the stage for its dramatic pronouncement by referring to the district court consideration as an illustration of the "Draconian liability" to which persons who trade on inside information can be subjected under rule 10b-5.[57]

The issue on appeal in *Fridrich* was succinctly identified by Judge Engle: "In the final analysis, the question is how far the courts are to extend the private civil right of action under Section 10(b) and Rule 10b-5 when the alleged violation is the unlawful use of inside information and the stock involved is traded on an impersonal market."[58] In resolving that issue the court determined that *Shapiro* had gone too far, and that both law and policy compelled a clear restriction on liability to those situations in which there is a direct causal connection between a trade on inside information and a claimed loss by an open-market trader. The Sixth Circuit declared: "Investors must be prepared to accept the risk of trading in an open market without complete or always accurate information."[59]

For the starting point of its analysis the court quite logically, and necessarily, chose *Texas Gulf Sulphur* and the "disclose or abstain" rule for which it stands. But after quoting the crucial Second Circuit language regarding that duty, Judge Engle observed that *Texas Gulf Sulphur* "involved an SEC enforcement action against the company and several corporate investors. That particular case did not involve an attempt to impose civil liability for damages upon insiders who trade in the open market without disclosure of inside information."[60]

To determine whether civil liability could be imposed in the nondisclosure setting, the court looked back to the 1951 decision in *Joseph v. Farnsworth Radio and Television Corp.*[61] as enunciating the controlling principle. That principle, in the eyes of the court, is that a "semblance of privity" must exist between one in possession of inside information and another transacting in the open market in order for liability to attach on the insider trading. The principle was, in the court's view, buttressed by the district court decision in *Reynolds v. Texas Gulf Sulphur Co.*,[62] in which recovery on a rule 10b-5 claim by an open-market purchaser based on an insider trading violation was denied. The *Reynolds* court held:

> Plaintiff Karlson sold his stock on December 11, 1963 through a stock exchange. There was no face to face transaction. [Defendant-insider] did not purchase the particular shares sold by Karlson. While it is not necessary for Karlson to establish privity of contract in order to

57. *See* 542 F.2d at 309.

58. *Id.* at 314.

59. *Id.* at 318.

60. *Id.* at 315.

61. 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd per curiam* 198 F.2d 883 (2d Cir. 1952).

62. 309 F. Supp. 548 (D. Utah 1970).

> recover for violations of the statute or the rule, and the fact that there was a total non-disclosure would not prevent recovery if some form of manipulation was involved, it nevertheless is necessary for Karlson to prove some causative effect.[63]

Having distinguished *Texas Gulf Sulphur*, the Sixth Circuit in *Fridrich* had only to face *Shapiro*. Correctly recognizing that rule 10b-5 carries with it the requirement that some "causal connection" exist between a defendant's misconduct and a plaintiff's loss, the court proceeded to attack the underlying principle of *Shapiro* as stated by Judge Tenney—that "[i]t is not the act of trading which causes plaintiffs' injury, it is the act of trading without disclosing material inside information which causes plaintiffs' injury . . . ."[64] Confronting this principle in *Fridrich*, Judge Engle declared:

> The flaw in this logic, we conclude, is that it assumes the very injury which it then declares compensable. It does so by presupposing that the duty to disclose is absolute, and that the plaintiff is injured when the information is denied him. The duty to disclose, however, is not an absolute one, but an alternative one, that of disclosing or abstaining from trading. We conceive it to be the act of trading which essentially constitutes the violation of Rule 10b-5, for it is this which brings the illicit benefit to the insider, and it is this conduct which impairs the integrity of the market and which is the target of the rule. If the insider does not trade, he has an absolute right to keep material information secret. . . . Investors must be prepared to accept the risk of trading in an open market without complete or always accurate information. Defendants' trading did not alter plaintiffs' expectations when they sold their stock, and in no way influenced plaintiffs' trading decisions.[65]

Although Judge Engle attributed to *Shapiro* the assumption that the duty to disclose under rule 10b-5 is absolute, *Shapiro*, made no such assumption. The real thrust of *Fridrich* is not directed at the assumption of an absolute duty, but rather the assumption of injury to ignorant open-market traders supplied by causation-in-fact analysis, which connects the breach of the duty by insider trading to transactions in the open market by those not possessed of the inside information.

The basic reasoning employed by the court in its attack is intriguing. It is to be expected, says the court, that investors in an open market face the "risk" of trading without complete or always accurate information; and this is so whether someone trades while in possession of material inside information or does not. How then, the court asks, does it make any difference to the open-market trader whether insider trading has occurred? While that insider may violate rule

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63. *Id.* at 558.

64. 353 F. Supp. at 278. *See* text accompanying notes 41-46 *supra*.

65. 542 F.2d at 318.

10b-5 by trading on undisclosed material information, and in so doing "impair the integrity of the market," if it has no direct impact upon open-market traders it cannot support civil recovery.

Thus, recognizing without equivocation that insider trading brings illicit benefit to the insider, impairs the integrity of the market, and as such is the target of rule 10b-5, the court refused to recognize any requisite nexus between that conduct and individual traders in the market. *Shapiro*, of course, found the requisite nexus in the *Affiliated Ute/Mills* view of causation.[66] The Sixth Circuit, however, distinguished *Affiliated Ute* on the basis of the kind of relationship there involved between plaintiffs and defendants. After quoting the Supreme Court's critical language regarding the obligation to disclose coupled with the withholding of a material fact as establishing requisite causation, Judge Engle declared:

> It is this language which the Second Circuit, in *Shapiro*, felt to be controlling upon it. We are unable to construe the language so broadly. It was shown in *Affiliated Ute* that the defendant bank employees had engaged in prior business dealings with the plaintiff Indians. They entered into a deliberate scheme to induce the plaintiffs to sell their stock without disclosure of material facts which would have influenced the decision to sell. The resulting sales were a direct result of the scheme. Thus it comes as no surprise that the Supreme Court concluded that '[U]nder the circumstances of this case . . . all that was necessary was that the information withheld be material in order to establish the requisite causation.'[67]

The correct interpretation of *Affiliated Ute*, according to the Sixth Circuit, is that since the plaintiffs and defendants had a relationship between them that involved a direct scheme to induce defendants to act—to sell their shares—the plaintiffs there had a right to expect that defendants would disclose all material facts to them. That direct relationship is what the court found lacking in *Fridrich*,[68] and, by

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66. *See* text accompanying notes 43-44 *supra*.

67. 542 F.2d at 319 (citation omitted).

68. In a footnote the court impliedly commented on the situation in which it might uphold a private remedy. The reference by Judge Engle was as follows:

> We specifically do not reach the question of availability of the remedy to open market situations where the insider trading with resultant price changes has in fact induced the plaintiffs to buy or sell to their injury. . . . Here there was no proof that defendants' insider trading had any impact whatever upon the value of Old Line stock.

Id. at 320 n.27.

The court's approach to "causation" analysis, and its restrictive reading of the *Affiliated Ute/Mills* causation reasoning is somewhat at odds with an earlier decision by another Sixth Circuit panel. In Ohio Drill & Tool Co. v. Johnson, 498 F.2d 186 (6th Cir. 1974), the court had occasion to consider a trial court determination in a proxy case that in order for losses to be recoverable under the proxy rules, those losses must be shown to have resulted from the nondisclosure in the proxy material. This, of course, is a strict causation approach. The Sixth Circuit rejected it, however, as being "a misapprehension of the law." 498 F.2d at 192. And indeed, on the basis of *Mills* the Sixth Circuit concluded: "The district court's holding that the plaintiffs must show a causal relationship between nondisclosures and the defendants' election to office in addition to demonstrating the materiality of the non-disclosures would constitute a blow

necessary implication, in *Shapiro* as well. The court was thus able to declare: "We hold, therefore, the defendants' act of trading with third persons was not causally connected with any claimed loss by plaintiffs who traded on the impersonal market and who were otherwise unaffected by the wrongful acts of the insider."[69]

Thus, the reintroduction of an element tantamount to traditional common-law privity into rule 10b-5 analysis is clear in *Fridrich.* When the court rejects any open market causation-in-fact interpretation, and looks instead to the need for a direct relationship between a plaintiff and defendant, the inescapable conclusion is that privity is required. To be sure, *Fridrich* does not stand for the proposition that the necessary relationship be one of absolute contractual privity between an insider and an open-market trader, but it does require a relationship tantamount to that based upon reliance notions.[70] Stated differently, the Sixth Circuit has imposed a requirement that in order for private damage recovery under rule 10b-5 to be available, it must be demonstrated that an open-market plaintiff bought or sold *because* of an insider's transaction, and not simply on the basis of an independent investment decision not influenced by the insider trade. The attempted revival of such a privity element in rule 10b-5 civil actions was expressly and emphatically rejected by Judge Tenney in his subsequent consideration of the extent of insider-trading liability for damages following the Second Circuit decision in *Shaprio.*[71]

Perhaps sensing the impact of its holding in the face of *Shapiro*, the *Fridrich* court sought to buttress its conclusions with policy considerations. The thrust of the court's policy analysis is simple: *a violation of rule 10b-5 in open-market transactions does not invariably mean that a damages remedy must be available.* Indeed, in the words of Judge Engle:

> The key issue, as we see it, is not whether the proscriptions of § 10(b) and Rule 10b-5 should encompass open market transactions,

to the proxy disclosure rules." 498 F.2d at 192. Such concern for the viability of private recovery under the proxy rules was obviously not carried over into rule 10b-5 analysis in *Fridrich*. The opinion in *Ohio Drill* was written by Judge Miller, joined by Judges McCree and Celebrezze.

69. 542 F.2d at 318-19.

70. The relationship that the court found to be requisite to sustain a rule 10b-5 claim might be more accurately characterized as transactional privity. It is not necessary that buyers and sellers be matched in the contractual privity sense, but it is necessary to find that a particular transaction in the open market occurred because of an insider's trading activity. The relationship is direct in every sense, but not contractual.

71. In response to the *Shapiro* defendants' contention that liability should be limited to only the period during which there was actual insider trading, Judge Tenney made this observation:

> During the momentary span of a defendant's sell order, the only purchases occurring probably corresponded with the shares sold. If liability were limited to the precise period of a defendant's trade, the effective result would be a revival of the element of privity. *Shapiro* dictated that " 'privity' between plaintiffs and defendants is not a requisite element of a Rule 10b-5 cause of action for damages."

[1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,377, at 98,878.

which they should, but whether the civil remedy must invariably be co-extensive in its reach with the reach of the SEC, which under the Act, was designated by the Congress as the primary vehicle of its enforcement.[72]

The principal concern of the court was the potential for massive damage liability that is almost unlimited in scope. The court saw this result as doing nothing more than creating a "windfall" for those people astute or fortunate enough to be aware of their rights as open-market traders—a result that the court felt would do violence to the intent of the statute and the rule.[73] Judge Engle contrasted the *Fridrich* open-market situation with the essentially face-to-face situations in which rule 10b-5 has been employed:

> [E]xtension of the private remedy to impersonal market cases where plaintiffs have neither dealt with defendants nor been influenced in their trading decisions by any act of the defendants would present a situation wholly lacking in the natural limitations on damages present in cases dealing with face-to-face transactions.[74]

Nor, according to the court, is there a sufficient policy of deterrence to support the extension of civil liability in these circumstances. The Exchange Act provides a well-stocked arsenal of sanctions to deter insider misconduct and the courts have broad general equity powers to require disgorgement by an insider of ill-gotten gains. And, of course, the court had before it an illustration of just that sort of power in the form of the SEC consent decree against Bradford, which had required disgorgement of his profit.[75]

In light of these policy justifications by the Sixth Circuit for its holding, the line of demarcation between *Fridrich* and *Shapiro* could not be any bolder. What the Sixth Circuit viewed as a potentially unlimited extension of insider trading liability in the open-market setting "could not only lead to individual injustice, but would have the effect of leading corporate officers, directors and other insiders to refrain from trading in the corporation with which they are associated. We cannot believe that this unhealthy result was intended by Congress in enacting the 1934 Act."[76]

72. 542 F.2d at 320.

73. *Id.* at 320-21. In a footnote reference Judge Engle calculated the potential exposure of Bradford at some seven million dollars, assuming a recovery by the class of open-market traders during the period of April 21, 1972 through November 20, 1972.

74. *Id.* at 321.

75. Judge Engle did add this, however: "Whether the sanctions imposed upon the defendants here together with others which were also available amount to a sufficient vindication of the public rights and to an adequate deterrent to future misconduct we need not say. We may at least observe that the impact is bound to be significant." *Id.* at 322.

76. *Id.*, n.33.

III. *Fridrich* IN CRITICAL PERSPECTIVE

A. *The Technical Legal Analysis: Failure to Recognize the Duty to Disclose*

According to the Sixth Circuit in *Fridrich*, the fact that some traders may have undisclosed, material information on which they base investment decisions, while in the same market others do not, does not mean that any wrong compensable under rule 10b-5 has occurred. Thus, an insider's gain by reason of a trade on undisclosed material information is of no consequence to the unknowing outsider who would have lost anyway by trading in an unknowing market. This view, although short on judicial foundation,[77] is not entirely without support among legal writers.[78] It is the same argument that was put before Judge Tenney in his initial consideration of *Shapiro*, and which he found to lead to "repugnant" results.[79]

In that first *Shapiro* opinion Judge Tenney recognized the deceptive persuasiveness of this approach to insider trading liability. He noted that its roots go deep in our fundamental concept of tort law that an injured party will not receive compensation for damages not actually caused by a defendant's acts. But the notion of causation that underlies this argument, as applied to insider trading liability, is based on the initial premise that, irrespective of whether an insider trades or abstains from trading while in possession of inside information, outsiders would still have traded. Judge Tenney looked upon the situation in a much broader perspective. Even assuming the truthfulness of this premise, he declared that the entire contention is fallacious, for "it is not the act of trading which causes plaintiffs' injury, *it is the act of trading without disclosing material inside information which causes plaintiffs' injury*."[80]

The sole concern in *Fridrich* is the act of trading by an insider. In the abstract view of the Sixth Circuit, an insider trade (given to be a rule 10b-5 violation) and the occurrence of an open-market transaction or ongoing transactions cannot be connected for purposes of a private recovery unless the latter occurs because of the former. But this view ignores the legal impact of the act of trading, *i.e., creation of the duty to disclose.*

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77. *Fridrich* cites two cases in support of this proposition: *Reynolds*, discussed in text accompanying notes 62-63 *supra*, and Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 315 F. Supp. 42, 44 (D. Colo. 1970), *rev'd on other grounds*, 474 F.2d 514 (10th Cir. 1973).

78. *See* Ratner, *Federal and State Roles in the Regulation of Insider Trading*, 31 BUS. LAWYER 947, 954-57 (1976); Comment, *Fashioning a Lid for Pandora's Box: A Legitimate Role for Rule 10b-5 in Private Actions Against Insider Trading on a National Stock Exchange*, 16 U.C.L.A. L. REV. 404 (1969); Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658 (1965).

79. 353 F. Supp. 264, 277-78 (S.D.N.Y. 1972).

80. *Id.* at 278.

The act of trading on inside information is itself a violation of section 10(b) and rule 10b-5, as indeed the Sixth Circuit recognized. But the teaching of *Texas Gulf Sulphur* and its progeny is that the analysis does not stop there because that act of trading, unlawful in and of itself, at the same time gives rise to a duty to disclose—a duty that runs to the marketplace and all those trading in that marketplace—which is also breached. In *Fridrich* Judge Engle looked to *Texas Gulf Sulphur* for the proposition that "[i]f an insider does not trade, he has an absolute right to keep material information secret."[81] That, of course, is precisely correct, but it is only one side of the coin. The other side is that if the insider *does* trade, then under the fundamental *Texas Gulf Sulphur* "disclose or abstain" rule the insider has a duty to disclose. It is this duty which the court ignores.

It is impossible to rationalize, as Judge Engle does, that the act of insider trading does not alter the informational imbalance in a market when undisclosed material information exists—or the ongoing trading in that fact-deficient market—if one recognizes the existence of a duty to disclose that is triggered by the act of insider trading. Clearly, the most problematic passage of the *Fridrich* opinion is where the application of the "disclose or abstain" principle is discussed:

> The duty to disclose . . . is not an absolute one, but an alternative one, that of either disclosing or abstaining from trading. We conceive it to be the act of trading which essentially constitutes the violation of Rule 10b-5, for it is this which brings the illicit benefit to the insider, and it is this conduct which impairs the integrity of the market and which is the target of the rule.[82]

Therein lies the flaw of *Fridrich.* The act of trading on inside information does indeed constitute the rule 10b-5 violation, but as the court itself recognizes in no uncertain terms, that act then gives rise to a duty to disclose. The logical next question is a duty to whom? And what, then, if that duty is breached? These questions were never reached by the court, yet the opinion and its assault on *Shapiro* begs their consideration.

The *Shapiro* result cannot be successfully attacked without confronting its most basic premise—the duty to disclose to the entire marketplace that arises upon the act of an insider trade. In *Fridrich* the Sixth Circuit failed even to attempt this confrontation by erroneously attributing to *Shapiro* a presupposition that the duty to disclose is "absolute" irrespective of whether there is insider trading.[83] The duty is not absolute, and neither *Shapiro* nor the *Texas Gulf Sulphur* line of cases suggests that it is. Rather, it is the act of trading that

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81. 542 F.2d at 318.
82. *Id.*
83. *Id.*

gives rise to the duty to disclose and the breach of this duty is connected by causation-in-fact analysis to open-market transactions. In the initial district court consideration in *Shapiro* Judge Tenney addressed the impact of the act of trading in this manner:

> [H]ad the selling defendants decided not to trade, there would have been no liability for plaintiffs' injury due to the eventual public disclosure of Douglas' poor financial position. But defendants did not choose to follow that course of action, and by trading in Douglas stock on a national securities exchange they assumed the duty to disclose the information to all potential buyers. It is the breach of this duty which gives rise to defendants' liability.[84]

Fridrich recognizes the act of trading as a violation but fails to then consider the creation of a duty to disclose and, most importantly, the impact of the breach of that duty.

B. *The Court's Policy Justifications: A Question of Whose Ox Gets Gored*

The policy analysis undertaken by the Sixth Circuit stands for the proposition that rule 10b-5 civil recovery for insider trading should be precluded except in those rare instances in which some direct causal relationship can be demonstrated to exist between a defendant and an open-market purchaser or seller. Judge Celebrezze's suggestion that the main opinion should be interpreted otherwise finds little support within it. Indeed, when given the opportunity to focus upon a specific limitation on potential recovery—a realistic measure of damages—the court declined to do so, finding no valid rule 10b-5 claim in the first place and thus no need to consider any rule of limitation on damages.[85] Presumably, any civil recovery by open-market plaintiffs in the *Fridrich/Shapiro* circumstances, where an insider has not had some direct, identifiable impact upon an open-market buyer or seller, would lead "inexorably to an unjust and unworkable result."[86]

The principal points of the Sixth Circuit's policy analysis are these: (1) the extension of civil liability under rule 10b-5 beyond that which is the subject of available SEC enforcement powers is contrary to the intent of the statute and the rule; (2) no deterrent to unlawful conduct is lost by precluding a rule 10b-5 private remedy; (3) the SEC has an ample arsenal of sanctions for unlawful conduct supported by general equity powers of the judiciary; and (4) state law may provide "various sanctions" against insider trading. The soundness of these separate policy justifications for denying private civil recovery largely depends upon whose ox gets gored.

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84. 353 F. Supp. at 278.

85. 542 F.2d at 318.

86. *Id.*

Fundamentally, private rights of action are implied under rule 10b-5 and other provisions of the federal securities laws that provide no express recovery either because such rights are deemed necessary in the face of the lack of an effective statutory remedy, or because such rights are necessary in light of the statutory purposes to provide a supplement to SEC enforcement powers.[87] No intent was ever expressed that there even be a private right of action under section 10(b) and rule 10b-5, let alone how far that remedy should reach in various settings. There simply is no "intent" for rule 10b-5 that can be mustered in support of any limitation on a remedy that was never imagined by the drafters.[88]

The purpose of implying a private remedy under rule 10b-5 was not to provide a deterrent to the commission of wrongful acts. Indeed, from the beginning in *Kardon v. National Gypsum*,[89] which first recognized an implied private right of action under rule 10b-5, the remedy was conceived to be compensatory in nature. In the years preceding *Kardon* it had become very apparent that neither section 10(b) nor rule 10b-5 could have any real significance as protective devices without a private right of enforcement that was compensatory in nature. Then, as now, none of the available SEC sanctions under the Exchange Act was compensatory.[90] Judicial inclusion of compensatory relief under rule 10b-5 gave that provision a truly protective effect that could not have obtained simply by SEC enforcement actions coupled with requests for ancillary relief pursuant to the general equity jurisdiction of the courts. Ordering the disgorgement of profits realized by one who trades with the advantage of undisclosed material information may lend support to the adage that crime does not pay, but it does nothing to compensate those who have unwitting-

87. *See, e.g.*, J.I. Case Co. v. Borak, 377 U.S. 426, 432-33 (1964). In *Borak*, the Supreme Court recognized an implied private right of action under Section 14(a) of the Exchange Act, with the court noting that such a private right was an absolute necessity as a supplement to SEC action.

88. For an analysis of the background of rule 10b-5, see Sommer, *Rule 10b-5: Notes for Legislation*, 17 CASE W. RES. L. REV. 1029 (1966).

89. 69 F. Supp. 512 (E.D. Pa. 1946).

90. Under provisions of the Exchange Act, government sanctions are limited to:
(a) Disciplining broker-dealers;
(b) Criminal prosecution of violators; and
(c) Injunctive relief from continued or future violations.
See 15 U.S.C. §§ 78f(b), 78a(e), 78ff (1973). In recent years the SEC has enjoyed considerable success in supplementing its statutory powers through "ancillary remedies." Such relief, imposed under general equitable powers of the judiciary, includes: appointment of receivers; special trustees or fiscal agents; restitution or disgorgement of profits; special independent audit committees or board members; special counsel; rescission offers; accounting; undertakings for establishment of compliance procedures, and others. *See generally* Bemporad, *Injunctive Relief in SEC Civil Actions: The Scope of Judicial Discretion*, 10 COLUM. J. LAW AND SOC. PROB. 328 (1974); Mathews, *SEC Civil Injunctive Actions*, 6 REVIEW OF SECURITIES REGULATION 955 (1973); Comment, *Equitable Remedies in SEC Enforcement Action*, 123 U. PA. L. REV. 1188 (1975); Note, *Ancillary Relief in SEC Injunction Suits for Violation of Rule 10b-5*, 79 HARV. L. REV. 656 (1966).

ly lost in an unfair market. If, as the Sixth Circuit acknowledges, the "target" of rule 10b-5 is conduct that "impairs the integrity of the market,"[91] it would seem that, rather than seeking to retreat from the recognition of broad based compensatory relief to those trading in a market so impaired, the court might well have heeded an earlier Supreme Court mandate that federal courts have a clear duty to provide the remedies necessary to make effective the congressional purpose of a statute.[92] In that sense the answer to Judge Engle's rhetorical question, "whether the civil remedy [under rule 10b-5] must invariably be co-extensive in its reach with the reach of the SEC, which under the Act, was designated by the Congress as the primary vehicle of its enforcement"[93] must be answered in the negative; it should be *broader.*

Finally, even Judge Engle acknowledged that state law provides little, if any, sanction against insider trading beyond corporate accountability of the insider. And no available state law claim would provide compensatory relief to any open-market buyers and sellers.[94] Therefore, none of the policy justifications advanced by the Sixth Circuit warrant the court's abrupt return to a privity limitation on rule 10b-5 actions for insider trading.

C. *Summary: The Fundamental Error*

The *Shapiro* decisions have prompted important and legitimate questions, most of which focus on the causation element on which both the district court and Second Circuit relied to connect the inside traders' breach of duty with outside traders' damages. *Fridrich* is a graphic expression of legitimate concern for truly massive liability potential and the need for rational delineation of a scope of rule 10b-5 protection in the open-market setting. But the case represents an end for which means were constructed. The court attempts to walk an extremely fine line that posits that the *Texas Gulf Sulphur* "disclose or abstain" principle is well established and correct, but that its extension into private liability analysis, as in *Shapiro*, is wrong. Unfortunately, the court fails to confront the basic principle that it recog-

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91. *See* 542 F.2d at 318.

92. *See* J.I. Case Co. v. Borak, 377 U.S. 426, 430-33 (1964).

93. 542 F.2d at 520.

94. *Id.* at 322 n.32. Professor Ratner has characterized the status of state law in the area as follows:

> As far as persons on the other side of the market is [*sic*] concerned, it is pretty clear they have no right of action under state law. The liberalizing trend of state decisions on insider trading . . . has applied exclusively to direct transactions in relatively closely held companies. When the insider trading takes place on an exchange or organized over-the-counter market, Goodwin v. Agassiz [283 Mass. 358, 186 N.E. 659 (1933)] is still the law and state courts do not recognize any fiduciary duty of insiders to others trading in the market.

Ratner, *supra* note 78, at 955.

nizes as sound—the *duty* to disclose or abstain. To attack the existence of a duty to disclose given the fact of insider trading would, in effect, have required the court to rewrite the entire line of cases from *Texas Gulf Sulphur* to *Shapiro*. *Fridrich*, of course, does not do so. But its failure to recognize and grapple with the fundamental principle that underlies all those cases, and that is the express foundation for *Shapiro*, leaves a holding which is, at best, an enigma. At worst, it must be viewed as an outright rejection of the "disclose or abstain" principle in the consideration of civil liability under rule 10b-5.

IV. The Celebrezze Concurrence: Imposing a Rational Limitation on the Scope of Insider Trading Liability

Recognizing the likely interpretation of the main opinion and the dramatic impact which that holding would have on the scope of rule 10b-5 liability for damages in the open-market setting, Judge Celebrezze wrote a separate concurring opinion. He chose to strike a note of moderation, declaring: "I do not read today's decision as a repudiation of the 'disclose or abstain' rule in private damage actions. Rather, I see the Court's opinion as imposing a rational limitation on the scope of civil liability under rule 10b-5 for insiders trading in the open market."[95]

A "rational limitation" was no doubt uppermost in the collective mind of the court from the outset of its consideration of *Fridrich*. But the limitation imposed by the holding that some direct, causal relationship must exist between an insider and outsider before civil liability may be imposed under rule 10b-5 is not conducive to the continued vitality of the "disclose or abstain" principle, which has at its heart an affirmative duty to disclose once an insider trade occurs. Although he did not expressly recognize the failure of the court's holding to confront this basic point, Judge Celebrezze cast the court's holding in the following light:

> In the present case, the Court holds that persons who trade on an open market weeks after an insider has concluded his trading activity must establish more than the materiality of the undisclosed information to demonstrate that their losses were caused by defendants' trading. As the Court notes, the 'disclose or abstain' rule is stated in the alternative. Trading is the gravamen of the offense. The public has no absolute right to the undisclosed information. *It is only when the insider enters the market and creates an informational imbalance that a duty to disclose is imposed to protect the anonymous investors trading with the insider.* . . . The duty of disclosure is owed to the class of investors trading contemporaneously with the insider and it is only this group who are the proper beneficiaries of the relaxed causation standard of *Affili-*

95. 542 F.2d at 323.

ated Ute. These investors as a class are disadvantaged by the superior knowledge of the insider. The stocks they traded generate the insiders' profits.[96]

The italicized portion of Judge Celebrezze's characterization represents the key element omitted from any consideration in the main opinion. The recognition of a duty to disclose arising upon an insider's trade, coupled with Judge Celebrezze's acknowledgment that the breach of that duty to disclose will indeed support civil liability through application of the "relaxed causation standard of *Affiliated Ute*" to "contemporaneous" open-market buyers and sellers, bears little resemblance to the main opinion. Indeed, it seems almost better suited for a dissent from the main holding, for Judge Celebrezze takes issue with *Shapiro* only in the manner in which the plaintiff class is to be defined. He even notes that in the *Shapiro* circumstances the court may well have correctly defined the class of potential plaintiffs as including all traders in the market up to the time of effective disclosure.[97]

This is more than subtle divergence from the problematic analysis of the main opinion in *Fridrich.* Indeed, the Celebrezze approach leaves no doubt as to the Judge's unqualified endorsement of the fundamental *Shapiro* reasoning, as the following language boldly underscores:

> [A]n insider should not escape civil liability for conduct which would clearly violate rule 10b-5 in a face-to-face transaction, by the simple expedient of restricting his trading to the open market where the mechanics of the marketplace make it difficult, if not impossible, to trace particular transactions.
>
> It was fear of creating a loophole in the 'disclose or abstain' rule which led the Second Circuit in *Shapiro* to reject the argument that the rule should be restricted to SEC injunctive actions or to private suits where the actual purchasers of the stock could be identified. . . . To do so, the Court reasoned, would be to circumvent the strong policy considerations supporting the rule and 'make a mockery' of an insider's duty to disclose or abstain from trading. . . . Indeed, the 'disclose or abstain' rule was devised to cope with the difficulty in tracing transactions in an impersonal market. Since the mechanics of the marketplace made it virtually impossible to identify the actual investors with whom an insider is trading, *the duty of disclosure is owned [sic] to investors as a class who trade on the Market during the period of insider trading. . . . The 'disclose or abstain' rule accomplishes two salutary purposes of rule 10b-5: it insures the integrity of the marketplace and it compensates for the inequity of trading with a corporate insider who has superior access to material inside.information.*[98]

96. *Id.* at 326 (emphasis added).

97. *Id.* at 327.

98. *Id.* at 323-24 (emphasis added).

Judge Celebrezze does, however, take issue with *Shapiro* over the manner in which the class of eligible plaintiffs is to be defined. Under his analysis, the duty to disclose "arises only when necessary to equalize the information available to outside investors who are actively trading with an insider who is privy to undisclosed material facts. When the insider ceases trading, the informational imbalance ends and the market returns to its normal state."[99] Thus, the only plaintiffs who are owed a duty are those trading contemporaneously with the insider. This conflicts with the analysis employed by Judge Tenney in the second district court consideration in *Shapiro*, where the class of plaintiffs was defined to be those traders who were in the market from the date of the first inside trade by a defendant through the date when public announcement of the information was made. In the above passage from *Fridrich*, Judge Celebrezze rejects only that aspect of *Shapiro*, urging instead that the informational imbalance is corrected when insider trading ceases. He thus observes that recovery in the *Fridrich* circumstances should be limited to those persons who sold their shares in the market during the period in which the insiders were actively purchasing. Since none of the plaintiffs fell within that period, however, he joined in the reversal.

The two divergent opinions in *Fridrich* have spawned an obviously difficult task of interpretation and application. The main opinion taken alone is a harsh rejection of the fundamental principle that there can be civil liability in open-market insider trading cases. Judge Celebrezze's concurrence, on the other hand, in careful and scholarly fashion fully indorses the *Shapiro* extension of liability, subject only to the narrowed scope of contemporaneous trading and the hope of a realistic measure of damages.[100]

The dilemma of *Fridrich* is that the separate concurrence is apparently designed to ameliorate the impact of the main opinion, and in so doing, prescribe what the case really stands for. Judge Celebrezze's characterization of the rule of law enunciated in *Fridrich* is simple: "In the present case, the Court holds that persons who trade on an open market weeks after an insider has concluded his trading activity must establish more than the materiality of the undisclosed information to demonstrate that their losses were caused by defendants' trading."[101] He viewed the panel's decision as simply declaring

99. *Id.* at 327.

100. Defining the class to include all those who trade contemporaneously with the insider, of course, still leaves the spectre of massive damage liability, but according to Judge Celebrezze, that prospect must remain until some realistic measure of damages is devised. This question, he declared, "is better left to the remedy stage where a court can employ its equitable powers in shaping an award or until such time as the Congress chooses to act on this problem." *Id.* at 326 n.11. This is precisely the approach taken by the Second Circuit in *Shapiro*.

101. *Id.* at 326.

that one who breaches the "disclose or abstain" rule by trading in the open market will not become a virtual insurer for losses sustained by investors who happen to trade in that same stock well after the insider trading has concluded. In all other respects, the legal and policy analyses underlying the rule and its application in the open-market setting are, under the Celebrezze approach, left intact.

Judge Celebrezze's characterization of the holding in *Fridrich* is an inviting one, and his analysis is sound. But for the majority's effort at policy justification for the outcome in *Fridrich*, one might agree with Judge Celebrezze that reintroduction of a privity requirement was not really intended by the court. Since it was clear that none of the plaintiffs had traded contemporaneously with the insider-traders, the Celebrezze position respecting the imposition of a simple contemporaneous trading limitation, coupled with the development of some realistic measure of damages, might well have emerged as the rule of the case, leaving courts and commentators to grapple with the relative merits of the Second and Sixth Circuit positions. But the main opinion does not support Judge Celebrezze's interpretation. Indeed, rather than suggesting a "rational limitation" on the scope of civil liability, the court challenges the very proposition that there should be recovery at all. The Celebrezze characterization of the *Fridrich* holding is in fact only a characterization of the result, for the real holding is that the act of insider trading must be causally connected with the losses of open-market plaintiffs, and that sufficient causal connection means something tantamount to a direct or traditional privity relationship.

There is evident in the Celebrezze concurring opinion an effort to extend the main opinion and its reasoning into a correct and consistent rule 10b-5 legal framework and thus preserve the viability of that framework in the circuit. Judge Celebrezze characterizes the class of contemporaneous open-market purchasers, who should be permitted recovery on the basis of the related *Affiliated Ute* causation analysis, as "surrogate plaintiffs" for those investors who do have the kind of direct relationship of which Judge Engle speaks.[102] Because mechanics of the market make the establishment of this relationship impossible, the entire class of contemporaneous traders takes the place of those individuals who, but for the open-market setting, would satisfy the strict causation requirement. Although Judge Celebrezze recognized that the class would include investors who were in no way involved with insider transactions except for their time of trading, he declared that in order "to accomplish the deterrent and compensatory purposes of 10b-5, it is better to be overinclusive in the definition of the plaintiff class than underinclusive."[103] Thus, by explication the

102. *Id.* at 326 n.11.

103. *Id.*

essential point of the main opinion is shaped to fit well into current 10b-5 analysis.

With deference and respect to Judge Celebrezze's attempt to supply substance to a deficient main opinion, the situation calls to mind the proverbial counsel concerning attempts to fashion a silk purse from the sow's ear. The essence of the Celebrezze analysis, derived from precedent from *Texas Gulf Sulphur* to *Shapiro*, is that there is a class of open-market traders for whom a relaxed causation principle is available. That, of course, is unqualifiedly rejected in the main opinion, and under it, there is no adequate substitute for a direct causal relationship.

Since the same result obtains in *Fridrich* regardless of whether the Engle or Celebrezze analysis is employed, the question arises as to which view of the case will emerge predominant, and corollary to that, which *should* be followed. One indication of the answer to the first question is already available. In the first application of *Fridrich* at the district court level, Judge Thomas of the Northern District of Ohio, declared, in *Imperial Supply Co. v. Northern Ohio Bank*:[104]

> Tested by *Fridrich*, the critical question that must be considered in asessing whether the complaint states a cause of action is whether it is adequately alleged that plaintiffs were 'influenced in their trading decisions by any act of the defendants.' . . . It is not alleged that the act of selling [Northern Ohio Bank] stock by [alleged inside trading] defendants, albeit with inside information, influenced the plaintiffs in their trading decisions.[105]

With this finding Judge Thomas dismissed from a multi-count class action complaint a count alleging that certain defendants sold shares on inside information over a substantial period of time. Plaintiffs, open-market purchasers, had relied directly on *Shapiro* to support the count, alleging that material facts on which insiders traded, if disclosed, "would have had a substantial effect on the market price of the common shares"[106] of the bank defendant. Plaintiffs contended that defendants' trading gave rise to a duty to disclose, which was breached. But the court concluded "[t]he allegations of count III [the insider trading count] do not allege any nexus between plaintiffs' purchases and the sale of stock by any of the count III defendants."[107]

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104. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,908 (N.D. Ohio 1976).

105. *Id.* at 91,403.

106. *Id.* at 91,402.

107. *Id.* Judge Thomas' analysis does contain within it, however, a perplexing ambiguity. After holding that no sufficient causal connection was alleged in the insider trading count, he made this observation:

> Moreover, under *Fridrich*, if the acts alleged to form the basis of defendants' liability consist of misrepresentation or omissions, to establish an implied right of action against an inside trader there must either exist a duty for the insider to reveal the information involved, as in *Affiliated Ute Citizens v. United States* . . . or the insider, if not required to disclose the inside information, would only be liable to a purchaser or

Although the court made reference to Judge Celebrezze's concurring opinion in *Fridrich* in a footnote, *Northern Ohio Bank* is a strict application of the main *Fridrich* opinion. The factual pattern and allegations in *Northern Ohio Bank* gave Judge Thomas the clear option of relying upon either *Fridrich* opinion for his ultimate conclusion. Trading in the shares of the bank apparently spanned some four years or more; there was no limiting allegation concerning who among the plaintiff class should be permitted to recover for alleged insider trading at specified times during that period of time, and there was no contemporaneous trading allegation. Just as Judge Celebrezze found that the *Fridrich* plaintiffs could not recover for lack of contemporaneous trading, Judge Thomas, employing the same rationale, could have restricted any claim in *Northern Ohio Bank* and indeed dismissed the claim before him without impairing the continuing vitality of the "disclose or abstain" rule.

Since both Sixth Circuit approaches restrict the scope of rule 10b-5 liability as enunciated in the *Shapiro* trilogy of decisions, it could be argued that *Fridrich* should not be followed at all. This writer, however, urges that *Fridrich* should indeed be followed, to the extent that it imposes a contemporaneous trading limitation on the scope of rule 10b-5 liability for insider trading in the open market setting. That is to say that the rationale and rule expressed in the Celebrezze concurrence should be adopted and applied as a rational limitation on otherwise potentially limitless liability. Judge Celebrezze's premise, as noted earlier, is simply that an insider who breaches the *Texas Gulf Sulphur* "disclose or abstain" rule should not become the virtual insurer for losses sustained by those who happen to be trading in the open market weeks after insider trading activity has ceased, as was the case in *Fridrich*. But recognition of the basic principle that the "disclose or abstain" rule does indeed create a duty owed to open-market investors *as a class* underscores the dilemma faced by those who must determine the scope of the civil accountability that it spawns.

There is, as Judge Celebrezze points out, a need to restrict the scope of rule 10b-5 civil liability for insider trading in the open-market setting. The imposition of massive civil liability which is, in every sense of the word, disproportionate to the extent of an insider's trading

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seller of stock in the open market if the insider nonetheless released misleading information. *Id.* at 91,403.

The meaning of this statement by the court is not entirely clear. Under the "disclose or abstain" rule of *Texas Gulf Sulphur*, a duty to disclose material information arises with an insider trade. The problem is then connecting that duty, or the breach of it, to open-market trading—a connection that *Affiliated Ute* arguably supplies. It would seem, then, that if Judge Thomas recognized the "disclose or abstain" rule as establishing a duty, then liability could be imposed. This, however, is inconsistent with the finding by the court that no requisite "nexus" was alleged. The author suggests that this paragraph of Judge Thomas' *Northern Ohio Bank* opinion will engender continuing debate.

activities, serves no useful compensatory purpose unless it can be linked to an actual market imbalance, a disadvantage to outside traders, which is brought on by the wrongful conduct. The admonition of the main opinion in *Fridrich* that investors must be prepared to accept the risk of trading in an open market without complete or always accurate information is valid, so far as it goes. But the fact is that rule 10b-5 now insures that the risk of trading without material information is qualified by the fact that all investors in that market face the identical risk. Before and after an insider trade, open-market traders may have access to the same information. But the use of undisclosed material information upsets the balance and counters the reasonable expectations of investors, and thus infects every other contemporaneous transaction. Thereafter, the balance returns and the market, although tainted by the prior unlawful activity, is fair again.

It is for this reason that a contemporaneous trading limitation on the scope of rule 10b-5 insider trading liability is a sound and rational one. In *Shapiro* Judge Tenney viewed the impact of a breach of the duty of disclosure as extending beyond the period of insider trading and continuing until disclosure is made, theorizing that an informational imbalance exists until it is affirmatively corrected. But the act of trading without disclosing material information can have an identifiable impact only upon those who trade in the same market within the same time parameters. It should not extend until the moment of disclosure is reached—a moment which could be days, weeks, or even months removed from insider trading activity. Insider trading does not, in the sense of the dissemination of false information, for example, alter the total mix of information until corrected. Rather, the alteration exists only within the time that insider trading destroys market integrity by creating unfair advantage. That is the thrust of the "disclose or abstain" rule—to preserve a constancy of market integrity.[108]

A contemporaneous trading restriction is consonant with the basic recognition that breach of the duty of disclosure owed by an insider-trader to the marketplace as a whole can and does result in

108. Professor Stuart Goldberg succinctly characterized this function as follows:

> The disclosure provisions of the federal securities acts can never protect a private investor from himself. They are not intended to do so. The sucker who has been given an "even break" remains a sucker; but at least he has been given the opportunity to exercise the evaluative capacity which he is presumed to possess. It is this opportunity which the anti-fraud provisions of the federal securities laws seek to guarantee.

S. GOLDBERG, SEC TRADING RESTRICTIONS AND REPORTING REQUIREMENTS FOR INSIDERS 42-43 (1973). Edward Brodsky adds this valuable insight:

> The securities laws are designed to make all material information about public companies available to all investors. What the outsider doesn't know hurts him—it may devastate him—because if he knew the adverse facts he wouldn't buy and wouldn't suffer what may be a substantial loss when the news becomes public.

E. BRODSKY, GUIDE TO SECURITIES LITIGATION 101 (1974).

measurable damages that are neither imaginary nor speculative. Buyers and sellers in the open market have the right to expect that th market in which they participate is a fair one, untainted and unimpaired by the presence of transactions based upon undisclosed materia information. Market integrity is based upon all investors havin equal knowledge on which to base investment decisions. Whethe all investors are capable of acquiring or utilizing the informatio available to the market in general or whether they use it at all in making investment decisions is not important. It is only important that i be available to all. This was the concern that gave birth to th "disclose or abstain" rule in *Texas Gulf Sulphur*—a rule that insure the integrity of the marketplace and compensates for inequity of trading with those who have superior access to material inside information.[109]

The opinion by Judge Engle in *Fridrich*, however, ignores thi inequity by precluding any private recovery for insider trading throug the imposition of a causation limitation that is virtually unworkable i an open-market setting. Such a result is unacceptable and should b rejected as an overreaction by the majority of the panel to what i deemed to be an intolerable *Shapiro* result. The class definition i *Shapiro*—the determination of who may recover—is not without it problems. Indeed, as the foregoing discussion highlights, Judg Tenney's view in *Shapiro* of the extent of the market impact, of th "informational balance," wrought by insider trading should be challenged as being too far removed from the precipitative act. But tha challenge as to who should recover surely does not and cannot mandate a determination that no one should recover as a matter of law Rather, it merely calls for the kind of rational limitation Judge Celebrezze has proffered.

V. Conclusion

In the final analysis conclusions as to the wisdom or aberranc of the Sixth Circuit in *Fridrich* will depend upon the purpose that i ultimately attributed to section 10(b) and rule 10b-5. In the conte of insider trading in the open-market setting, if it is determined th rule 10b-5 is, or should be, concerned only with imposing sanctio

109. Judge Waterman's expression in *Texas Gulf Sulphur* of the "core" of rule 10b should not be forgotten:

> The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks,—which market risks include, of course the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital. . . . [I]nequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.

401 F.2d at 851-52.

against persons who engage in such trading and thus deter the practice, then the objection of Professor Ratner—that the imposition of damages having nothing to do with "imaginary losses" suffered by open-market traders and unrelated to profits realized by defendants is unrealistic[110]—is correct. But, on the other hand, if the private right of action under the rule continues to be viewed not merely as a basis for sanction, but also as a device for compensating those harmed by the unlawful conduct, then it cannot be said that the recognition of a broad private remedy based upon the duty owed by an inside trader to open-market buyers and sellers is either inappropriate or unjust.

While the *Fridrich* court overtly endorsed the view that the rule 10b-5 private action is compensatory in nature,[111] its policy rationale for denying recovery clearly supports a much more restrictive deterrence objective. The court attempts a balancing act in which it strives not to upset accepted notions but at the same time to reject them in application. The expressed desire of the court to restrict the scope of rule 10b-5 civil liability in the insider-trading context is consistent in result with that court's recent pronouncements on other more generalized aspects of rule 10b-5 claims.[112] But this drive of the court to assume a cohesive conservative stance in rule 10b-5 litigations fails in the *Fridrich* main opinion for want of a realistic approach to the genuine problem of the extent of insider-trading liability in an open-market setting.

In reasoned and consistent analyses from *Texas Gulf Sulphur* to *Shapiro*, the judiciary has enunciated a rule that recognizes the importance of compensating for genuine harm done to the fairness and integrity of the marketplace as a whole and those participating in it without the benefit of an insider's knowledge. It is based upon a basic duty of disclosure that arises in the face of insider trading and which compels equalization of information among all of those participants.

The extension of the scope of liability under the "disclose or abstain" rule and its concomitant duty to the degree represented by *Shapiro* is, in this writer's considered judgment, unwarranted. At the same time, however, its rejection in *Fridrich* is wholly unacceptable both as a matter of law and policy. The foundation for rule 10b-5 civil liability in the open-market setting, as cemented in *Shapiro*, is sound. Reasonably applied, it leads to results that are just and con-

110. *See* Ratner, *supra* note 78, at 956.

111. 542 F.2d at 321.

112. *See, e.g.*, Marsh v. Armada Corp., 533 F.2d 978 (6th Cir. 1976) (standing and substantive fraud); Chelsea Assocs. v. Rapanos, 527 F.2d 1266 (6th Cir. 1975) (reliance); SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974) (rule 10b-5 secondary liability). *But see* Nickels v. Koehler Management Corp., 541 F.2d 611 (6th Cir. 1976) (general fraud statute of limitations applied); Spoon v. Walston & Company, Inc., 478 F.2d 246 (6th Cir. 1973) (private cause of action for violation of Exchange Act margin restrictions).

form to the dominant purpose attributed to section 10(b) and rule 10b-5 throughout their history.

The fear of "Draconian" liability cannot now support the majority rationale in *Fridrich.* Indeed, to do so is to say in substance that no person may recover because a few too many may recover. The desire to fashion a rational limitation on the scope of open-market liability is needed and welcome, but a limitation that effectively extinguishes private recovery is neither rational nor desirable. In an effort to limit a remedy the majority of the panel instead crumbled the legal foundation for the claim. Judge Celebrezze recognized this, and his concurring opinion represents an effort to channel the impact of the main opinion away from adverse liability analysis and instead to the establishment of a limitation on potential recovery.

There is, in this instance along with many others, a fine line between the legal substance of a claim and determining that some individuals are not within the class of persons who may recover, for indeed as to that group not within the class there is no claim. But the line does exist. A legally cognizable claim does not lose its character as such because a particular class of plaintiffs is deemed to have no remedy under it. Whether the extent of the damage recovery permitted in *Shapiro* was right or wrong, or whether it is ultimately upheld or not, the recognition as a matter of law that there does exist a class of open-market investors having no direct privity relationship with an inside trader who suffers injury caused by inside trading remains intact. Not so, however, in *Fridrich* if the main opinion is to emerge as the rule of the case. For in *Fridrich* the essence of legal liability, the "disclose or abstain" rule and the duty it creates, is cast aside in the rush to limit a remedy.

It is the Celebrezze opinion in *Fridrich* which properly recognizes the established legal foundation for damage liability for insider trading in the open market setting. And it is that opinion which proffers the needed rational limitation on recovery and which should emerge not only as the Sixth Circuit position but the rule of law throughout all of the circuits. Let there be a rational limitation on recovery in the form of a contemporaneous trading requirement, and at the same time, let there continue the vitality of fundamental rule 10b-5 protection of the markets through the "disclose or abstain" rule. To do less can only amount to the rejection of a time-honored principle of federal securities regulation that securities markets shall be free and honest.