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# Securities Commentary

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# SECURITIES

## COMMENTARY

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For many years the United States Supreme Court neglected the federal securities laws and permitted the district and circuit courts to cultivate a large and complex field of litigation. This was especially so with respect to implied private actions. In the perception of one observer,

> [c]ivil liability has become a jungle as the lush growth of the "implied" actions—not only under rule 10b-5 but also under the proxy rules, the tender offer provisions of 1968, the Federal Reserve credit rules and section 36 of the Investment Company Act—has dwarfed, upstaged, outshone, and made wide end runs around, the express civil liability provisions.[1]

The role of the Second Circuit in this development was crucial; indeed the Circuit was on occasion referred to as the "Mother Court" in this area of the law.[2]

Starting in 1975, the Burger Court turned its attention to the federal securities laws and accepted certiorari in a number of significant cases in order to express its criticism of lower court interpretations and to give those courts guidance. Particularly with respect to implied damage claims, the Supreme Court articulated a limited scope for the role of the federal securities laws in the de-

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[1] Loss, *Introduction: The Federal Securities Code—Its Purpose, Plan and Progress*, 30 VAND. L. REV. 315, (1977).

[2] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 762 (1975) (Blackmun, J., dissenting).

velopment of general corporate law and a stricter approach to statutory construction than the circuit and district courts had been using.

This Commentary will analyze the response of the Second Circuit and some district courts in that circuit, during the 1976-77 term and subsequently, to the new federal securities law precedents established by the Supreme Court. This response is one phase of a dialogue that likely will continue and should prove instructive not only to securities lawyers but also to observers of the federal judicial process.

## OVERVIEW OF IMPLIED ACTIONS

Implied rights of action under the federal securities laws have been recognized at least since 1946 when Morris Kardon sued the National Gypsum Company.[3] That implied action was brought under section 10(b) of the Securities Exchange Act of 1934 (Exchange Act)[4] and rule 10b-5[5]—general antifraud provisions which, notwithstanding express statutory civil remedies,[6] have become the most widely used vehicles under the securities laws for private plaintiffs. For the next thirty years implied actions expanded in scope and number as a result of broad judicial interpretations of the securities laws. This expansive development, contributed to in large measure by the Second Circuit, substantially increased the class of private plaintiffs entitled to recover in securities-related transactions and increased the class of defendants exposed to liability. Also, limits on the extent of liability became uncertain as the formulation of damages awarded became more complex.

It was not, however, until 1964 that the Supreme Court actually confirmed that a private right of action exists under the federal securities laws by recognizing an implied action under Section 14(a) of the Exchange Act[7] for a false and misleading proxy statement.[8] The Supreme Court rationalized that since section 14(a) was principally intended to protect investors, the availability of judicial relief

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[3] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) (suit for fraudulent inducement to sell stock in two corporations for less than true value).

[4] 15 U.S.C. § 78j(b) (1976).

[5] 17 C.F.R. § 240.10b-5 (1977).

[6] Civil remedies are expressly provided, for example, in §§ 11, 12, and 15 of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77*l*, 77o (1976), and in §§ 9, 16, 18, and 20 of the Exchange Act, *id.* §§ 78i, 78p, 78r, 78t.

[7] 15 U.S.C. § 78n(a) (1976).

[8] J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

must be implied to achieve that result.[9] Private enforcement of the proxy rules, the Court said, is necessary to supplement the activities of the Securities and Exchange Commission (SEC) and to further the congressional purpose of protecting investors from fraudulent proxy material.[10] It was not until 1971 that the Supreme Court confirmed, with virtually no discussion, that a private right of action exists under section 10(b) and particularly rule 10b-5.[11]

From 1946 until 1975 the Supreme Court accepted few securities cases. To the extent that it commented upon the expansion of defendants' liability and the enhancement of private remedies in the lower courts, the Court merely confirmed certain of these developments with sweeping opinions that afforded the private plaintiff considerable rights and remedies under the securities laws—especially under rule 10b-5.[12]

Within the last three years, however, the Court's blessings of yesterday have been replaced by an aversion to broad classes of plaintiffs, to vexatious litigation, and to diluted principles of causation. Decisions by the current Supreme Court have had the effect of halting the expansive development of private plaintiffs' remedies and limiting the extent of liability imposed upon defendants. Two of these recent decisions were reversals of the Second Circuit,[13] a court which over the years has been a highly regarded interpreter of the federal securities laws and a contributor to the expansive development of implied actions. The Second Circuit's response to these reversals cannot be fully understood except in its historical context.

## EXPANSION OF LIABILITY

Lower courts originally took the position with respect to rule 10b-5 actions that common law elements of fraud or deceit applied.[14] As time went on, there occurred a general dilution of the common law elements and a broader reading of the "purchase or sale"[15] and the "in connection with"[16] elements of the rule.

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[9] *Id.* at 432.

[10] *Id.*

[11] Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

[12] *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

[13] Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977).

[14] *See, e.g.*, Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

[15] *See, e.g.*, Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir.

This dilution of the rule's elements expanded the class of plaintiffs who could recover under it and at the same time expanded the class of defendants exposed to liability. Some courts imposed liability under rule 10b-5 for negligent as well as deliberate misrepresentations.[17] Others held that a mere failure to disclose would suffice for recovery and that, where a failure to disclose was the primary wrongdoing, positive proof of reliance was not a prerequisite to recovery.[18] The rule broadened further as it became a general prohibition against trading on inside information in many anonymous open-market transactions as well as face-to-face dealings.[19] The Supreme Court itself expanded rule 10b-5 liability further by holding that while fraud must be in connection with a purchase or sale, it need not relate to all of the terms of the transaction.[20] Even where all the directors of a corporation had full knowledge of a transaction and no shareholder authorization was required, minority shareholders were permitted to maintain a derivative action under rule 10b-5, based on an alleged failure to disclose material information to them.[21] And, two years ago, the Second Circuit further expanded rule 10b-5 liability to cover a "going private" transaction where there was full and fair disclosure; the only alleged misconduct was breach of fiduciary duty by con-

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1973), *cert. denied*, 416 U.S. 960 (1974) (shareholders of corporation purchasing car-leasing business with newly issued stock may sue under rule 10b-5, even though not purchasers or sellers of stock); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 907 (1967) (plaintiff forced to surrender stock in short-form merger is a seller for purposes of rule 10b-5); A.T. Brod v. Perlow, 375 F.2d 393 (2d Cir. 1967) (a broker is a permissible plaintiff under rule 10b-5, even though not an investor). *But see* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1951), *cert. denied*, 343 U.S. 956 (1952).

[16] *See, e.g.*, Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[17] *E.g.*, White v. Abrams, 495 F.2d 724 (9th Cir. 1974). *But see* Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

[18] *E.g.*, Affiliated Ute Citizens v. United States, 431 F.2d 1349 (10th Cir. 1970), *aff'd*, 406 U.S. 128 (1972); List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

[19] *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Cady Roberts & Co., 40 S.E.C. 907 (1961). Defendants were thus liable to unknown plaintiffs who purchased or sold in the open market during a certain period of time. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

[20] Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

[21] Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

trolling shareholders on the basis of an unfair price offered to the minority.[22]

Expansion of liability was not limited to ever-broader readings of rule 10b-5. Courts found implied actions, and engaged in broad interpretations, under other provisions of the securities laws, which also expanded plaintiffs' remedies and defendants' liabilities. Under section 6 of the Exchange Act,[23] for example, an implied action was recognized on behalf of a public investor against a registered stock exchange for failure to enforce its rules,[24] against a member firm for violation of an exchange's rules,[25] and against a listed company for violation of the exchange's rules incorporated in the listing agreement.[26] Under section 7 of the Exchange Act,[27] a private right of action has been held to exist for an investor/borrower against his broker/creditor for the latter's violations of the Federal Reserve Board's credit regulations.[28] And, in a case where the damages awarded were astronomical, the Second Circuit held that a tender offeror had a private action for damages under section 14(e) of the Exchange Act[29] against a competing tender offeror, the target company, and an investment banker for loss incurred as a result of false and misleading solicitations to the target company's shareholders.[30]

The expansive development of implied actions under the federal securities laws appeared to have no clear limitations. Only the extent of plaintiff's imagination seemed to present any barrier to making triable claims under the securities laws. The broad readings given by courts to the various provisions and rules, especially rule

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[22] Green v. Santa Fe Indus., Inc., 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977).

[23] 15 U.S.C.§ 78f (1976).

[24] Baird v. Franklin, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944).

[25] *See* Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

[26] *See* Van Gemert v. Boeing Co., 520 F.2d 1373 (2d Cir. 1975). All of these implied actions were found to exist based on registered stock exchange obligations under § 6 of the Exchange Act. 15 U.S.C. § 78f (1976). As a result of the Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 16, 89 Stat. 146, those same obligations are now under section 19(g) of the Exchange Act, 15 U.S.C. § 78s(g) (1976).

[27] 15 U.S.C. § 78g (1976).

[28] Pearlstein v. Scudder & German, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971). *See also* Pearlstein v. Scudder & German, 527 F.2d 1141 (2d Cir. 1975).

[29] 15 U.S.C. § 78n(e) (1976).

[30] Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1975), *cert. denied*, 414 U.S. 910 (1973).

10b-5, granted license to a large class of plaintiffs to seek unlimited recovery against a large number of defendants.

These developments also had other effects. Broad interpretations of the securities laws contributed to the substantial growth of federal influence over corporations. Areas normally left to state corporation law were now affected by the federal securities laws.

## UNLIMITED LIABILITY

In addition to the expansion of liability under the implied actions, the potential for unlimited damages caused concern as to where lines should be drawn.[31] Whereas consequential damages based on a rescissionary theory is suitable for face-to-face dealings, the measurement of damages in open-market transactions is indeed problematical and difficult to formulate.[32] Dean Ruder demonstrated that if the class action against Texas Gulf Sulphur had gone to trial and judgment instead of being settled, the theoretical liability would have been several hundred billion dollars.[33]

Nowhere was the magnitude of damages more of a burning issue—perhaps bearing on the question of liability itself—than in the *Chris-Craft Industries, Inc., v. Piper Aircraft Corp.*[34] litigation. Chris-Craft, an unsuccessful tender offeror, brought an action for damages caused by the fraudulent conduct of a competing tender offeror, the target company, and an investment banker. The alleged misconduct resulted in a denial of a fair opportunity for

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[31] *See* Mullaney, *Theories of Measuring Damages in Security Cases and the Effects of Damages on Liability*, 46 FORD. L. REV. 277 (1977); Reder, *Measuring Buyers' Damages in 10b-5 Cases*, 31 BUS. LAW. 1839 (1976).

[32] One commentator has noted that a broad application of the rescission measure of damages in open-market transactions where no privity exists would cause financial ruin to numerous defendants. Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371, 377 (1974).

[33] Ruder, *Texas Gulf Sulphur—the Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423 (1968). In Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir., *cert. denied*, 404 U.S. 1004 (1971), plaintiffs had sold in reliance on the first fraudulent press release. The court applied a measure of damages derived from the tort of conversion on the theory that plaintiffs had the opportunity to repurchase their stock within a reasonable time after learning the true facts.

In Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974), the Second Circuit showed some sensitivity to the potential burden of damages, stating that it was "not unmindful of the arguments pressed upon us by all defendants that the resulting judgment for damages may be very substantial in amount—in the words of defendants' counsel, a 'Draconian liability.'" *Id.* at 242.

[34] 384 F. Supp. 507 (S.D.N.Y. 1974), *aff'd in part and rev'd in part*, 516 F.2d 172 (2d Cir. 1975), *rev'd*, 430 U.S. 1 (1977).

Chris-Craft to compete for control. In rejecting the district court's damages formulation (awarding $2.40 per share), the Second Circuit substituted a rescission measure of damages—purchase price less a hypothetical sales price five months after the alleged misconduct—and set damages at about $37.00 per share. The fifteen-fold increase in damages, together with prejudgment interest, amounted to more than $36,000,000.[35] The Second Circuit's formulation of damages did not, however, take into account the extent to which a decline in the market value of Chris-Craft's shares may have been the result of factors having nothing to do with loss of interest or control, such as general market decline.[36]

Although the subsequent Supreme Court opinion in *Piper v. Chris-Craft Industries, Inc.*[37] did not directly address the Second Circuit's damages formulation (which was thoroughly briefed by all parties, including the SEC as amicus curiae[38]), the language of the opinion suggests that the magnitude of the potential damages very well may have had a bearing on the liability issue itself.[39]

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[35] Counsel for the defendants argued that, with interest, the damages awarded totalled almost five times the total price of the securities underwritten by the investment banker, more than 900 times the investment banker's $40,000 fee, and one half its net worth. The competing offeror, the target company, and the investment banker were found jointly and severally liable. Brief for Petitioner First Boston Corporation at 46-55, Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977).

[36] The magnitude of the damages award as formulated by the Second Circuit in *Chris-Craft* raised serious questions as to the limits of liability and whether—and, if so, to what extent—§ 28(a) of the Exchange Act, 15 U.S.C. § 78aa(a) (1976), applies to implied actions. Section 28(a) limits the financial liability for violation of any provision of the Exchange Act to "actual damages." In addition, questions were raised as to whether, in measuring the damages against a statutory underwriter (the investment banker), the court should disregard the damage limitations and causation principles prescribed in § 11(e) of the Securities Act, 15 U.S.C. § 77k(e) (1976). Section 11(e) expressly precludes damages in connection with misstatements in registration statements that represent other than depreciation in value of the security resulting from the violation of the Act. It also precludes damages based on a decline in the value of a security due to other causes, including general market decline.

[37] 430 U.S. 1 (1977).

[38] Brief for Petitioner First Boston Corporation at 46-55; Brief for Petitioners Howard Piper, Thomas F. Piper, and William T. Piper, Jr., at 46-50; Brief for the Securities and Exchange Commission as Amicus Curiae at 141-51.

[39] In this regard, the Supreme Court stated:

> [T]he prospect [is likely] that shareholders may be prejudiced . . . if there is a possibility of massive damages claims for what courts subsequently hold to be an actionable violation of § 14(e). Even a contestant who "wins the battle" for control may well wind up exposed to a costly "war" in a later and successful defense of its victory. Or at worst—on Christ-Craft's damages theory . . . the target corporation might be subject to a large substantive judgment, plus high costs of litigation.

Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 40 (1977).

An effort to deal with seemingly unlimited damage awards is manifested in certain provisions of the American Law Institute's proposed Federal Securities Code.[40] In codifying many of the court-established private causes of action,[41] the Code specifically sets a damage limitation with respect to liabilities in connection with open-market purchases and sales.[42] In addition, on the basis of the damages limitations provided, the Code would then establish machinery for prorating recovery among all persons entitled to it.[43]

## RECENT SUPREME COURT CASES

The thrust of the major securities law decisions of the last three years by the United States Supreme Court has been to contract and define liability and to put a halt to the expansive development of unlimited liability.[44]

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[40] ALI FED. SEC. CODE §§ 1702(d), (e), 1708, 1723 (Proposed Official Draft Mar. 15, 1978) [hereinafter cited as ALI CODE].

[41] *See id.* XVII.

[42] The damage limitation, found in each provision dealing with open-market transactions, is the greatest of the following: (a) $100,000, (b) 1% (to a maximum of $1,000,000) of gross income in the defendant's last fiscal year, or (c) the defendant's profit. No limitation would exist where the plaintiff proves knowledge of falsity, nor would it apply with respect to the registrant (to the extent that an offering statement covers a primary offering), or with respect to an underwriter. *Id.* §§ 1708(c)(2), 1710(d).

The rationale, in part, for the Code's damages limitation provisions is reflected in a dialogue between Professor Louis Loss (the Code's Reporter) and SEC Chairman Harold Williams at a recent Commission meeting to discuss the Code. In response to questions from Chairman Williams about prescribed limitations on damages, Professor Loss said:

> Besides it [the $100,000 damage limitation] is only a number. If it should be 200 or 250 let's change it. But there's got to be some limitation because otherwise we're just kidding ourselves. No court is going to give unlimited damages. They'll find some reason not to and they'll do it by torturing some other name like "scienter" or "intent" or something else. That's what courts are in business for, to avoid gross injustices one way or the other.

Transcript of Open Meeting of the Securities and Exchange Commission, "Meeting to Discuss a Proposed Federal Securities Code," at 94 (Nov. 22, 1977).

[43] ALI CODE, *supra* note 40, § 1711.

[44] *See generally* Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977); Note, *Judicial Retrenchment under Rule 10b-5: An End to the Rule as Law?*, 1976 DUKE L.J. 789. The Court's recent activism in the securities area has not been restricted to implied actions. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976) (material fact in rule 14a-9 action defined as one involving substantial likelihood that a reasonable shareholder, knowing the fact, would vote differently); Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232 (1976) (no § 16(b) liability where defendant not a 10% owner before purchase and sale); United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975) (rental interest evidenced by shares in a public cooperative housing project is not a security).

In *Cort v. Ash*,[45] which was not a securities case, the Supreme Court set forth its most comprehensive analysis of when a private right of action under a federal statute would properly be implied. The Court held that four factors would have to be considered: (1) whether the plaintiff is a member of a class for whose *"especial"* benefit Congress enacted the statute; (2) whether the legislative intent was to grant or deny a private remedy; (3) whether a private right is consistent with the legislative scheme of the statute;[46] and (4) whether a federal remedy, rather than a state remedy, is appropriate to the area of law in question.

The significance of this formulation in a securities case was seen in *Piper v. Chris-Craft Industries, Inc.*[47] There the Court, relying heavily on the analysis in *Cort*, reversed a Second Circuit decision and said that a tender offeror does not have standing to bring a private action for damages under section 14(e) of the Exchange Act against either a competing tender offeror, the target company, or an investment banker. The Court observed that implying a private remedy would not be necessary to effectuate Congress' purposes in enacting section 14(e). That provision was intended for the "especial" benefit of shareholders of target companies and not for those whom the statute was designed to regulate.[48] Since the Court found this and the other *Cort v. Ash* requirements lacking in *Piper*, it reversed the decision of the Second Circuit.[49]

In addition to not permitting certain new private actions, the Supreme Court has restricted existing ones. Implied actions under rule 10b-5 have been particularly curtailed by the Court's deci-

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[45] 422 U.S. 66 (1975). The issue in *Cort* was whether a private cause of action for damages against corporate directors was to be implied in favor of corporate stockholders under the Federal Election Campaign Act Amendments of 1974, 18 U.S.C. § 610 (1976).

[46] With respect to this requirement, the Court cited Securities Investor Protection Corp. v. Barbour, 421 U.S. 412, 421-23 (1975), wherein the Court denied a private action under the Securities Investor Protection Act, 15 U.S.C. §§ 78aaa-78eee (1976), because Congress did not intend to provide for a private remedy and because a private remedy would be inconsistent with the legislative scheme. 422 U.S. at 78.

[47] 430 U.S. 1 (1977).

[48] It should be noted that the Supreme Court, in what may be a cutting away from the *J.I. Case Co. v. Borak* rationale, stated in *Piper* that "institutional limitations alone" cannot justify the creation of a new cause of action not contemplated by Congress. 430 U.S. at 41. In *Borak*, besides noting Congress' intent in § 14 to protect investors from fraudulent proxy materials, the Court stressed that implied actions are a necessary supplement to SEC enforcement of the proxy rules.

[49] As noted above, *see* text accompanying notes 34-39 *supra*, the damages issue in *Piper* is a possible underlying reason contributing to the Court's not implying a private remedy.

sions in *Blue Chip Stamps v. Manor Drug Stores*[50] and *Ernst & Ernst v. Hochfelder*.[51] In *Blue Chip*, the Court adopted the Second Circuit's *Birnbaum* doctrine[52]—that private plaintiffs who are not purchasers or sellers of the securities in question have no cause of action under rule 10b-5. It overturned the Ninth Circuit's decision because it did not agree that the particular circumstances warranted an exception to the *Birnbaum* rule. Most important, however, *Blue Chip* reflected the current Supreme Court's attitude toward the development of unlimited plaintiffs' remedies under the securities laws. It expressed concern over the increased litigation that could result from a widely expanded class of plaintiffs under rule 10b-5. Without the purchaser-seller requirement, the Court foresaw a tide of unlimited vexatious litigation where causation would be all but impossible to prove. Thus, in *Blue Chip* the Court determined who is a proper plaintiff under rule 10b-5.

In *Ernst & Ernst v. Hochfelder*, on the other hand, the Court said who is a proper defendant under rule 10b-5. Interpreting section 10(b) to be addressed only to "deceptive" or "manipulative" conduct or contrivances, the Court declared that in order for a private plaintiff to recover against an aider and abettor under rule 10b-5, he must show that the defendant acted with intent to deceive or manipulate, *i.e.*, with scienter. This decision resolved a split in the federal circuits over the question whether merely negligent conduct would consititute a violation of rule 10b-5 in a private action for damages.[53] The effect of *Hochfelder* is to decrease substantially the number of prospective defendants in private actions for damages and to increase the evidentiary burden on private plaintiffs.

*Blue Chip* and *Hochfelder* have substantially rolled back the expansive development of plaintiffs' rights under the federal securities laws. They also indicate that the current Supreme Court looks with disfavor upon notions of unlimited liability and vexatious litigation under the securities statutes.

Recent evidence of this attitude can be found in *Santa Fe Industries, Inc. v. Green*,[54] a crucial reversal of a Second Circuit

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[50] 421 U.S. 723 (1975).

[51] 425 U.S. 185 (1976).

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

[53] *Compare* White v. Abrams, 495 F.2d 724 (9th Cir. 1974), *with* Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

[54] 430 U.S. 462 (1977).

opinion by Judge Medina. In *Santa Fe*, the majority shareholders effected a short-form merger to eliminate minority interests without any justifiable business purpose. The Supreme Court held that since there was full and fair disclosure and since defendants' conduct was neither deceptive nor manipulative, the mere breach of a fiduciary duty by the majority shareholders did not violate rule 10b-5. It said that a breach of a fiduciary duty which did not involve deception, misrepresentation, or nondisclosure would not violate rule 10b-5. Besides invoking the *Hochfelder* analysis of who is a proper defendant under rule 10b-5, the Court also stated that its decision was based on policy grounds. Finding a violation under these circumstances

> would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation. In addition to posing a "danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5," . . . this extension . . . would overlap and quite possibly interfere with state corporate law.[55]

The Court's *Santa Fe* opinion is a logical extension of its opinions in *Blue Chip* and *Hochfelder* and further restricts plaintiffs' rights under rule 10b-5. Again the Court's aversion to expanded classes of plaintiffs and vexatious litigation is evident. In addition, the Court especially noted that rule 10b-5 does not authorize the interdiction of corporate mismanagement appropriately left to state regulation. So-called "federal corporation law," to the extent that it is founded on rule 10b-5, would thus appear to have less of a future as a factor influencing corporate behavior.

Plaintiffs' remedies have been restricted by the Court not only in actions for damages but also in actions for injunctive relief. In *Rondeau v. Mosinee Paper Corp.*,[56] the plaintiff corporation brought an injunctive action, under section 13(d) of the Exchange Act,[57] against a shareholder who obtained more than five percent of the corporation's stock without making timely filings with either the SEC or the corporation. The Seventh Circuit had held that an injunction should issue even though the defendant shareholder's violation was incidental and corrective measures were taken. The Supreme Court reversed, holding that, even where a private right

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[55] *Id.* at 478-79 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975)).

[56] 422 U.S. 49 (1975).

[57] 15 U.S.C. § 78m(d) (1976).

of action may exist, the plaintiffs are not relieved of the burden of establishing irreparable harm as well as the other traditional prerequisites for equitable relief.

It is abundantly evident from these as well as other recent decisions,[58] that the Supreme Court's reaction to almost thirty years of expanding liability under the federal securities laws is to draw some limits. Those limits have been most clearly drawn with respect to implied private actions, particularly under rule 10b-5. The Court has curtailed and more precisely defined plaintiffs' rights and remedies as well as defendants' liabilities. In so doing, it has not hesitated to articulate strong policy grounds for limiting an expansion that perhaps had gone too far.

## THE SECOND CIRCUIT'S RESPONSE

The Second Circuit's response to these recent Supreme Court decisions[59] has been varied. On one hand the Second Circuit has applied the requirements of *Cort* and *Piper* and refused to expand implied actions under section 6 of the Exchange Act.[60] On the other hand, it has applied those same requirements and found new implied actions under section 17 of the Exchange Act[61] and under section 206 of the Investment Advisers Act of 1940.[62] *Santa Fe Industries, Inc. v. Green*, although specifically followed on occasion, has also been read narrowly, with painstaking effort to have prior decisions survive. Notwithstanding *Blue Chip's* strong policy grounds against unlimited liability and vexatious litigation, the Second Circuit has construed the purchaser-seller requirement as applying only to rule 10b-5 actions. As for defendants, it has interpreted the *Hochfelder* scienter requirement to be satisfied by mere reckless conduct when a fiduciary is involved. Moreover, with respect to important procedural questions, the Second Circuit appears to have given some latitude to the private plaintiff under certain circumstances. At first glance, the cases of the 1976-77 term indicate a mixed bag of responses to the Supreme Court's decisions.

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[58] *See* cases cited in note 45 *supra*.

[59] Two of the recent Supreme Court decisions reversed the Second Circuit. Santa Fe Indus., Inc., v. Green, 430 U.S. 462 (1977), *rev'g* 533 F.2d 1283 (2d Cir. 1976); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977), *rev'g* 516 F.2d 172 (2d Cir. 1975).

[60] Arneil v. Ramsey, 550 F.2d 774 (2d Cir. 1977); Lank v. New York Stock Exch., 548 F.2d 61 (2d Cir. 1977).

[61] Redington v. Touche Ross & Co., [Current] FED. SEC. L. REP. (CCH) ¶ 96,404 (2d Cir. Apr. 21, 1978).

[62] 15 U.S.C. § 80b-6 (1976). *See* Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 2253 (1978), *discussed* in text accompanying notes 88-99 *infra*.

A. *In the Wake of* Cort *and* Piper—Lank v. New York Stock Exchange *and* Redington v. Touche Ross & Co.

In *Lank v. New York Stock Exchange*,[63] the Second Circuit addressed the issue whether a stock exchange member has a private action under section 6 of the Exchange Act against the exchange for damages suffered as a result of the exchange's failure to force that member to comply with its rules. Lank, a receiver of a defunct brokerage firm, which was a former member of the New York Stock Exchange, sued the Exchange on behalf of the brokerage firm. He argued that if the Exchange had enforced its net capital rules and suspended the firm from membership at the appropriate time for noncompliance, the firm would still be solvent. Thus, the Exchange's inaction, he alleged, caused the firm's customers, shareholders, subordinated lenders, and creditors to suffer substantial losses.

Writing for a unanimous panel, Judge Medina cited precedent for a private right of action under section 6, on behalf of public investors against an exchange, for failure to enforce compliance with its rules by member firms.[64] In analyzing section 6 with the guidance of *Cort* and *Piper*, the Second Circuit found strong support for that precedent, because section 6, as well as the Exchange Act in general, was designed to protect public investors. It found, however, no indication that the section was intended for the "especial" benefit of exchange members, whose conduct the section was in fact designed to regulate. Thus, it held that no private action exists under section 6 on behalf of exchange members.

Even though the receiver's asserted claims were only those of the firm, the district court's decision to grant the action had considered the interests of the creditors also.[65] The district court reasoned that the receiver was suing to maximize the pool of corporate assets from which the creditors could be satisfied.[66] It relied on *New York Stock Exchange v. Sloan*,[67] which had expanded the class of "protected investors" under section 6 to include limited partners and subordinated lenders of member organizations.

In disallowing the private action, the Second Circuit noted

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[63] 548 F.2d 61 (2d Cir. 1977).

[64] *Id.* at 64 (citing Baird v. Franklin, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944)).

[65] Lank v. New York Stock Exch., 405 F. Supp. 1031, 1037 (S.D.N.Y. 1975), *rev'd*, 548 F.2d 61 (2d Cir. 1977).

[66] *Id.*

[67] 394 F. Supp. 1303 (S.D.N.Y. 1975).

that the receiver was only asserting the claims of the brokerage firm. It, nonetheless, went on to take issue with the reasoning of the *Sloan* decision by also noting that "[s]ince [a] member corporation may not sue the exchange, neither may its receiver or its creditors, for the latter cannot bring themselves within the protected class. . . . To allow the receiver to sue as representative of the corporation's creditors would be to allow the corporation itself to sue, for ultimately the recovery is the same."[68]

In a later decision, *Arneil v. Ramsey*,[69] the same Second Circuit panel that decided *Lank* made it clear that, in accord with *Cort*, investors in an exchange member, whether as limited partners, subordinated lenders, or purchasers of other than its publicly traded securities, have no claim under section 6 against an exchange for damages suffered as a result of the exchange's violation of that section. Only public investors were intended to be protected by that section.

The *Cort* requirements, however, have not been insurmountable for the Second Circuit in other actions involving a bankrupt brokerage firm. Most recently, in *Redington v. Touche Ross & Co.*,[70] it found that an implied private action exists under section 17(a) of the Exchange Act[71] on behalf of customers of a defunct broker-dealer against an accountant who allegedly failed to audit properly the financial condition of the firm, as reflected in reports filed with the SEC. Plaintiff sued on the basis of alleged misleading certifications by the accountant which hid the true financial condition of the broker-dealer and thus contributed to the firm's liquidation and plaintiff's losses.

In its *Cort* analysis, the Second Circuit first said that the function of the financial reporting requirements under section 17 is to protect brokers' customers by ensuring that the firm has sufficient net capital to meet financial demands. The customers of those broker-dealers, therefore, are "members of a class peculiarly protected by Section 17."[72] The section provides special protection, the court felt, because the failure of a broker-dealer to supply accu-

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[68] 548 F.2d at 67.

[69] 550 F.2d 774 (2d Cir. 1977).

[70] [Current] FED. SEC. L. REP. (CCH) ¶ 96,404 (2d Cir. Apr. 21, 1978). Three separate opinions were written in *Redington*. Judge Lumbard authored the opinion of the court; Judge Timbers wrote a concurring opinion; and Judge Mulligan wrote a dissent.

[71] 15 U.S.C. § 78g (1976).

[72] [Current] FED. SEC. L. REP. (CCH) ¶ 96,404, at 93,433. At one point, brokers' customers are described as "favored wards of Section 17." *Id.* at 93,435.

rate reports would leave customers without safeguards against a firm's insolvency. Although it found no legislative history supporting or denying a private action under the section, the court thought a private action would be consistent with the Exchange Act's purpose—the protection of investors. Furthermore, it thought that because the SEC does not have the resources to examine and audit all of the documents it receives and because an accountant's certificate is substantially relied on, a private action would effectuate the purposes of section 17. A federal remedy is contemplated because "just as the problems caused by insolvent brokers are national in scope, so must be the standards governing their reporting."[73]

The Second Circuit rejected the district court's finding that section 18 of the Exchange Act,[74] with its purchaser-seller requirement, was the exclusive private remedy for misleading statements filed with the SEC. It said that section 18 would not be a remedy for customers of brokers who suffer loss as a result of an accountant's misleading statements, absent the purchase or sale of an affected security. Because section 17 was meant especially to protect customers, an appropriate remedy—a private action—had to be available. If section 18 does not make it available, then section 17 must.[75]

In permitting the Securities Investor Protection Corporation (SIPC) and the trustee of the defunct broker-dealer to maintain the implied actions, the Second Circuit distinguished *Lank*. It said that they were suing not on behalf of the broker-dealer but, rather, on behalf of the customers. Because SIPC had already compensated, up to a certain amount, the customers of the firm, it was subrogated to those customers' claims against third parties, such as accountants. The trustee, acting as bailee of the broker's property for the bailor customers, was allowed to sue on behalf of customers not fully reimbursed by SIPC.[76] Thus SIPC and the trustee were

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[73] *Id.*

[74] 15 U.S.C. § 78r (1976).

[75] In his dissent, [Current] FED. SEC. L. REP. (CCH) ¶ 96,404, at 93,438, Judge Mulligan thought that the majority misread the legislative history of §§ 17 and 18, 15 U.S.C. §§ 78q, 78r (1976). Section 18, he felt, was intended to be the exclusive private remedy if improper statements are filed with the SEC pursuant to § 17 or other provisions of the Exchange Act. Beyond that, however, Judge Mulligan thought that even *Cort* would not support a private action under § 17. The primary intent was to prevent insolvency of brokers, not to create lawsuits for damages after insolvency has occurred. In addition, a private action was not necessary to effectuate the purposes of the section.

[76] Judge Mulligan, in dissent, argued that SIPC is subrogated by statute only to

proper plaintiffs to bring the newly found private action under section 17.

The district courts in the Second Circuit have also been active in response to *Cort* and *Piper*. In *Gluck v. Frankel*,[77] for example, the district court was asked whether a private right of action under section 7 of the Exchange Act[78] exists in favor of a *creditor* corporation. The Second Circuit in earlier decisions had specifically found a private cause of action under section 7 on behalf of a *borrower*.[79] Noting that the validity of those earlier decisions had been put in doubt by amendment of section 7[80] and by *Cort*, the district court found that corporate creditors or margin lenders were never intended to be part of the class for whose "especial" benefit section 7 was created.[81] No private action was permitted.

The validity of a borrower's private action under section 7, in light of *Cort* and *Piper*, was addressed in *Schy v. Federal Deposit Insurance Corp.*[82] The district court said that no private action for borrowers exists under section 7 for a corporation which was extended credit unlawfully to finance a tender offer and that the effect of *Cort* was to overturn prior Second Circuit decisions finding such an implied action.[83] Because the credit provisions primarily had "macro-economic objectives" and were not enacted for the "especial" benefit of borrowers, no private action could be implied.[84]

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claims against the debtor's estate, not to those against third parties, and that labelling the trustee a bailee for the customers was a fiction inconsistent with *Lank*. The trustee, he felt, was in fact suing as trustee of the broker-dealer. [Current] FED. SEC. L. REP. (CCH) ¶ 96,404, at 93,444.

The Second Circuit opinion nowhere refers or cites to the Bankruptcy Act, 11 U.S.C. §§ 1-1255 (1976), as having any bearing on how to characterize the claims of SIPC and the trustee or to resolve questions as to their standing. *See* Chaplin v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972).

[77] 440 F. Supp. 1143 (S.D.N.Y. 1977).

[78] 15 U.S.C. § 78g (1976).

[79] Pearlstein v. Scudder & German, 527 F.2d 1141 (2d Cir. 1975); Pearlstein v. Scudder & German, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971).

[80] Section 7 of the Exchange Act was amended in 1970 by the addition of subsection (f). Act of Oct. 26, 1970, Pub. L. No. 91-508, § 301(a), 84 Stat. 1124 (amending 15 U.S.C. § 78g (1970)).

[81] 440 F. Supp. at 1145-46.

[82] [1977] FED. SEC. L. REP. (CCH) ¶ 96,242 (E.D.N.Y. Oct. 27, 1977, amended Nov. 7, 1977), *appeal pending*, No. 77-7581 (2d Cir.).

[83] *Id.* at 92,631.

[84] *Accord*, Nussbacher v. Chase Manhattan Bank, 444 F. Supp. 973 (S.D.N.Y. 1977); Theoharous v. Bache & Co., Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,281 (D. Conn., Sept. 7, 1977); Drasner v. Thomson McKinnon Sec., Inc., 433 F. Supp. 485 (S.D.N.Y. 1977). *But see* Palmer v. Thomson & McKinnon

Although the Supreme Court in *Piper* stated that no private action for damages exists under section 14(e) on behalf of a competing tender offeror, it specifically left open the question whether a private action could exist for *injunctive* relief.[85] Recently a district court said, in *Humana, Inc. v. American Medicorp, Inc.*,[86] that such a private action does exist under section 14(e). It rationalized that injunctive relief may be very beneficial to solicited shareholders (the intended beneficiaries of section 14(e)'s protections) who are in need of accurate information about the competing parties at a crucial time. Also an injunction can be "closely tailored" to the needs of the occasion and can take into account the interests of a tender offeror who is probably most interested in effective enforcement. In *Piper* the Supreme Court suggested that the question of what relief is requested may be important.[87] It seems certain that the Second Circuit will soon have to address this issue, as well as the broader question of whether and under what circumstances the existence of a private action depends upon the relief requested.

### B. *Satisfying* Cort *and* Piper *and Limiting* Blue Chip—Abrahamson v. Fleschner

The most significant case of the 1976-77 term in which the Second Circuit found an implied action was *Abrahamson v. Fleschner*.[88] Plaintiffs were limited partners in an investment partnership and did not participate in managing the partnership portfolio. Defendants were the general partners who managed the portfolio and sent monthly reports to the limited partners. The defendants misrepresented the investment policies of the partnership and failed to disclose the firm's sizable investments in unregistered securities. The partnership incurred substantial losses on these unregistered securities. Plaintiffs sued to recover their losses suffered between the time of the first misrepresentations and omissions and

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Auchincloss, Inc., 427 F. Supp. 915 (D. Conn. 1977). District courts have also held other sections not to allow private actions. Lewis v. Elam, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,013 (S.D.N.Y. April 5, 1977) (§ 13(a) of the Exchange Act); DeWitt v. American Stock Transfer Co., 433 F. Supp. 994 (S.D.N.Y.) (same), *modified*, 440 F. Supp. 1084 (S.D.N.Y. 1977); Koch v. Moseley, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,283 (E.D.N.Y. Dec. 19, 1977) (§ 17(a) of the Securities Act).

[85] 430 U.S. 1, 47 n.33 (1977).

[86] 445 F. Supp. 613 (S.D.N.Y. 1977).

[87] *See* 430 U.S. at 47 n.33.

[88] 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 2253 (1978).

the time when they withdrew from the partnership. They argued that had they known of defendants' fraudulent conduct, they would have withdrawn immediately. They, therefore, claimed damages for the total loss in value of their investments during that time. The action was brought under section 10(b) and rule 10b-5 of the Exchange Act and under section 206[89] and rule 206(4)-1[90] of the Investment Advisers Act of 1940 (Advisers Act).

The Second Circuit, in an opinion written by Judge Timbers,[91] quickly dismissed the rule 10b-5 claim because it did not satisfy the dictates of *Blue Chip*. That is, the requirement of fraud in connection with the purchase or sale of a security is not satisfied by an allegation that plaintiffs were fraudulently induced *not* to sell their securities. The court next focused on the Advisers Act claim. In a significant finding, it concluded that the general partners received substantial compensation for advising others (the limited partners) as to their investments, and thus they fell within the Act's definition of "investment adviser."[92]

The Second Circuit then turned to the question whether a private action for damages exists under section 206 on behalf of the limited partners against the general partners/investment advisers. *Cort* was closely analyzed. The court first found that the Advisers Act as a whole was designed for the "especial" benefit of persons who rely upon their investment advisers for advice. Second, the legislative history of section 206, although mute on the question, did not indicate any congressional intent that there should not be a private action. Third, although the jurisdictional provision of the Advisers Act, section 214,[93] does not provide for "actions at law"—as is done in section 22 of the Securities Act[94] and section 27 of the Exchange Act[95]—the court thought that this absence of language only reflects the fact that the Advisers Act, unlike the Securities Act and the Exchange Act, has no express civil liability provisions. It felt that a private action under section 206 was consistent with the legislative scheme.[96] Moreover, it thought that in

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[89] 15 U.S.C. § 80b-6 (1976).

[90] 17 C.F.R. § 275.206(4)-1 (1977).

[91] Judges Gurfein and Mansfield completed the panel. Judge Gurfein concurred in part and dissented in part.

[92] 15 U.S.C. § 80b-2(a)(11) (1976).

[93] *Id.* § 80b-14.

[94] *Id.* § 77r.

[95] *Id.* § 78aa.

[96] Judge Gurfein, in dissent, took particular issue with the majority here. He felt that the fact that § 214 does not have the "action at law" language provided a clear

view of the SEC's inadequate resources to police the securities laws alone, a failure to recognize a private action would frustrate effectuation of the Act's purposes. Finally, the court found a clear congressional intent that the area was to be subject to federal regulation. Thus, the Second Circuit said that the *Cort* requirements were satisfied and concluded that a private action does exist under section 206.

Whether the limited partners were proper plaintiffs to bring the private action was the next question. The Second Circuit considered whether the *Blue Chip* purchaser-seller requirement should apply even though neither section 206 nor rule 206(4)-1 contains such language. Plaintiffs argued that they were fraudulently induced into *not* selling their interests in the partnership. In *Blue Chip* this was exactly the type of situation that the Supreme Court thought could very likely lead to vexatious litigation, to a greatly increased class of plaintiffs, and to substantial evidentiary burdens as to what was on someone's mind when he did not purchase or sell. The Second Circuit, nonetheless and in spite of a strong dissent by Judge Gurfein, gave short shrift to this policy argument. It said that because the purchaser-seller language does not appear in section 206 and because *Blue Chip* was a rule 10b-5 case, the purchaser-seller limitation has no application in this context.[97] The limited uncertainties this may cause would be adequately offset by requiring proof that the misrepresentations were material and that plaintiff actually relied on them. Thus, the limited partners were proper plaintiffs.

With respect to damages,[98] the court did not agree that plain-

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indication that Congress did not intend, and that the legislative scheme does not contemplate, actions at law under the Advisers Act. 568 F.2d at 880-84 (dissenting opinion).

[97] Judge Gurfein, in his dissent, emphasized the broad concerns of *Blue Chip*:

> I am not sure that *Blue Chip* is so limited in its application. I think that the underlying concern in *Blue Chip*, though standing was involved, was not the lack of a technical "purchase or sale," which ingenuity might have supplied, . . . but, perhaps, the sheer inability to disprove what a plaintiff says he *would have* done if he had but known the truth. This problem is as acute in suing investment advisers as in suing offerors, perhaps even more acute in the former situation. There is a distinct danger that, by implying an open-ended private right of action, the court is giving the clients of investment advisers *carte blanche* to convert themselves from victims to defrauders.

*Id.* at 884 (emphasis in original) (citation omitted).

[98] *Id.* at 878-79. The plaintiffs had been limited partners for some time and when they actually withdrew, enjoyed net profits from their investment. The court still concluded that damages were available.

tiffs were entitled to the total loss in value of the investment between the beginning of the fraudulent conduct and when they withdrew. Instead, the Second Circuit formulated a measure of damages which would take into account only those losses attributable to the misrepresentations and omissions regarding investment policy, particularly with respect to the unregistered securities. General market decline and other unrelated decreases in value would not be recoverable. This formulation of the damages measurement appears to be a straightforward effort by the Second Circuit to calculate the loss actually caused by the defendant's conduct with precision. In that regard, it represents a stronger effort than the court's *Chris-Craft* formulation, which resulted in an enormous damages award, including market decline.[99]

### C. *Digesting* Santa Fe—Goldberg v. Meridor *and* Cole v. Schenley Industries, Inc.

The Second Circuit's response to *Santa Fe Industries, Inc.* v. *Green*[100] has been interesting because of the seemingly different attitudes of different panels. In one case the panel engaged in fine line-drawing to distinguish between conduct that only breaches fiduciary duties and conduct that violates the federal securities laws. In other cases, however, the panels have followed the dictates of *Santa Fe* fully and made it clear that mere breaches of fiduciary duty are best left for state law. The Second Circuit's most notable cases dealing with *Santa Fe* in the 1976-77 term were *Goldberg. v. Meridor*[101] and *Cole v. Schenley Industries, Inc.*[102]

In *Cole v. Schenley Industries, Inc.*, the circuit court affirmed a dismissal of a consolidated complaint brought by minority shareholders challenging the merger of the Schenley Corporation, a subsidiary of another corporation, with a wholly owned subsidiary of the same parent corporation. The complaint charged violations of sections 10(b) and 14(a) of the Exchange Act[103] and alleged (1) false and misleading proxy statements in that Schenley's cash holdings were misrepresented; (2) unfairness to minority shareholders based

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[99] Chris-Craft Indus., Inc. v. Piper Aircraft Co., 516 F.2d 172 (2d Cir. 1975), *rev'd*, 430 U.S. 1 (1977).

[100] 430 U.S. 462 (1977).

[101] 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 1249 (1978). The *Goldberg* panel comprised Judges Friendly, Timbers, and Meskill.

[102] 563 F.2d 35 (2d Cir. 1977). Circuit Judges Smith and Oakes and District Judge Carter sat on the *Schenley* bench.

[103] 15 U.S.C. §§ 78j(b), 78n(a) (1976).

on the merger's terms; and (3) breaches of fiduciary duty by the parent corporation and Schenley's directors.

The panel first concluded that the proxy statements adequately disclosed the amount of Schenley's liquid assets as well as other information and therefore affirmed the dismissal of the section 14(a) allegation.[104] In dealing with the minority shareholders' claim that defendants violated section 10(b) by consummating an unfair merger, the Second Circuit cited *Santa Fe*. It concluded that, without a finding of material misrepresentation or failure to disclose material facts, plaintiffs' claim failed to give them a private action under section 10(b). Absent that type of conduct, the kind of deception or manipulation covered by section 10(b) was not present. The court went on to say:

> Corporate conduct such as is involved in mergers, tender offers, and liquidations and abuses related to such conduct, has traditionally been left to state regulation. We agree that "there may well be a need for uniform federal fiduciary standards to govern mergers," but those standards will have to be supplied by legislation rather than through judicial extensions of § 10(b) and Rule 10b-5.[105]

Thus, the Second Circuit, in *Cole*, followed the Supreme Court's direction in *Santa Fe* to the letter. The court's analysis and rationale were taken directly from the Supreme Court's opinion in *Santa Fe*. Although *Cole* appears to be a whole-hearted acceptance of the Supreme Court's opinion,[106] that appearance of whole-hearted acceptance was to some extent put in doubt by *Goldberg v. Meridor*.

*Goldberg* is perhaps the Second Circuit's most telling response of the 1976-77 term to *Santa Fe*. In a derivative action, the minority shareholders of a subsidiary sued a parent corporation, among others, for violations of rule 10b-5. They alleged that defendants had engaged in a fraudulent and unfair transfer of the subsidiary's

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[104] In Browning Debenture Holders' Comm. v. DASA Corp., 560 F.2d 1078 (2d Cir. 1977), the Second Circuit applied *Santa Fe* to alleged breaches of fiduciary duties which plaintiffs argued violated § 14(a). Citing *Santa Fe*, the court held that violations of fiduciary duties (*i.e.*, nondisclosure of conflicts of interest or unfairness of conversion price) will not be a constructive fraud in violation of § 14(a).

[105] 563 F.2d at 44 (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479-80 (1977)).

[106] The Second Circuit's opinion in Browning Debenture Holders' Comm. v. DASA Corp., 560 F.2d 1078 (2d Cir. 1977), also appears to subscribe fully to the dictates of *Santa Fe* with respect to § 14(a) of the Exchange Act, 15 U.S.C. § 78n(a) (1976). *See* note 104 *supra*.

stock in return for the grossly over-valued assets and under-valued liabilities of the parent. Plaintiffs further charged that the defendants had engaged in deceptive conduct to raid the assets of the subsidiary and thereafter to ensure its doom. All the directors of the subsidiary had knowledge of and agreed to the transaction. Plaintiffs argued that failure to disclose the fraudulent nature of the transaction to the minority shareholders and the issuance of two misleading press releases about the financial condition of the parent constituted violations of rule 10b-5 as well as breaches of fiduciary duty.

All of the subsidiary's directors had approved and had knowledge of the transaction, and shareholder approval of the transfer was unnecessary. Inadequate consideration and improper purpose seemed the crux of the alleged misconduct. Therefore, the *Goldberg* panel[107] was squarely faced with the question of to what extent the Second Circuit's 1968 opinion in *Schoenbaum v. Firstbrook*[108] survived *Sante Fe*. In *Schoenbaum*, the court, sitting en banc, had held that even though all the directors had full knowledge of a transaction, a rule 10b-5 action is nonetheless permissible on behalf of minority shareholders in a derivative action based on the controlling party's failure to disclose important information to them, even though no shareholder vote was required, and based on the controlling party's acquisition of the company's stock for inadequate consideration.[109] Because the alleged misconduct in *Schoenbaum* for the most part looked like a mere breach of fiduciary duty by all the directors, *Santa Fe* cast a shadow on that opinion and thus on plaintiffs' case in *Goldberg*.

The *Goldberg* court first noted that the existence of a "controlling interest" or "wholly inadequate consideration" (both present, among other things, in *Schoenbaum*) cannot alone, in light of *Santa Fe*, form the basis of liability under rule 10b-5. However, *Schoenbaum*, the panel said, involved deception of the corporation, which could form the basis of liability under rule 10b-5. Second, with respect to disclosure, the court said *Schoenbaum* rests on the ground that deception of the corporation occurs when there is nondisclosure or misleading disclosure to the minority shareholders.

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[107] Judge Friendly authored the panel opinion; Judge Meskill concurred in part and dissented in part.

[108] 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

[109] The Supreme Court in *Santa Fe* cited *Shoenbaum* approvingly, as a case involving an allegation of "deception," without analyzing the exact nature of the deception. 430 U.S. 462, 475 n.15 (1977).

When a corporation is influenced by its controlling shareholders to engage in a transaction adverse to the interests of the minority, nondisclosure or misleading disclosure to those shareholders constitutes deception of the corporation. This is so even if all directors approved the transaction and no shareholder vote was required. Thus, in a significant interpretation of *Santa Fe*, the Second Circuit, in *Goldberg*, said that *Santa Fe* could be read to allow rule 10b-5 actions based on the type of deception complained of in *Schoenbaum*. Accordingly, *Schoenbaum* survives.[110]

The Second Circuit was mindful of the Supreme Court's concerns in *Santa Fe* about the difficulty of drawing lines between various kinds of fiduciary duties involving securities transactions. The *Goldberg* court interpreted those concerns to mean that there must be something more than internal corporate mismanagement as a basis for rule 10b-5 liability, *i.e.*, a failure to disclose or a misrepresentation of material information. But, in the court's view, full disclosure to all the directors is insufficient when they allegedly are involved in the scheme. Even though a shareholder vote is not required, disclosure to minority shareholders is important because it affords them an opportunity to pursue other action to prohibit the transaction.[111]

The substance of the parent's alleged misconduct in *Goldberg* was its failure to disclose its poor financial condition and its is-

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[110] Judge Meskill, in dissent, criticized the majority's heavy reliance on *Schoenbaum* because in that case materiality was not addressed and because breach of fiduciary duty (the issuance of stock for inadequate consideration) was held actionable under rule 10b-5. Although he agreed that a corporation could be deceived by all of its directors acting together, Judge Meskill thought the *Schoenbaum* holding concerning deception under rule 10b-5 had been overruled by the Supreme Court in *Santa Fe*. 567 F.2d at 222 n.4.

[111] *Id.* at 218-20. In his dissent, Judge Meskill took particular issue with the majority concerning the impact of *Santa Fe*. After failing to find that any of the alleged nondisclosures or misrepresentations concerning value were material, he criticized the majority for finding "deception" by the controlling interests because they failed to disclose their purposes in effecting the transaction:

> The apparent theory is that those about to loot a corporation can be shamed into honesty through a requirement that they reveal their nefarious purposes
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> . . . .
>
> Those who breach their fiduciary duties seldom disclose their intentions ahead of time. Yet under the majority's reasoning the failure to inform stockholders of a proposed defalcation gives rise to a cause of action under 10b-5. Thus, the majority has neatly undone the holdings of *Green*, *Piper* and *Cort* by creating a federal cause of action for a breach of fiduciary duty that will apply in all cases, save for those rare instances where the fiduciary denounces himself in advance.

*Id.* at 225.

suance of misleading statements indicating a sound economic future for the subsidiary after the transaction. Because the misconduct, in essence, appeared to be failure to disclose the inadequacy of consideration,[112] together with the intent to "loot" the subsidiary's assets, *Goldberg*, like *Schoenbaum*, dealt with conduct resembling mere breach of fiduciary duties. Judge Friendly, writing for a divided panel, nonetheless found that the corporation (*i.e.*, the minority shareholders) was deceived, both by the alleged nondisclosures and by misrepresentations concerning the transaction. Therefore, at least for now, *Schoenbaum* in large measure survives *Santa Fe*, and *Goldberg* permits a rule 10b-5 action against a parent corporation based on conduct that resembles a mere breach of fiduciary duty. Such characterization of conduct as deceptive, however, may not be quite as easy to make in future cases involving breach of fiduciary duty.[113] The survival of *Schoenbaum* may indeed require some fine lines to be drawn between mere breaches of fiduciary duty and conduct in violation of rule 10b-5.[114] On the basis of *Goldberg*, it appears that the Second Circuit (or at least one panel) is willing to draw those fine lines and, in doing so, perhaps to draw some boundaries around *Santa Fe*.

### D. *Recklessness by a Fiduciary Satisfies* Hochfelder—Rolf v. Blyth, Eastman Dillon & Co., Inc.

In *Rolf v. Blyth, Eastman Dillon & Co., Inc.*[115] the Second Circuit addressed questions about a registered representative's obligation to an investment adviser's clients and about aider and abettor liability for a fiduciary under rule 10b-5. A long-time customer of a brokerage firm decided to employ an independent adviser to manage his account. The customer, however, left the account and its accompanying trading commissions with the brokerage firm in return for a registered representative's general supervision of the

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[112] Financial information about the parent was, it seems, publicly available. *See id.* at 222 n.2.

[113] A recent case appears to approach the limits laid down in *Santa Fe*. Stratton Group, Ltd. v. Sprayregen, [Current] FED. SEC. L. REP. (CCH) ¶ 96,302 (S.D.N.Y. Jan. 24, 1978).

[114] It should be noted that some recent Delaware cases (apparently also responding to *Santa Fe*) have emphasized high standards of fiduciary obligation under that state's corporation law. Tanzer v. IGI, Inc., 379 A.2d 1121 (Del. 1977); Singer v. Magnovox Co., 367 A.2d 1349 (Del. 1976).

[115] 570 F.2d 38 (2d Cir. 1978).

account. The investment adviser, acting through the representative, executed a series of transactions unsuited to the customer. The adviser was found to have defrauded the customer in violation of section 10(b), thereby causing substantial losses in the account. During the course of the adviser's misconduct, the representative failed generally to ensure the suitability of the transactions yet all the while gave assurances of suitability to the customer. The customer sued both the representative—for, among other things, aiding and abetting the adviser's rule 10b-5 violation—and the brokerage firm for failing adequately to supervise the adviser.[116]

The Second Circuit, in an opinion by Judge Oakes,[117] said that the representative was not simply an "order taker"; in view of the circumstances under which the account remained at the brokerage firm, the investor was the customer not only of the investment adviser but also of the registered representative, who owed that customer a fiduciary duty with respect to his account. The representative's failure to supervise the account, although he was aware of the adviser's activities, added to his unknowing assurances to the investor, constituted reckless conduct with respect to the account. The court therefore determined that under these circumstances the representative was a fiduciary, and that his recklessness satisfied the scienter requirement of *Hochfelder*.[118] It concluded that the representative rendered substantial assistance to

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[116] Because rule 10b-5 liability was sustained by the Second Circuit, it saw no need to address, and did not, the question whether an implied right of action on behalf of a customer of a brokerage firm exists under New York Stock Exchange Rule 405 or under article III, § 2, of the National Association of Securities Dealers' Constitution. It characterized those questions as "thorny" issues whose resolution can be avoided for now. 570 F.2d at 48 n.19.

[117] The opinion represented the view of Judge Smith as well. Judge Mansfield dissented.

[118] *See* text accompanying note 53 *supra*. The court subsequently amended its opinion in *Rolf* to clarify that its holding with respect to the liability of the registered representative was based on the particular facts of the case and that the opinion did not impose new fiduciary obligations generally on brokers who execute trades for customers of investment advisers:

> This decision does not impose liability on a broker-dealer who merely executes orders for "unsuitable" securities made by an investment adviser vested with sole discretionary authority to control the account. In the present case, the broker-dealer, although charged with supervisory authority over the adviser and aware that the adviser was purchasing "junk," actively lulled the investor by expressing confidence in the adviser without bothering to investigate whether these assurances were well-founded.

Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978), *amended*, May 22, 1978.

the adviser and thus was liable under rule 10b-5 as an aider and abettor of the adviser's violations.[119]

In holding that the representative was liable, the Second Circuit referred to its 1973 decision in *Lanza v. Drexel & Co.*,[120] which laid down a test of "willful or *reckless* disregard for the truth"[121] as a predicate for the mental state required under rule 10b-5. It said, "[W]e consider that *Hochfelder* left intact our rule [in *Lanza*] that recklessness is a form of scienter in appropriate circumstances."[122] On the basis of *Rolf*, it appears that the Second Circuit construes *Hochfelder* as having little if any impact on its position, as enunciated in *Lanza*, concerning the mental state required under rule 10b-5 in private actions.[123]

With respect to damages, the *Rolf* court formulated a measurement different from the district court's, which would result in substantially greater recovery for the plaintiff. The district court essentially gave the plaintiff churning damages, *i.e.*, commission costs, amounting to about $56,000.[124] The Second Circuit disagreed with that formulation. It computed the damages by taking the plaintiff's gross economic loss during the time of the fraudulent conduct (approximately $712,000) and subtracting market decline during that period as reflected in a leading index.

### E. Exploring New Procedural Latitudes for Private Plaintiffs—Shore v. Parklane Hosiery Co. *and* Lasker v. Burks

Other Second Circuit cases of the 1976-77 term dealt less directly with plaintiffs' remedies than the aforementioned cases, but in the long run their impact may be as, if not more, significant. In *Shore v. Parklane Hosiery Co.*[125] and in *Lasker v. Burks*,[126] the

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[119] 570 F.2d at 48. On the basis of the court's holding concerning the registered representative, the brokerage firm admitted controlling person liability under § 20 of the Exchange Act, 15 U.S.C. § 78t (1976).

[120] 479 F.2d 1277 (2d Cir. 1973) (en banc).

[121] *Id.* at 1306 (emphasis in original).

[122] 570 F.2d at 46.

[123] Judge Mansfield, in dissent, characterized the defendant's conduct differently. He said that the registered representative was being held liable as an aider and abettor under rule 10b-5 for nothing more than negligence in failing to make an adequate inquiry into investments recommended by the investment advisor. By so deciding, "the majority has ended up with a holding that is virtually indistinguishable from that reversed in *Hochfelder*." *Id.* at 52.

[124] Rolf v. Blyth, Eastman Dillon & Co., 424 F. Supp. 1021, 1045 (S.D.N.Y. 1977), *aff'd in part*, 570 F.2d 38 (2d Cir. 1978).

[125] 565 F.2d 815 (2d Cir. 1977), *cert. granted*, 98 S. Ct. 1875 (1978).

[126] 567 F.2d 1208 (2d Cir. 1978), *petition for cert. filed*, 46 U.S.L.W. 3766 (U.S. June 2, 1978) (No. 77-1724).

court appeared to carve new procedural rights which very well may enhance the bringing of private actions.

In *Shore*, the court held that the defendants, who had certain factual issues determined against them in a prior nonjury trial brought by the SEC for an injunction, were collaterally estopped from relitigating the same issues in a subsequent private action for damages. Defendants' seventh amendment rights to a jury trial are not violated, the court said, when they already have had a full and fair nonjury trial of the same issues by a court sitting in equity.[127] Of course, in accordance with collateral estoppel principles, the issues must in fact be the same and defendants must have had a full and fair opportunity to litigate them.[128]

The impact of *Shore* on private plaintiffs' remedies could be significant. If the SEC has already litigated a case and obtained an injunction, a private plaintiff will have strong incentive and advantage, from an evidentiary standpoint at least, to bring his own action arising out of the same facts. At the same time, defendants, in an effort to avoid the effects of *Shore* and to preserve the right to a jury trial, may very well move to consolidate the SEC and private actions.[129] All the effects of *Shore* cannot be measured at this time. However, the Supreme Court has recently granted certiorari to at least resolve a difference of opinion in the circuit courts on the issues presented,[129a] and perhaps to provide needed guidance.

In *Lasker*, stockholders of an investment company brought a nonfrivolous derivative action alleging that the company's investment adviser and certain of its interested directors breached fiduciary obligations under provisions of the Investment Company Act of 1940[130] and the Investment Advisers Act of 1940.[131] The suit was blocked, however, by the independent directors, who were appointed pursuant to the requirements of the Investment Company Act. Exercising their business judgment, the independent directors felt that a derivative action on the specific claims would not prevail or be in the best interests of the company. The district

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[127] 565 F.2d at 818-20. *But see* Rachal v. Hill, 435 F.2d 59 (5th Cir. 1970).

[128] If, for example, the SEC does not have to prove scienter in a rule 10b-5 action and a private plaintiff must (in accordance with *Hochfelder*), *Shore* would not apply with respect to the issue of mental state.

[129] *But see* 15 U.S.C. § 78u(g) (1976). Another possible effect of *Shore* is that defendants may be more likely to consent to, rather than litigate, SEC demands, to avoid being collaterally estopped in subsequent private actions.

[129a] 98 S. Ct. 1875 (1978).

[130] 15 U.S.C. §§ 80a-1 to -52 (1976).

[131] *Id.* §§ 80b-1 to -21.

court had dismissed the action based on the motion of the independent directors.[132]

The Second Circuit held that statutory disinterested directors of a registered investment company have no such authority to terminate a nonfrivolous derivative action. It found no congressional intent to give disinterested directors such power. Disinterested directors were intended to be a check on the actions of the majority directors who are controlled by the investment adviser. They were not to have the power to foreclose nonfrivolous derivative actions by shareholders against those same persons for breach of fiduciary duties. This action by the Second Circuit appears to promote derivative actions by shareholders under the 1940 Acts, at least where the defendants are the majority directors of the investment company and its adviser. The court in effect held that federal policies concerning the relationship of an advisor to an investment company override principles of state corporation law that independent directors exercising their good faith business judgment may decide whether or not to pursue a possible corporate claim, even when it is a derivative action. It is interesting to note that in so holding the court did not discuss the Supreme Court's opinion in *Santa Fe*.

F. *The Second Circuit's SEC Cases*—SEC v. Bausch & Lomb, Inc. *and* SEC v. Commonwealth Chemical Securities, Inc.

The Supreme Court's recent decisions circumscribing the coverage of the securities laws have involved private plaintiffs, not the SEC. The Court has specifically noted in some cases that its particular holding was not addressed to SEC actions,[133] and the SEC has taken the position that the limitations on securities law actions set forth by the current Supreme Court should not apply when it is the plaintiff.[134] Yet these recent Supreme Court decisions have raised the question whether and to what extent the SEC as a plaintiff should be treated differently from a private plaintiff. Neither the courts nor the SEC have focused on the differing public policy considerations applicable to cases inviting huge damage claims by private parties and civil law enforcement actions brought

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[132] Lasker v. Burks, 426 F. Supp. 844 (S.D.N.Y. 1977), *rev'd*, 567 F.2d 1208 (2d Cir. 1978), *petition for cert. filed*, 46 U.S.L.W. 3766 (U.S. June 2, 1978) (No. 77-1724).

[133] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 751 n.14 (1975).

[134] *See, e.g.*, Brief for Appellant at 31-37, SEC v. Bausch & Lomb, Inc., 565 F.2d 8 (2d Cir. 1977) and Brief for Appellant at 23-43, SEC v. American Realty Trust, 429 F. Supp. 1148 (E.D. Va. 1977), *appeal pending*, No. 77-1839 (4th Cir.).

by governmental agencies. However, this may become critical in the future.

The Second Circuit has not dealt with these questions directly. It has, however, made certain statements affecting SEC actions. In *SEC v. Bausch & Lomb, Inc.*,[135] the court held, among other things, that in order for the SEC to obtain injunctive relief, it must at least show that a reasonable likelihood of recurrence exists. Thus, there is no per se rule that an injunction will issue, even when requested by the SEC, merely upon the showing of a past violation.[136] In *SEC v. Commonwealth Chemical Securities, Inc.*,[137] the Second Circuit reiterated the analysis in *Baush & Lomb* as to injunctive relief and indicated a more circumspect judicial attitude toward SEC injunctions than had previously prevailed:[138] "Experience has shown that an injunction, while not always a 'drastic remedy . . ., often is more than the mild prophylactic'. . . . In some cases the collateral consequences can be very grave . . . ."[139]

It should be noted that, in *Commonwealth*, the SEC requested and obtained disgorgement. Efforts by the SEC and the courts to distinguish between private damage claims and SEC injunctive actions may be complicated by the prevalence of disgorgement requests. However, claims for disgorgement would usually not result in the same type of open-ended liability as implied damage claims. As noted by Judge Friendly in *Commonwealth*, the theory supporting disgorgement is quite different from the theory supporting damages.

## CONCLUSION

The response of the Second Circuit to the Supreme Court's new view of the securities laws has been measured and thoughtful. To the extent the Second Circuit has been able to preserve prior precedents which were considered significant, it did so.[140] To the

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[135] 565 F.2d 8 (2d Cir. 1977).

[136] *Id.* at 18. This holding can be understood as a statement of the general equity principles applicable to all injunction proceedings. However, it may presage a more restrictive attitude toward SEC injunction applications in response to Rondeau v. Moisnee Paper Co., 422 U.S. 49 (1975). The basis of the court's decision in *Bausch & Lomb* made it unnecessary for the court to deal with the SEC's arguments that the holdings of *Blue Chip* and *Hochfelder* were inapplicable to SEC actions.

[137] 574 F.2d 90 (2d Cir. 1978).

[138] *Id.* at 98-102.

[139] *Id.* at 99 (citations omitted).

[140] *See, e.g.*, Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 1249 (1978).

extent the Supreme Court's new direction provided an excuse to dispose of cases the Second Circuit or the lower courts disliked,[141] it seized upon the opportunity to do so. However, the court was at the same time obviously concerned about continuing to afford agrieved individual investors access to the courts.[142]

Complete consistency in circuit court decisions cannot be expected because of the multiplicity of panels and the varying perspectives of different judges. The Second Circuit, nonetheless, seems to be making a valiant attempt to reach a new consensus on securities law cases in response to the Supreme Court, without wholly repudiating its own prior decisions. Whether or for how long the Second Circuit can continue that effort remains to be seen. Success in reaching a consensus will be dependent not only on future cases coming before the court but also on the continued interest in the federal securities laws by the current Supreme Court. Whether the Court will pursue further limitations on implied actions and perhaps revisit its own prior decisions expanding liability under the securities laws will bear heavily on what the Second Circuit's new consensus will be. Its recent decisions are a reaction to a change of attitude by a new Supreme Court. That Court, however, may have much more to say concerning the implied rights of plaintiffs under the securities laws.

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[141] The Second Circuit seemed particularly to disapprove of actions brought by a receiver or bankruptcy trustee on behalf of creditors other than brokerage customers. *E.g.*, Lank v. New York Stock Exch., 548 F.2d 61 (2d Cir. 1977).

[142] *See, e.g.*, Redington v. Touche Ross & Co., [Current] FED. SEC. L. REP. (CCH) ¶ 96,404 (2d Cir. Apr. 21, 1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978); Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 98 S. Ct. 2253 (1978).