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Securities Regulation—Fraud—Rule 10b-5 No Longer Scares the Judiciary, but May Scare Corporate Defendants: The United States Supreme Court Switches Directions. *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*, 532 U.S. 588 (2001).

Bhavik R. Patel

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SECURITIES REGULATION—FRAUD—RULE 10B-5 NO LONGER SCARES THE JUDICIARY, BUT MAY SCARE CORPORATE DEFENDANTS: THE UNITED STATES SUPREME COURT SWITCHES DIRECTIONS. *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*, 532 U.S. 588 (2001).

I. INTRODUCTION

Securities¹ enjoy the peculiarity of being perhaps the most deviously named product available. From the time of their inception, through the 1929 stock market crash, the savings and loan crises in the 1980s, and up through the Enron debacle in 2000, securities have not been for the most part secure.² Nevertheless, in the wake of the largely unregulated speculation leading up to the stock market crash of 1929, the federal government implemented an inclusive set of disclosure regulations that attempted to minimize the risk inherent in the investment instrument itself.³ Most notably, federal regulation of securities markets includes the Securities Act of 1933, which regulates initial offerings of stock to the public,⁴ and the Securities Exchange Act of 1934, which purports to regulate most other aspects of the sale and resale of securities.⁵

These Acts explicitly provide for various means of government enforcement; however, they also provide an implied source of private remedies.⁶ These implied remedies have become powerful weapons for both private and state plaintiffs seeking to redress securities law violations arising from marketplace transactions.⁷ Because of the utility of implied remedies

1. A “security” is defined as:

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights . . . or, in general, any interest or instrument commonly known as a “security”, [sic] or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2000).

2. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.2, at 6–9 (3d ed. 1996).

3. *Id.*

4. 15 U.S.C. §§ 77a–77bbbb.

5. 15 U.S.C. §§ 78a–78III (2000).

6. See *infra* notes 77–78 and accompanying text.

7. For example, fifteen percent of the Securities Exchange Commission’s (SEC) 1992 civil enforcement actions contained claims of aiding and abetting. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 200 n.11 (1994) (Stevens, J., dissenting). Aiding and abetting is to assist or facilitate the commission of a crime, or to promote its accomplishment. BLACK’S LAW DICTIONARY 83 (7th ed. 1999).

and their well-established place in private suits, Rule 10b-5,⁸ the Securities and Exchange Commission's (SEC) sweeping antifraud provision, has emerged as the most encompassing antifraud provision of the federal securities laws.⁹ Initially, the scope of Rule 10b-5 was defined broadly.¹⁰ Although Rule 10b-5 provides an implied private right of action to victims of securities fraud, the United States Supreme Court and the legislative branch have, in the past, narrowed its overly broad scope.¹¹ However, in *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*,¹² the United States Supreme Court departed from this narrowing trend and began to rely on newly enacted legislative reform acts to limit Rule 10b-5's scope.¹³

This note begins with the facts of *Wharf*, followed by a brief review of the policy and history of section 10(b)¹⁴ and Rule 10b-5.¹⁵ Next, the note discusses the elements of a 10b-5 cause of action. An examination of Rule 10b-5 cases follows, including a sampling of decisions involving narrow judicial interpretations of the rule. The note then discusses Congress's implementation of the Private Securities Litigation Reform Act of 1995 (PSLRA)¹⁶ and the Securities Litigation Uniform Standard Act of 1998 (SLUSA).¹⁷ Part IV conducts an analysis of the Court's reasoning in *Wharf*, where a unanimous Court held that a secret intent to not honor an oral options contract is a deceptive device in violation of section 10(b) and Rule 10b-5. The note concludes with a discussion of the significance of the Court's departure from narrowly interpreting a Rule 10b-5 cause of action, suggesting that the judiciary should avoid law making and rely on Congress's interpretation of Rule 10b-5.

8. Rule 10b-5 provides:

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

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

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

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2001).

9. See HAZEN, *supra* note 2, § 13.2, at 763.

10. See *infra* Part III.

11. See *infra* Part III.B-C.

12. 532 U.S. 588 (2001).

13. *Id.* at 594-96.

14. 15 U.S.C. § 78j(b) (2000).

15. 17 C.F.R. § 240.10b-5 (2001).

16. 15 U.S.C. § 78u-4; see *infra* Part III.C.1.

17. 15 U.S.C. § 77p (2000); see *infra* Part III.C.2.

II. FACTS

In 1991 the Hong Kong government publicized its intent to grant an exclusive license for the operation of a cable television system.¹⁸ Wharf (Holdings) Ltd. (“Wharf”) is a Hong Kong company with holdings in transportation, communications, and real estate.¹⁹ Wharf chose to prepare a bid for the cable franchise.²⁰ Peter Woo, Wharf’s chairman, recognized that for a successful bid, Wharf needed experienced partners with technical expertise and credibility.²¹ Soon after the announcement by the Hong Kong government, Wharf’s managing director, Stephen Ng,²² initiated negotiations with United International Holdings, Inc.’s (“United”) Vice President Mark Schneider to discuss the involvement of United, a Denver-based cable television consulting and investment company, in preparing the bid for the Hong Kong cable system.²³ During this meeting, United agreed to provide services to Wharf in exchange for the right to invest in the Hong Kong cable system should Wharf obtain the license.²⁴ In response to United’s request for ownership rights, Ng explained to Schneider that under the current law in Hong Kong, United could not own more than ten percent of the cable venture.²⁵

In June 1992 Ng told Schneider that Wharf selected United as its cable partner.²⁶ Beginning in August 1992, United’s employees assisted Wharf in creating the cable proposal while the two companies continued negotiations about the details of United’s payment.²⁷ In the meantime, United sent employees to Hong Kong to assist in the project’s negotiation, system design, and financing.²⁸ Wharf submitted an initial letter of intent to United, which recognized both parties’ intention to cooperate and invest in the Hong Kong cable system.²⁹ In a memo entitled “Corporate Structure and Shareholdings,” it was stated that United would hold ten percent of the company’s

18. *Wharf (Holdings) Ltd. v. United Int’l Holdings, Inc.*, 532 U.S. 588, 590 (2001); *see also United Int’l Holdings, Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207, 1214 (10th Cir. 2000).

19. Brief for Petitioner at 4, *Wharf (Holdings) Ltd. v. United Int’l Holdings, Inc.*, 532 U.S. 588 (2001) (No. 00-347).

20. *Wharf*, 532 U.S. at 590.

21. *Id.*; Brief for Respondent at 5, *Wharf* (No. 00-347).

22. Harold S. Bloomenthal & Samuel Wolff, *SECURITIES AND FEDERAL CORPORATE LAW* § 13:40.2 (2d ed. 2001).

23. *United*, 210 F.3d at 1214.

24. *Id.*

25. *Id.*

26. *Id.* at 1214–15.

27. *Wharf (Holdings) Ltd. v. United Int’l Holdings, Inc.*, 532 U.S. 588, 590 (2001).

28. *Id.*

29. *Id.* at 590–91.

share capital.³⁰ However, the memo also provided that it “does not create legally binding and enforceable obligations and is intended to identify in general terms a number of the principal matters forming the basis of the cooperation between the parties.”³¹ In addition, the parties never signed any of these agreements.³²

In September 1992 Schneider attended Wharf’s final bid preparations in Hong Kong.³³ On September 25 Wharf demonstrated a need to secure sufficient technical expertise and entered into a Technical Cooperation Agreement (TCA) with United.³⁴ The TCA acknowledged that Wharf wanted to keep the benefit of United’s cable experience.³⁵ The TCA agreement, however, described United as “an independent contractor,” not as a potential owner.³⁶ Furthermore, the TCA specifically mentioned that any modification to it must be in writing.³⁷ Significantly, United signed the TCA, and it represented the only signed agreement between the parties.³⁸

Wharf finally submitted a bid on September 30, 1992, in which it publicly told the Hong Kong government that the company would be the sole owner of the cable system.³⁹ In part of its bid entitled “ownership structure,” Wharf had stated that it might consider United as an expert partner.⁴⁰ Wharf’s non-committal language concerned United officials.⁴¹ United understood, however, that the bid was structured only as a strategic move to win the cable license.⁴²

At a meeting on October 8, 1992, Ng requested that United continue to provide well-trained employees to staff the venture until Wharf could hire suitable permanent employees.⁴³ United insisted that its officials would only comply with Wharf’s request if Wharf provided an enforceable right to ownership in the cable system.⁴⁴ In response, Ng offered United an oral option to invest in the cable system in exchange for United’s services.⁴⁵ The alleged terms of the right to invest were: (1) United had an option to purchase ten percent of the cable system stock; (2) United’s option purchase

30. *United*, 210 F.3d at 1215.

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*

36. *United*, 210 F.3d at 1215–16.

37. *Id.* at 1216.

38. *Id.* The senior vice president of United, Michael Fries, signed the TCA. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

42. *United*, 210 F.3d at 1216.

43. *Id.*

44. *Id.*

45. *Wharf (Holdings) Ltd. v. United Int’l Holdings, Inc.*, 532 U.S. 588, 591 (2001).

price was ten percent of the equity capital required to fund the project, less United's expenses and the value of United's previous services; (3) United's option was exercisable only if United demonstrated its ability to fund its portion of the project's equity capital requirements for eighteen months; and (4) the option expired if not exercised by United within six months after Wharf received the franchise.⁴⁶ The parties never reduced this agreement to writing.⁴⁷ Ng later denied granting United an oral option to purchase securities in its cable system.⁴⁸

On May 27, 1993, the Hong Kong government awarded the cable franchise to Wharf.⁴⁹ In turn, United conducted a public offering of its stock to finance its initial investment in Wharf's cable system pursuant to the oral options contract.⁵⁰ In late July or early August, United informed Ng that it was ready to exercise its option, but Wharf refused to sell United stock in the cable system.⁵¹

During this time, internal Wharf documents suggested that Wharf never intended to honor the option Ng orally granted United.⁵² For instance, on September 9, 1992, after a Wharf board meeting, Ng wrote a letter to an executive: "Didn't get very far with the Chairman! More interested in a telecom partner! How do we get out?"⁵³ Additionally, a few weeks before the October 8, 1992 meeting,⁵⁴ Wharf's Chairman Woo wrote, "No, no, no, we don't accept that" in a memorandum stating that United was interested in investing in the Hong Kong cable system.⁵⁵ Despite Wharf's internal repudiation of United's right to invest, however, Schneider attended Wharf's station launch on October 31, 1993, and, after the launch, Ng urged Schneider to be patient.⁵⁶ But in a November 24 document titled "Biweekly Meeting with Chairman," an executive noted that Wharf should "start to back pedal, and activate Technical Cooperation Agreement."⁵⁷ In December 1992 United submitted another memorandum of understanding to Wharf, stating that United's possibility of ownership was contingent upon Wharf's board

46. *Id.*; see also Brief for Respondent at 4, *Wharf* (No. 00-347).

47. *Wharf*, 532 U.S. at 591.

48. *United*, 210 F.3d at 1216-17.

49. *Wharf*, 532 U.S. at 591; *United*, 210 F.3d at 1217.

50. *United*, 210 F.3d at 1217. United conducted a public offering to finance an amount of \$66,000,000 (its ten percent share according to the October 8 agreement's requirements). *Id.*

51. *Wharf*, 532 U.S. at 591; *United*, 210 F.3d at 1217.

52. *Wharf*, 532 U.S. at 591-92; *United*, 210 F.3d at 1217-18.

53. *United*, 210 F.3d at 1218.

54. See *supra* text accompanying notes 43-47.

55. *Wharf*, 532 U.S. at 591.

56. *United*, 210 F.3d at 1218.

57. *Id.* For the terms of the TCA, see *supra* text accompanying notes 34-38. In another Wharf document entitled "Agenda for Meeting with Chairman," the word "stall" appeared beside the heading giving United possible partnership. *United*, 210 F.3d at 1219.

approval.⁵⁸ Ng's copy of the memo says "be careful, must deflect this. How?"⁵⁹ A December 11 internal Wharf document explained that the company did not want United's oral options agreement to bind Wharf's actions.⁶⁰

On March 18, 1994, after continuous efforts by United to exercise the oral option contract, Schneider met with Wharf's board to express United's desired involvement and to request a right to invest in Wharf.⁶¹ Approximately two hours after the meeting, Ng informed Schneider that the board was not willing to consider United's investment.⁶²

United initiated suit in November 1994 against Wharf⁶³ for its refusal to allow United to invest in the Hong Kong cable television franchise under the oral agreement pursuant to section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.⁶⁴ United contended that the services it rendered to Wharf were part of a mutual understanding that United would purchase ten percent of Wharf's stock in the Hong Kong cable system.⁶⁵ In April 1997 a federal jury in Colorado found that Wharf did not fulfill its obligation under the oral agreement to sell ten percent of its stock to United and awarded United compensatory and punitive damages of over \$125,000,000.⁶⁶ Wharf appealed the decision, and the United States Court of Appeals for the Tenth Circuit affirmed.⁶⁷ Wharf further appealed the decision to the United States Supreme Court.⁶⁸ On May 21, 2001, the Supreme Court affirmed the Tenth Circuit, holding that Wharf's grant of an oral option to buy securities, while secretly intending to deny United's exercise of

58. *United*, 210 F.3d at 1218.

59. *Wharf*, 532 U.S. at 592.

60. *United*, 210 F.3d at 1218. Another confidential document stated:

[P]roper legal disclaimers have been inserted in the language so as to not bind us to [United's] representation which speaks to an "opportunity" to acquire a [ten percent] interest in Wharf Cable. Our next move should be to claim that our directors got quite *upset* over these representations and have therefore instructed us to "settle up" on the [TCA] only. Publicly, we *do not* acknowledge the opportunity and speak only to [United's] involvement vis-a-vis the [TCA].

Id. (alterations in original).

61. *Id.* at 1219.

62. *Id.*

63. *Id.*

64. *See Wharf*, 532 U.S. at 593; *see infra* Part III.B.

65. *United*, 210 F.3d at 1219.

66. *Wharf*, 532 U.S. at 592; *see also* John Accola, *Decision Against Wharf Upheld State's Largest Jury Award Withstands High Court Test*, ROCKY MOUNTAIN NEWS, May 22, 2001, at 1B.

67. *United*, 210 F.3d at 1237. The court held, "we are convinced that [United's] allegations not only are substantial and nonfrivolous, but state an actionable 10b-5 claim" Brief of Respondent at 16-17, *Wharf* (No. 00-347).

68. *See Wharf*, 532 U.S. at 588.

the option, violated section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.⁶⁹

III. BACKGROUND

Since the inception of Rule 10b-5, a victim of fraudulent or deceptive practices by a seller or purchaser of securities has had a particular statutory remedy that falls outside the common law remedy for fraud.⁷⁰ In fact, the number of suits brought pursuant to Rule 10b-5 has steadily increased due to the broad scope of liability under Rule 10b-5.⁷¹ For many years, attempts to persuade Congress to pass a statutory definition of fraud were unavailing; therefore, fearing the adverse effects of excessive litigation, the judiciary began to restrict the scope of Rule 10b-5.⁷² Furthermore, legislative intervention has also addressed this concern.⁷³ After a glimpse into the history and policy underlying federal securities regulation under section 10(b) and Rule 10b-5, this section will describe a Rule 10b-5 cause of action and the judiciary's narrow interpretation of its elements. This section concludes with a discussion of the PSLRA and SLUSA, Congress's attempts to reform Rule 10b-5's broad scope.

A. History and Policy of Securities Regulation: The Intent of Section 10(b) and Rule 10b-5

The United States Supreme Court has stated that the fundamental purpose of the Securities Exchange Act of 1934 was to implement a philosophy of full disclosure in securities transactions.⁷⁴ The legislative intent to accord broad application of section 10(b) and Rule 10b-5 has served to justify the prohibition of various deceptive acts, devices, or contrivances in connection with securities deals.⁷⁵ A plaintiff does not have to show an actual intent by the wrongdoer to influence the price of a security; rather, the plaintiff need only show that the wrongdoer's action caused a reasonable investor to alter his or her mind, thereby affecting value.⁷⁶

69. *Id.* at 588, 597. The Court held that an option was a security under Rule 10b-5; that an oral contract was within the scope of Rule 10b-5; and that the sale of an option with a secret intent not to honor it violated Rule 10b-5. *Id.* For a thorough analysis of the Court's reasoning, see *infra* Part IV.

70. See *supra* note 8.

71. See *infra* Part III.B.

72. See *infra* Part III.B.

73. See *infra* Part III.C.

74. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477-78 (1977).

75. See 15 U.S.C. § 78j(b) (2000); 17 C.F.R. § 240.10b-5 (2001).

76. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 (1976). Judge Friendly of the United States Court of Appeals for the Second Circuit expanded on this idea:

In 1946 a federal district court held in *Kardon v. National Gypsum Co.*⁷⁷ that absent an express private right of action, Rule 10b-5 gives rise to an implied private remedy in the hands of injured investors.⁷⁸ However, it was not until twenty-four years later that the United States Supreme Court acknowledged this implied private right of action.⁷⁹ Nevertheless, since *Kardon*, the implied remedy in Rule 10b-5 has remained firmly entrenched.⁸⁰ However, the courts have limited the breadth (or scope) of Rule 10b-5 in many respects.⁸¹ For example, the United States Supreme Court has limited standing for a plaintiff to bring a Rule 10b-5 suit,⁸² precluded private suits for aiding and abetting violations,⁸³ required proof of scienter in suits for both damages⁸⁴ and injunctive relief,⁸⁵ reduced the average period of the statute of limitations for suits,⁸⁶ limited the occasions on which use of inside information violates the rule,⁸⁷ and imposed a stringent test for tippee liability.⁸⁸

The purpose of [section] 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.

Chem. Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 (2d Cir. 1984).

77. 69 F. Supp. 512 (E.D. Pa. 1946).

78. *See id.* at 513–14.

79. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 & n.9 (1971) (“It is now established that a private right of action is implied under [section] 10(b)” and Rule 10b-5.).

80. There are numerous writings about the evolution of Rule 10b-5 and its remedy. *See, e.g.*, 1 ALAN R. BROMBERG & LEWIS D. LOWENFELS, *BROMBERG AND LOWENFELS ON SECURITIES FRAUD AND COMMODITIES FRAUD* §§ 1.0–3.2 (2d ed. 1996); Craig J. Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, U. ILL. L.F. 651 (1972); David S. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of the Legislative Intent?*, 57 NW. U. L. REV. 627 (1963).

81. *See infra* Part III.B.

82. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754–55 (1975).

83. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

84. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

85. *Aaron v. SEC*, 446 U.S. 680, 702 (1980).

86. *See Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 352–57 (1991); *see also* Christopher R. Leslie, *Den of Inequity: The Case for Equitable Doctrines in Rule 10b-5 Cases*, 81 CAL. L. REV. 1587, 1608 (1993).

87. *Chiarella v. United States*, 445 U.S. 222, 227 (1980).

88. *Dirks v. SEC*, 463 U.S. 646, 660 (1983). A tippee is defined as a person who acquires material nonpublic information from someone in a fiduciary relationship with the company to which that information pertains. BLACK’S LAW DICTIONARY 718 (7th ed. 1999). When the insider provides this information to the tippee in breach of the insider’s fiduciary duty to the corporation, and the tippee knows or should know of the breach, then the tippee assumes a fiduciary duty to the shareholders not to trade on this information. *Dirks*, 463 U.S. at 660.

B. Section 10(b) and Its Weapon of Choice, Rule 10b-5: The Judiciary Interferes

The SEC promulgated Rule 10b-5 as a remedy for securities fraud available under the Securities Exchange Act.⁸⁹ Section 10(b) of the Securities Exchange Act of 1934 provides that it is unlawful “[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”⁹⁰ The SEC has recognized and utilized this rulemaking power in many instances,⁹¹ and in Rule 10b-5 it created its most encompassing prohibition.⁹² It is clear that Rule 10b-5’s broad language could have potentially prohibited a large group of activities.⁹³

To state an effective claim under Rule 10b-5, a plaintiff must prove that there was fraud or deceit⁹⁴ by any person in connection with the purchase or sale⁹⁵ of any security.⁹⁶ Furthermore, because Rule 10b-5 requires some type of fraud, the elements of common law fraud also apply, such as materiality and reliance.⁹⁷ Since its adoption, Rule 10b-5 has proven to be a powerful weapon against securities fraud.⁹⁸ However, the broad language of Rule 10b-5 created potential unlimited liability.⁹⁹

89. 17 C.F.R. § 240.10b-5 (2001). *See generally* Milton Freeman, *Happy Birthday 10b-5: 50 Years of Antifraud Regulation*, 61 *FORDHAM L. REV.*, at S1 (1993).

90. 15 U.S.C. § 78j(b) (2000). *See generally* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 *STAN. L. REV.* 385 (1980).

91. *See* 17 C.F.R. §§ 240.10b-1 to -18.

92. *Id.* § 240.10b-5; *see HAZEN, supra* note 2, at 763.

93. *See supra* note 8.

94. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976); *see also infra* Part III.B.1.

95. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754–55 (1975). Only actual purchasers and sellers of securities have standing to bring a Rule 10b-5 cause of action, not potential purchasers or sellers. *Id.*

96. 17 C.F.R. § 240.10b-5.

97. Some courts have identified six principal elements of a Rule 10b-5 claim: “(1) a misstatement or omission (2) of a material (3) fact (4) with scienter (5) upon which the plaintiff justifiably relied (6) that proximately caused the plaintiffs’ [sic] damages.” *Bently v. Legent Corp.*, 849 F. Supp. 429, 431 (E.D. Va. 1994); *see infra* Part III.B.4. A statement is material if there is substantial likelihood that a reasonable person would consider it important to affect his or her decision. *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988). Scienter is defined as “a mental state embracing intent to deceive, manipulate, or defraud.” *Ernst & Ernst*, 425 U.S. at 193–94 n.12.

98. According to the leading advocate of Rule 10b-5, Milton Freeman:

It was one day in the year 1943, I believe. I was sitting in my office in the SEC building in Philadelphia and I received a call from Jim Treanor who was then the director of the Trading and Exchanged Division. He said, “I have just

By employing such broad language as the phrases "in connection with" and "any security," section 10(b) and Rule 10b-5 reach a wide range of acts and schemes that may defraud investors.¹⁰⁰ Because of this broad potential interpretation, both the judiciary and the legislature have begun to narrow the scope of section 10(b) and Rule 10b-5 due to the fear that frivolous litigation or unfair results would occur.¹⁰¹ The United States Supreme Court observed that Rule 10b-5 represented a "judicial oak which has grown from little more than a legislative acorn," badly in need of pruning because of the potential overbreadth of its language.¹⁰²

In the last three decades, the Supreme Court has generally embraced a restrictive view of Rule 10b-5's reach.¹⁰³ While earlier decisions read the

been on the telephone with Paul Rowen," who was then the SEC Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around and buying up the stock of his company from his own shareholders at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be \$2.00 a share for the coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.

We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Summer Pike who said, "Well, we are against fraud, aren't we?"

Conference on Codification of the Federal Securities Law, 22 BUS. LAW. 793, 922 (1967); see also *Blue Chip Stamps*, 421 U.S. at 767.

99. See *supra* note 8.

100. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152 (1972). In *Affiliated Ute*, the Court held that employees violated 10b-5 by misstating a material fact, namely, that the prevailing market price of the shares was the figure at which non-Indians made the purchases, and the activities of the employees constituted a "course of business" or a "device, scheme or artifice" that operated as a fraud on the Indian sellers. *Id.*; see also *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (holding that section 10(b) bars deceptive devices and contrivances in the purchase or sale of securities in face-to-face or market transactions).

101. See *infra* notes 103-11 and accompanying text; see also *infra* Part III.C.

102. *Blue Chip Stamps*, 421 U.S. at 737.

103. For reviews of this trend, see Douglas M. Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L.J. 263 (1981); James D. Cox, *Choices: Paving the Road Toward a "Definition" of Insider Trading*, 39 ALA. L. REV. 381, 390 (1988); C. Larimore Whitaker & James E. Rotch, *The Supreme Court and the Counter-Revolution in Securities Regulation*, 30 ALA. L. REV. 335 (1979). See also *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 352-57 (1991); *Dirks v. SEC*, 463 U.S. 646, 660 (1983); *Aaron v. SEC*, 446 U.S. 680 (1980); *Chiarella v. United States*, 445 U.S. 222 (1980); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps*, 421 U.S. at 723.

language of section 10(b) “not technically and restrictively, but flexibly to effectuate its remedial purposes,”¹⁰⁴ the Court has since construed these provisions with more skepticism and has limited much of Rule 10b-5’s potency.¹⁰⁵

1. *The Fraud Element*

In 1977 the United States Supreme Court narrowed section 10(b) and Rule 10b-5 when it wandered from the broad statutory language and concluded that mismanagement does not constitute deceptive or manipulative behavior, and therefore, did not give rise to any action for securities fraud.¹⁰⁶ In *Santa Fe Industries, Inc. v. Green*, the Court held that a claim of fraud under Rule 10b-5 could only succeed if the conduct alleged can be fairly viewed as manipulative or deceptive within the meaning of section 10(b).¹⁰⁷ The case involved a majority shareholder’s use of a short-form merger to oust the corporation’s minority shareholders.¹⁰⁸ Rather than accept the appraisal remedy available to them under state law, some of the excluded shareholders challenged the transaction under Rule 10b-5.¹⁰⁹ The Court dismissed the suit and ruled that the adequate disclosure provided to the shareholders¹¹⁰ rendered the transaction neither “deceptive” nor “manipulative” under Rule 10b-5 and section 10(b).¹¹¹ The United States Supreme Court further justified the ruling by noting that the “language of [section] 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.”¹¹² Therefore, after *Santa Fe*, the plaintiff must prove that the defendant tricked him or her into entering into the particular transaction before he or she can satisfy the fraud element in a Rule 10b-5 private action.¹¹³

104. *Affiliated Ute Citizens*, 406 U.S. at 151 (quoting *SEC v. Capital Gains Research Bur., Inc.*, 375 U.S. 180, 186 (1963)); see also *Bankers Life & Cas.*, 404 U.S. at 12; *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

105. See *supra* notes 82–88 and accompanying text.

106. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977).

107. *Id.* at 472. The United States Supreme Court later clarified by stating that whether a complaint states a cause of action for “fraud” (scienter) under Rule 10b-5, “we turn first to the language of [section] 10(b), for ‘[t]he starting point in every case involving construction of a statute is the language itself.’” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (alterations in original).

108. *Santa Fe*, 430 U.S. at 465.

109. *Id.* at 466–67.

110. *Id.* at 474 n.14 (holding that the failure to give advance notice of the merger was not a material nondisclosure); see also Harvey Gelb, *Rule 10b-5 and Santa Fe—Herein of Sue Facts, Shame Facts, and Other Matters*, 87 W. VA. L. REV. 189, 192 (1983).

111. *Santa Fe*, 430 U.S. at 474–77.

112. *Id.* at 473.

113. *Id.* at 476.

2. *The "In Connection with the Purchase or Sale" Element*

The judiciary has long assumed that any statement found to affect the investment decisions of reasonable investors would achieve the "in connection with" requirement.¹¹⁴ In *Blue Chip Stamps v. Manor Drug Stores*,¹¹⁵ however, the United States Supreme Court again chipped away at Rule 10b-5's broad scope when it held that a plaintiff must be an actual purchaser or seller of securities to have standing to bring a Rule 10b-5 claim.¹¹⁶ In *Blue Chip Stamps*, the plaintiff belonged to a class of retailers to whom defendant Blue Chip Stamps was obligated to offer a substantial number of its shares pursuant to an antitrust consent decree.¹¹⁷ The suit alleged that the prospectus for the offering presented a pessimistic assessment of Blue Chip Stamps to discourage the retailers from buying the shares at the below-market price to which the decree entitled them.¹¹⁸ Without rejecting the truth of the allegation, the Court dismissed the Rule 10b-5 action because the plaintiff's asserted injury did not derive from the purchase or sale of Blue Chip Stamps's stock.¹¹⁹ In turn, the Court held that would-be purchasers could not state a Rule 10b-5 cause of action.¹²⁰ The outcome of this holding is that potential sellers or buyers of securities do not have standing to raise Rule 10b-5 claims, even if a fraudulent scheme or device affected their decision not to purchase or sell securities.¹²¹

However, the United States Court of Appeals for the District of Columbia Circuit held that an oral contract for sale can be the basis of a Rule 10b-5 claim in *Threadgill v. Black*.¹²² In this case, the complaint alleged that Threadgill was a shareholder of B&W Productions, Inc., a corporation controlled by Black.¹²³ Threadgill was to receive money in exchange for giving

114. *See, e.g.*, *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 858-61 (2d Cir. 1968) (holding that misstatements in a corporate press release were made "in connection with" purchases or sales made by shareholders in the open market and violated Rule 10b-5, even though the corporation itself was neither buying nor selling shares).

115. 421 U.S. 723 (1975).

116. *Id.*

117. *Id.* at 725-26.

118. *Id.* at 726-27.

119. *Id.* at 745-46.

120. *Id.*

121. *See, e.g.*, *Calenti v. Boto*, 24 F.3d 335, 339 (1st Cir. 1994) (alleging misstatements in connection with proposed amendment to articles of incorporation that would eliminate the right to redeem preferred shares was not actionable under 10b-5 as there was neither a purchase nor a sale); *see also* *Ruff v. Genesis Holding Corp.*, 728 F. Supp. 225, 229 (S.D.N.Y. 1990) (holding that an offeree was only a would-be purchaser and thus lacked Rule 10b-5 standing).

122. 730 F.2d 810 (D.C. Cir. 1984) (*per curiam*). However, the parties must have made an enforceable contract. *Reprosystem, B.V. v. SCM Corp.*, 727 F.2d 257, 265 (2d Cir. 1984).

123. *Threadgill*, 730 F.2d at 811.

up his ownership rights in B&W, but Black refused to execute a written memorandum stating such an agreement.¹²⁴ The *Threadgill* court held that “fraud in the purchase or sale includes ‘[e]ntering into a contract of sale [of a security] with the secret reservation not to fully perform.’”¹²⁵ This included oral contracts of sale.¹²⁶

3. *The “Any Security” Element*

Rule 10b-5 applies to any kind of entity that issues something which can be classified as a “security,”¹²⁷ regardless of whether the security is registered under the Securities Act of 1933 or the Securities Exchange Act of 1934.¹²⁸ Therefore, Rule 10b-5’s broad scope has allowed it to be invoked in many situations.¹²⁹ In the history of securities regulation, the judiciary has defined a variety of objects as securities other than those mentioned in either the Securities Act of 1933 or the Securities Exchange Act of 1934.¹³⁰

4. *The Common Law Elements: Materiality and Reliance in Rule 10b-5 Actions*

In a common law action for fraud or deceit, the successful plaintiff must prove a material misstatement or omission and reliance upon it.¹³¹ As is the case with the common law action, the materiality and reliance requirements also apply to Rule 10b-5 causes of action.¹³²

124. *Id.*

125. *Id.* at 811–12 (quoting *Walling v. Beverly Enters.*, 476 F.2d 393, 396 (9th Cir. 1973)).

126. *Id.*

127. *See supra* note 1.

128. *See infra* note 130.

129. *See supra* note 1; *see also infra* note 130.

130. *See supra* note 1; *see also* *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (fruit trees); *Bailey v. T.W.K. Props., Inc.*, 904 F.2d 918 (4th Cir. 1990) (animal feeding programs); *Eberhardt v. Waters*, 901 F.2d 1578 (11th Cir. 1990) (cattle embryos); *Threadgill*, 730 F.2d at 811 (oral contracts); *Bell v. Health-Mar, Inc.*, 549 F.2d 342 (5th Cir. 1977) (vacuum cleaners); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) (cosmetics); *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476 (9th Cir. 1973) (self-improvement courses); *Cont’l Mktg. Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967) (beavers); *Kolibash v. Sagittarius Recording Co.* 626 F. Supp. 1173 (S.D. Ohio 1986) (master recording contracts); *SEC v. M.A. Lundy Assocs.*, 362 F. Supp. 226 (D.R.I. 1973) (scotch whiskey); *Halloway v. Thompson*, 42 N.E.2d 421 (Ind. App. 1942) (cemetery lots); *State v. Robbins*, 240 N.W. 456 (Minn. 1932) (muskrats).

131. *See generally* W. PAGE KEETON ET AL., *PROSSER AND KEETON ON TORTS* § 108 (5th ed. 1984).

132. *See HAZEN, supra* note 2, § 13.2.1, at 770.

a. Materiality

Information is material when a reasonable investor would have considered the matter significant in making investment decisions;¹³³ it is not necessary, however, to show that the investor would have acted differently.¹³⁴ The fact that a court will determine materiality in context means that a purchaser or seller is not necessarily entitled to all information relating to each of the circumstances surrounding the transaction.¹³⁵ Courts have held, for example, that failure to disclose negotiations concerning post-redemption plans for plaintiff's shares is not a material nondisclosure.¹³⁶ However, a court will likely find information tending to show conflicts of interest of directors, officers, or other major participants to be material.¹³⁷ Similarly, facts pertaining to management integrity are likely to be material.¹³⁸

The test of materiality depends not upon the literal truth of statements, but upon the ability of reasonable investors to become accurately informed.¹³⁹ Accordingly, when there is adequate cautionary language warning investors as to certain risks, optimistic statements are not materially misleading.¹⁴⁰ However, the mere fact that information may be publicly available does not mean that it is necessarily incorporated in every statement made.¹⁴¹

133. *Basic Inc. v. Levinson*, 485 U.S. 224, 236 (1988) (holding that the "determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . .") (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)) (alteration in original). It is not sufficient to show that information is false or incomplete, if the misrepresented fact is not significant. *Id.* at 238. It is not sufficient to show that a shareholder might have found the information to be of interest. *Milton v. Van Dorn Co.*, 961 F.2d 965, 968-69 (1st Cir. 1992).

134. *Folger Adam Co. v. PMI Indus., Inc.*, 938 F.2d 1529, 1532-33 (2d Cir. 1991).

135. *See, e.g., Ward v. Succession of Freeman*, 854 F.2d 780, 791-93 (5th Cir. 1988). Management's motives frequently will not be material, and therefore, need not be disclosed. *Id.* at 791. Where the total mix of information showed a bleak financial picture, the court held that overly optimistic statements by the incoming chairman of the board were not material. *Data Controls N., Inc. v. Fin. Corp. of Am.*, 688 F. Supp. 1047, 1057 (D. Md. 1988).

136. *Trecker v. Scag*, 747 F.2d 1176 (7th Cir. 1984). Especially if the plaintiff had little choice in the matter. *See List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965).

137. *See, e.g., Kahn v. Wien*, 842 F. Supp. 667, 677-78 (E.D.N.Y. 1994).

138. *E.g., Colonial Ltd. P'ship Sec. Litig.*, 854 F. Supp. 64 (D. Conn. 1994) (holding that reasons for discharge of general partner were material).

139. *E.g., McMahan & Co. v. Warehouse Entm't, Inc.*, 900 F.2d 576, 579 (2d Cir. 1990) ("Some statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors.").

140. *See, e.g., In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1415 (1994).

141. *See United Paperworkers Int'l Union v. Int'l Paper Co.*, 985 F.2d 1190, 1198-99 (2d Cir. 1993).

b. Reliance

The reliance requirement is a corollary of materiality.¹⁴² The United States Supreme Court, in *Affiliated Ute Citizens v. United States*,¹⁴³ held that in a face-to-face transaction between seller and purchaser where the defendant purchaser omitted material facts, the plaintiff's reliance can be presumed from the materiality of the omissions.¹⁴⁴ The Court held that upon a finding of materiality, it is then up to the defendant to prove that the plaintiff did not in fact rely on the material omissions.¹⁴⁵ Many subsequent district court and court of appeals decisions have followed this presumption of reliance, but have refused to extend this ruling to the extent of eliminating the reliance requirement from a Rule 10b-5 claim, even in face-to-face transactions.¹⁴⁶

C. The Need for Reform: Factors Leading to Legislative Intervention

As discussed in Part III.B, by employing such broad language as the phrases "in connection with" and "any security," section 10(b) and Rule 10b-5 reach a wide range of acts and schemes that may defraud investors.¹⁴⁷ Because of this broad statutory language, the legislature has also begun to narrow the scope of section 10(b) and Rule 10b-5 because of the fear that frivolous litigation or unfair results would occur.

Many factors caused Congress to maintain the implied liability of Rule 10b-5 in a narrow manner. Abuses of Rule 10b-5 have caused severe consequences; for example, supporters of reform assert that individuals use Rule 10b-5 to hedge the risk of investment.¹⁴⁸ Such abuse occurs when investors simply sue under Rule 10b-5 to recover from an unexpected loss.¹⁴⁹ Addi-

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

143. 406 U.S. 128 (1972).

144. *Id.* at 153-54.

145. *Id.* at 152-53.

146. *See, e.g., DuPont v. Brady*, 828 F.2d 75, 78 (2d Cir. 1987) (placing burden of rebutting the presumption of reliance on defendant lawyer); *Barnes v. Res. Royalties, Inc.*, 795 F.2d 1359 (8th Cir. 1986) (presuming reliance in face-to-face transactions).

147. *See supra* Part III.B.

148. *See* 138 CONG. REC. 23,475-80, 23,151-52 (1992) (statement of Sen. Domenici and Rep. Tauzin). Both Senator Domenici and Representative Tauzin alleged that speculators were instituting suits under Rule 10b-5 to recover investment losses. *Id.* at 23,475, 23,151. Senator Domenici further stated that an individual may employ a lawsuit investment hedge regardless of whether the stock price moves up or down, because any move in the price of a stock produces losses. *Id.* at 23,475.

149. *See id.* at 23,476; *see also Kennedy v. Josephthal & Co.*, 635 F. Supp. 399, 405 (D. Mass. 1985) (admonishing the plaintiff that Rule 10b-5 was not designed to provide recovery for an ordinary investment loss), *aff'd*, 814 F.2d 798, 806 (1st Cir. 1987).

tional abuse of Rule 10b-5 occurs when speculators coerce large settlements from defendants.¹⁵⁰

These perceived abuses of Rule 10b-5 have adversely affected the national economy.¹⁵¹ For example, the increased incidence of securities fraud litigation has discouraged experienced directors and officers from sitting on the boards of directors of publicly held corporations.¹⁵² Although Rule 10b-5 abuses do exist,¹⁵³ there are other underlying issues that are partially responsible for the perceived abuses attributed to Rule 10b-5 litigation. These underlying issues include the perception of excess litigation in society and the abuse of class action litigation.¹⁵⁴

Over the past decades, debate about the perception of litigation as a national pastime has forcefully ensued.¹⁵⁵ The love for litigation that Americans share hinders national competitiveness by discouraging the development of new products, increasing unemployment,¹⁵⁶ and flooding the courts with frivolous cases that expend judicial time and effort more appropriately reserved for meritorious suits.¹⁵⁷ Politicians and scholars have argued that Congress or the judiciary should somehow restrict access to the courts.¹⁵⁸ Consistent with this trend, litigation reform efforts have recently focused on restricting suits under Rule 10b-5, an effort that is explored in the following sections.

Supporters of Rule 10b-5 reform assert that under current principles of securities litigation, the settlement values of meritless suits are identical to meritorious ones.¹⁵⁹ This encourages frivolous litigation because the incentive for a plaintiff to bring a meritless securities fraud suit is the same as the

150. See 138 CONG. REC. at 23,475-76.

151. See *id.* at 23,475.

152. See *id.*

153. See, e.g., *Kennedy*, 635 F. Supp. at 405.

154. See *infra* notes 155-66 and accompanying text.

155. Compare WALTER K. OLSON, *THE LITIGATION EXPLOSION* (1991) (arguing that America is experiencing an increase in lawsuits whether meritorious or not), with Marc Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (and Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 UCLA L. REV. 4 (1983) (analyzing data on the way society currently processes disputes and arguing that claims that America is an overly litigious society draw upon weak scholarship and flawed policy analysis).

156. See 138 CONG. REC. at 23,475.

157. See Marc Galanter, *Pick a Number, Any Number*, AM. LAW., Apr. 1992, at 82.

158. See, e.g., Joe Queenan, *Birth of a Notion*, WASH. POST, Sept. 20, 1992, at C1 (reporting that Vice President Dan Quayle argued that litigation costs Americans \$80 billion dollars per annum); Nancy E. Roman, *Angry at Bush and Quayle, Lawyers Pour Funds to Clinton*, WASH. TIMES, Oct. 5, 1992, at A5 (reporting that Vice President Dan Quayle had argued repeatedly that there are "too many lawyers and too much litigation and that frivolous lawsuits increase medical costs, consumer costs, and insurance premiums").

159. See 138 CONG. REC. at 23,475 (1992).

incentive to bring a meritorious one.¹⁶⁰ Nevertheless, the threat of a class action heightens the vigilance of would-be defendants and promotes the enforcement of the securities laws.¹⁶¹ One author describes the importance of the class action to securities fraud litigation as “essential to the integrity of our financial markets.”¹⁶²

As discussed above, the courts have placed significant limitations on securities fraud under Rule 10b-5 by limiting its exponential scope.¹⁶³ More significantly, Congress, in the Private Securities Litigation Reform Act of 1995 (PSLRA),¹⁶⁴ sought to prevent the filing of frivolous securities fraud suits by heightening the standard for pleading scienter.¹⁶⁵ When plaintiffs reacted to PSLRA by seeking to file class actions in state courts, Congress, in the Securities Litigation Uniform Standards Act of 1998 (SLUSA),¹⁶⁶ mandated that most class actions alleging securities fraud must be filed in federal court.¹⁶⁷ The limitations placed on Rule 10b-5 suits by the courts and Congress provide a number of new weapons, such as heightened pleading, to defendants to combat securities fraud suits filed under Rule 10b-5. Nevertheless, this implied right of action is apt to continue as a fertile source of significant litigation.

1. *The Private Securities Litigation Reform Act of 1995*

In an attempt to limit the broad interpretation of section 10(b) and Rule 10b-5, Congress enacted the PSLRA.¹⁶⁸ While the PSLRA mainly focuses on meritless strike suits,¹⁶⁹ the final bill extended far beyond the regulation of frivolous litigation.¹⁷⁰ The PSLRA establishes uniform pleading stan-

160. See *id.* Securities suits that take the form of a class action have a predisposition toward abusive litigation because the merits of such cases are irrelevant. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 517 (1991). This study did not, however, single out litigation under Rule 10b-5, nor does it support sweeping reform of Rule 10b-5. *Id.*

161. See William Lerach, *Counterpoint: Class Action Suits Help Keep Predators Away*, SAN JOSE BUS. J., May 25, 1992, at 7.

162. *Id.*

163. See *supra* Part III.B.

164. 15 U.S.C. § 78u-4(b)(2) (2000); see *infra* Part III.C.1.

165. 15 U.S.C. § 78u-4(b)(2).

166. 15 U.S.C. § 77p (2000); see *infra* Part III.C.2.

167. 15 U.S.C. § 77p.

168. Stephen Muniz, Note, *The Private Securities Litigation Reform Act of 1995: Protecting Corporations from Investors, Protecting Investors from Corporations, and Promoting Market Efficiency*, 31 NEW ENG. L. REV. 655, 690 (1997).

169. See David M. Brodsky, *The Private Securities Litigation Reform Act of 1995: Principal Provisions*, in SECURITIES LITIGATION 1996, at 1265, 1267, 1283 (PLI Corp. Law & Practice Course Handbook Series No. B-958, 1996).

170. See Jeffrey Silva, *Lawmakers Bring to Floor New Securities Litigation*, RCR RADIO COMM. REP., May 26, 1997.

dards among federal courts.¹⁷¹ Thus, in order to bring a securities action in federal court the complaint must specifically set forth the facts giving "rise to a 'strong inference' that the defendant acted with the required state of mind."¹⁷² It additionally requires the complaint to specify each alleged misleading statement, why it is misleading, and to state with particularity all facts that form reasonable belief.¹⁷³

The PSLRA also prevents liability for statements made by company representatives that were not known to be false at the time they were made, or that were accompanied by meaningful cautionary statements.¹⁷⁴ Additionally, the PSLRA provides a stay on discovery during the pendency of a dismissal motion.¹⁷⁵ Congress intended the discovery provision to end the frivolous claims previously brought under the Court's broad interpretation of liability under Rule 10b-5.¹⁷⁶ Despite the goals of the PSLRA, the fact remains that it is only applicable at the federal level, leaving the states in limbo as to what the standards should be.¹⁷⁷

2. *The Aftermath: Securities Litigation Uniform Standards Act of 1998*

Although the PSLRA appeared to address legislative concerns,¹⁷⁸ a loophole enabled attorneys to initiate meritless lawsuits in state courts that Congress clearly intended to bar.¹⁷⁹ Because the heightened pleading stan-

171. See *Marksman Partners v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1311 (C.D. Cal. 1996) (indicating Congress intended to create uniform pleading standard).

172. See *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 973 (9th Cir. 1999) (quoting 15 U.S.C. § 78u-4(b)(2)).

173. 15 U.S.C. § 78u-4(b)(2).

174. *Id.* § 78u-4(b)(1)(B) (2000); see Patrick J. Coughlin & Eric A. Isaacson, *Commencing Litigation Under the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, in *SECURITIES LITIGATION 1996*, at 9, 15 (PLI Corp. Law & Practice Course Handbook Series No. B-958, 1996).

175. 15 U.S.C. § 78u-4(b)(3)(B); see John L. Latham & Jenna L. Fruechtenicht, *Securities Regulation*, 48 *MERCER L. REV.* 1677, 1687-88 (1997). A stay on discovery during the pendency of a dismissal motion is burdensome for plaintiffs because, without discovery, plaintiffs often cannot survive a defendant's motion to dismiss. See Latham & Fruechtenicht, *supra*, at 1687-88.

176. See *supra* Part III.B.

177. See Bruce G. Vanyo et al., *Securities Class Action Litigation in State Courts*, in *SECURITIES LITIGATION 1996*, at 207, 401 (PLI Corp. Law & Practice Course Handbook Series No. B-958, 1996).

178. See Denis T. Rice, *A Practitioner's View of the Private Securities Litigation Reform Act of 1995*, 31 *U.S.F. L. REV.* 283, 324 (1997).

179. See generally Nicholas E. Chimicles, *The Future of Securities Litigation Under the Private Securities Litigation Reform Act of 1995*, in 1 *SWEEPING REFORM: LITIGATING AND BESPEAKING CAUTION UNDER THE NEW SECURITIES LAWS 1996*, at 591, 616 (PLI Corp. Law & Practice Course Handbook Series No. B-923, 1996).

dards of the PSLRA only apply in federal courts,¹⁸⁰ attorneys began filing suit in state courts where the heightened standards do not apply.¹⁸¹ The result was an explosion of securities litigation in state courts.¹⁸² The PSLRA had essentially been rendered ineffective due to the ability of claimants to side step the heightened requirements by filing in state court.¹⁸³ In response, Congress passed the SLUSA, which requires removal of class actions to federal court, thereby preventing Rule 10b-5 suits in state court.¹⁸⁴

According to reform supporters, the PSLRA and SLUSA, in a combined effort, balance private civil enforcement of the securities laws with the needs of properly functioning capital markets.¹⁸⁵ Numerous examples now exist of courts implementing the heightened standards of proof of the PSLRA, dismissing actions where plaintiffs are unable to allege concrete wrongdoing and scienter, and staying state court action brought in contravention to SLUSA.¹⁸⁶ While legislative reform tactics have not ended all

180. See Vanyo, *supra* note 182, at 401.

181. See Stuart J. Baskin, *Recent Developments in State Securities, Derivative and Corporate Law*, in SECURITIES LITIGATION 449, 451 (PLI Corp. L. and Practice Course Handbook Series No. B-958, 1996).

182. See *Securities Litigation Abuses, 1997: Before the Sec. Subcomm. of the Senate Comm. on Banking, Housing and Urban Affairs*, 105th Cong. (1997) (statement of Richard I. Miller, General Counsel, American Institute of Certified Public Accountants) (reiterating that plaintiffs were still filing cases that did not meet the federal court standards in state courts and bringing about the same “coercive pressure to settle meritless claims that Congress sought to eliminate”) [hereinafter Miller Statement]; see also *Concerning the Implementation of the Private Securities Litigation Reform Act of 1995: Before the Subcomm. on Fin. and Hazardous Materials*, 105th Cong. 21 (1997) (testimony of Arthur Levitt, Chairman, SEC) (explaining that since the PSLRA created a loophole, securities litigation plaintiffs began to file in state court because of the lack of heightened pleading and the discovery stay does not apply).

183. See Miller Statement, *supra* note 182.

184. 15 U.S.C. § 77p (2000). Congress stated its objectives:

(1) the [PSLRA] sought to prevent abuses in private securities fraud lawsuits; (2) since enactment of that legislation, considerable evidence has been presented . . . that a number of securities class action lawsuits have shifted from Federal to State courts; (3) this shift has prevented that Act from fully achieving its objectives; . . . and (4) in order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA], it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits.

15 U.S.C. § 78a (2000). The SLUSA provides that any covered class action brought in state court shall be removable to the federal district court. 15 U.S.C. § 77p(c).

185. See *J.I. Case Co. v. Borak*, 377 U.S. 426, 430–32 (1964). Even the United States Supreme Court recognized early on that the SEC cannot review every public filing for evidence of fraud and that private civil enforcement efforts can be more effective. *Id.*

186. See, e.g., Colleen DeBaise, *Judge Dismisses Lawsuits Against Analyst Meeker*, WALL ST. J., Aug. 22, 2001, at C13 (describing dismissal of complaint where emphasis of

abuses in Rule 10b-5 actions, they limit the amount of frivolous securities fraud lawsuits.

IV. REASONING

In *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*,¹⁸⁷ a unanimous United States Supreme Court affirmed the United States Court of Appeals for the Tenth Circuit and held that Wharf acted fraudulently in the sale of an oral option to buy stock and that this violated section 10(b) and Rule 10b-5's prohibition against fraud in connection with the sale of a security.¹⁸⁸ The Court began its analysis in *Wharf* by stating the issue that it would address: whether selling an oral option to buy stock while secretly intending never to honor the option violated section 10(b) of the Securities Exchange Act of 1934.¹⁸⁹ The Court determined that to succeed in a Rule 10b-5 action, the plaintiff must prove that the "defendant used, in connection with the purchase or sale of a security, one of the four kinds of manipulative or deceptive devices to which the Rule refers."¹⁹⁰ Such deceptive devices mentioned in the rule include any device to defraud, any untrue statement of a material fact, any omission of material fact, and any other act to defraud.¹⁹¹

For the Court to determine whether Rule 10b-5 applied to the circumstances of this case, it had to establish what security was at issue.¹⁹² The Court held that the security at bar was not the stock for the cable system, but rather the option to purchase that stock.¹⁹³ This holding was consistent with the Securities Exchange Act of 1934's language that defines a security to include both "any . . . option . . . on any security" and "any . . . right to . . . purchase" stock.¹⁹⁴ The Court refused to give attention to Wharf's effort to deny its concession of the applicable security.¹⁹⁵

Consequently, the Court addressed the issue of whether Wharf's secret intent to not honor the oral option amounted to a "deceptive device" under

complaint was popular outcry rather than proof of wrongdoing or intent to deceive).

187. 532 U.S. 588 (2001).

188. *Id.* at 590.

189. *Id.* at 589-90.

190. *Id.* at 593; *see supra* note 8.

191. *Wharf*, 532 U.S. at 593.

192. *Id.*

193. *Id.* The Court reached this conclusion fairly easily because Wharf conceded to this point at the Tenth Circuit. *Id.* "Wharf does not contest on appeal the classification of the option as a security." *United Int'l Holdings, Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207, 1221 (10th Cir. 2000).

194. *Wharf*, 532 U.S. at 593 (quoting 15 U.S.C. § 78c(a)(10) (2000)).

195. *Id.* at 594.

section 10(b) and Rule 10b-5.¹⁹⁶ The Court split its analysis into two sub-parts: (1) whether the materially false and misleading statements were in connection with the sale or purchase of a security, and (2) whether section 10(b) applies to an oral agreement.¹⁹⁷ Wharf strongly urged that Rule 10b-5 does not apply to oral agreements and that because of the actual purchase or sale requirement in *Blue Chip Stamps v. Manor Drug Stores*,¹⁹⁸ the oral options agreement was outside section 10(b)'s coverage.¹⁹⁹ However, the Court rejected Wharf's argument because, unlike the potential purchasers of securities in *Blue Chip Stamps*, United actually purchased a security in the present case—the option to buy securities at a later date.²⁰⁰ Thus, Wharf's material misstatements were in connection with a securities transaction, and therefore, within the purview of Rule 10b-5.²⁰¹

The Court further held that there was no credible rationale to interpret Rule 10b-5 to exclude oral contracts as a protected class.²⁰² To the contrary, it specifically protects "any contract" for the sale or purchase of securities.²⁰³ The Court reasoned that oral contracts for the sale of a security are a common enforceable right.²⁰⁴ Therefore, any limits placed on oral agreements to purchase or sell securities would considerably undermine the Act's basic purpose by narrowing its scope.²⁰⁵

Next, the Court emphasized that any fraudulent scheme used in securities transactions must affect the value of the security.²⁰⁶ The Court explained that here, Wharf's secret intent not to honor United's option to purchase stock was materially misleading because a buyer presumes good faith on the part of the option's seller.²⁰⁷ Consequently, any secret reservation not to honor the option renders it valueless.²⁰⁸

The final issue the Court faced was whether interpreting Rule 10b-5 to cover oral options would cause an increase in litigation of federal securities claims that are no more than normal state law breach of contract claims.²⁰⁹ The Court distinguished the case at bar from an ordinary contract claim because Wharf actually sold United a security while intending not to honor

196. *Id.*

197. *Id.* at 593–95.

198. 421 U.S. 723 (1975); see *supra* notes 115–21 and accompanying text.

199. *Wharf*, 532 U.S. at 594.

200. *Id.*

201. *Id.* at 595.

202. *Id.*; see also 15 U.S.C. § 78c(a)(13)–(14) (2000).

203. *Wharf*, 532 U.S. at 595 (citing 15 U.S.C. §§ 78c(a)(13)–(14)).

204. *Id.*

205. *Id.*

206. *Id.* at 596.

207. *Id.*

208. *Id.*

209. *Wharf*, 532 U.S. at 596.

it, which is different than *Wharf* just failing to carry out a promise to sell securities.²¹⁰ The Court relied on the PSLRA to justify its conclusion that there is no need to protect the federal courts from excessive litigation.²¹¹ The Court held that Rule 10b-5's breadth includes an oral option for the sale of securities with the secret intent to never honor it.²¹²

V. SIGNIFICANCE

In *Wharf*, the United States Supreme Court unanimously upheld the largest Colorado jury award in history—\$67 million in compensatory damages and \$58.5 million in punitive damages, along with an additional \$75 million in post judgment interest—a total of \$200 million.²¹³ The only out-of-pocket economic loss shown by United was less than one million dollars in expenditures incurred for services rendered.²¹⁴

Most would agree that securities antifraud regulation is important—it promotes fair investment practices and encourages fair business practices. Furthermore, securities antifraud regulation seeks to increase proficiency and productivity. However, on occasion, securities regulation results in a windfall judgment such as that recovered in *Wharf*.

Rule 10b-5 was overbroad at its inception. A thirty-year trend shows that the judiciary has consistently narrowed the overly broad scope of Rule 10b-5 and its blanket language protecting victims of fraudulent practices. Congress eventually intervened fearing the adverse affects of Rule 10b-5's broad reach. In doing so, Congress passed the PSLRA and later the SLUSA. These laws protect defendants from the abusive uses of Rule 10b-5. In *Wharf*, the United States Supreme Court relied on the PSLRA and turned away from its trend of narrowly interpreting Rule 10b-5. A deeper look at the *Wharf* decision will disclose several tiers of significance. First, as a Rule 10b-5 case, *Wharf* provides for a broader reading of Rule 10b-5. Second, the Court refuses to address an important unresolved issue as to the potential federalization of basic state law breach of contract claims. Finally, the Court's holding unintentionally rewards sloppy business practices.

A. Changing Directions and Relying on the PSLRA

On a superficial level the United States Supreme Court's decision in *Wharf* is brief and unremarkable, except perhaps for the fact that it was unanimous. Nevertheless, because it was based as a policy matter on the

210. *Id.*

211. *Id.* at 597; see also *supra* Part III.C.1.

212. *Wharf*, 532 U.S. at 593–97.

213. Accola, *supra* note 66, at 1B.

214. See Brief of Petitioner at 19, *Wharf* (No. 00-347).

enactment of the PSLRA, it marks a turning point in the Court's jurisprudence with regard to Rule 10b-5 under the Securities Exchange Act of 1934. For approximately thirty years, the United States Supreme Court has narrowed the overly broad scope of Rule 10b-5, case by case.²¹⁵ In *Wharf*, the Court finally allowed the implied private right of action to rest on Congress's efforts of reform. Prior to both the PSLRA and SLUSA, the outcome of *Wharf* may have differed tremendously.

Because Congress enacted legislation requiring certain heightened requirements for pleading a Rule 10b-5 cause of action and requiring class action Rule 10b-5 suits to be brought in federal court, the judiciary does not have to decide the question of whether allowing the plaintiff to recover will open the floodgates of litigation. Furthermore, the Court is showing faith in the legislature,²¹⁶ and by doing so allows courts to focus on standardizing Rule 10b-5 by eliminating outside consequences including litigation increases and abusive class action suits as factors in the analysis. The holding in *Wharf* may encourage courts to give a more literal reading to Rule 10b-5, so long as the PSLRA's requirements can be met.

B. Misopportunity: An Important Unresolved Issue

Wharf tried making the security at issue not the oral option, but the stock in the cable system. Wharf was unsuccessful because the Court regarded the option as the security, a moot point considering that Wharf had conceded this before the Tenth Circuit.²¹⁷ This, in turn, made it relatively easy for the Court to reach its decision because the option was obviously valueless given Wharf's intent to dishonor it.²¹⁸

Every contract to sell or purchase a security, however, is not a security, and the Court's opinion does not directly answer the broader issue of whether a contractual promise to sell or purchase a security that the promisor does not intend or only conditionally intends to perform is within the scope of Rule 10b-5. Justice Breyer was not concerned that the decision in *Wharf* might federalize breach of contract actions involving the purchase or sale of securities.²¹⁹ He rejected the notion that the Court's decision would allow Rule 10b-5 claims "outside the [1934] Act's basic objectives" by allowing claims "that are in reality no more than ordinary state breach of con-

215. See *supra* Part III.B.

216. This is important given the Court's recent revival of separation of powers concerns. See generally Keith Werhan, *Checking Congress and Balancing Federalism: A Lesson from Separation-of-Powers Jurisprudence*, 57 WASH. & LEE L. REV. 1213, 1215 (2000).

217. *Wharf*, 532 U.S. at 593.

218. *Id.* at 596.

219. *Id.*

tract claims.²²⁰ The Court then, by relying on the PSLRA, actually moved away from its intended purpose. Because of *Wharf*, there will be an increase in federal lawsuits for acts that are merely state breach of contract claims.

C. Rewarding Sloppy Business Practices: An Unintended Consequence

Finally, the United States Supreme Court rewarded United for acting recklessly and sloppily in its business dealings. Both parties, Wharf and United, are sophisticated companies that have been in similar dealings throughout their course of business with each other. Despite its experience, United never managed to get an oral agreement amounting to such great proportions—partial ownership of the Hong Kong cable system—in writing, and in fact only signed the agreement that identified United as an independent contractor.²²¹ Both companies had many opportunities to reach a compromise, and each time failed to do so. This lack of reaching a written agreement is clear evidence that the parties never reached the mutual assent required to form an enforceable oral options contract. United, without any concrete confirmation such as a written agreement, continued to render services to Wharf. Moreover, Wharf explained that it required approval of its board before United could obtain any ownership rights in the cable system.²²² The facts clearly show that Wharf never obtained approval from its board.²²³ Nevertheless, the United States Supreme Court, with another agenda, rewarded United in order to show its reliance on the PSLRA and to depart from its earlier trend of narrowly interpreting the scope of Rule 10b-5. Sometimes, cases that seem rather easy and clear may lead to a bad result, such as ruling in favor of an irresponsible company.²²⁴ In *Wharf*, the United States Supreme Court affirmed a \$200 million windfall judgment and by doing so disregarded the fact that United acted recklessly and sloppily.²²⁵

*Bhavik R. Patel**

220. *Id.*

221. *United Int'l Holdings, Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207, 1215–16 (10th Cir. 2000).

222. *Id.* at 1218.

223. *Id.* at 1219.

224. United's cost for relying on the oral agreement was only one million dollars, and *Wharf* affirmed a nearly \$200 million jury verdict in its favor. *See supra* text accompanying notes 218–19.

225. *Id.*

* J.D. expected May 2003; M.B.A. in Strategic Management expected August 2003, Illinois Institute of Technology, Stuart School of Business; B.B.A. in Finance, December 1999, Georgia State University, summa cum laude. The author would like to thank Professors Frances Fendler and Erica Beecher-Monas for their valuable insight and helpful comments. The author also thanks the editorial board, especially Jennifer L. Wethington, and the

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