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Ninth Circuit Review—Recent Ninth Circuit Developments in Securities Law

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RECENT NINTH CIRCUIT DEVELOPMENTS IN SECURITIES LAW

I. The Definition of a Security Under the 1933 and 1934 Securities Acts

A. Introduction

In the years immediately following the Great Depression, an increasing concern arose for the regulation and control of securities activities. The Securities Act of 1933 (1933 Act)[1] and the Securities Exchange Act of 1934 (1934 Act)[2] were the initial products of this concern.

The main thrust of the 1933 Act was to regulate public offerings of securities by requiring the registration of most securities prior to their offer and sale.[3] For the purposes of the 1933 Act,

> The term "security" means any note, stock, treasury stock, 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," 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.[4]

The 1934 Act, primarily concerned with antifraud provisions, created the Securities Exchange Commission and extended federal regulation to reach the trade of securities that were already issued and outstanding. A potential controversy arose when the language used to define "securities" in the 1934 Act varied in several ways from the language in the 1933 Act.[5] However, the definition of "security" provided

1. 15 U.S.C. §§ 77a-77bbbb (1971 & Supp. 1972-1979).
2. 15 U.S.C. §§ 78a-78kk (1971 & Supp. 1972-1979).
3. Prior to the Securities Exchange Act of 1934, administration of the 1933 Act was assigned to the Federal Trade Commission.
4. 15 U.S.C. § 77b(1) (1977).
5. As provided in the 1934 Act,

[t]he term "security" means any note, stock, treasury stock, bond, debenture, certif-

in the 1934 Act was declared to be "virtually identical" to that of the 1933 Act and was subsequently treated as such.[6]

However, this did not quell the growing controversy over the language of the two Acts. The definitions, patterned after the early state blue sky regulations,[7] did not purport to contain exclusive, rigid catalogues of security transactions, but, rather, were broad enough to allow the courts great latitude in their interpretation. Thus, present day courts have been able to employ those same definitions created in the early 1930's when confronting the problem of defining the extent and scope of today's complex, multi-level financial schemes. In establishing boundaries for elusive concepts such as "investment contracts," the courts have responded by providing continually expanding readings of "security."

B. Early Decisions

1. *SEC v. Joiner Leasing Corp.*

In *SEC v. Joiner Leasing Corp.*,[8] the Supreme Court was called upon for the first time to determine whether a particular transaction was governed by the Securities Acts. The case involved the sale of assignments of oil leases. The leases were granted with the agreement that a test well would be drilled by the lessees. The Joiner Corporation undertook to finance the drilling, and initiated a mail campaign to encourage investment in the project. Suit was brought when the securities were not registered with the Securities and Exchange Commission.

In analyzing the transaction, the Court rejected defendant's argument for the employment of the *ejusdem generis* rule,[9] as well as for the

icate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10) (1977).

6. Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967).

7. For an interesting discussion of one such state regulation, see Brown, *The Minnesota "Blue Sky" Law*, 3 MINN. L. REV. 149 (1919).

8. 320 U.S. 344 (1943).

9. Where general words follow an enumeration of persons or things, by words of a particular and specific meaning, such general words are not to be construed in their widest extent, but are to be held as applying only to persons or things of the same general kind or class as those specifically mentioned.

maxim *expressio unius est exclusio alterius*.[10] Instead, the Court laid the foundation for all future cases by declaring that the test for construing an investment contract should be determined not by the label that is placed upon it, but, rather, by "what character the instrument is given in commerce by terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."[11] These factors, examined in light of congressional intent in enacting the Acts, led the Court to find the transaction involved a security.

2. The *Howey* Test

A broad construction of the term "investment contract" was later solidified in the landmark case of *SEC v. W.J. Howey Co.*[12] W.J. Howey Company had offered certain citrus groves for sale to the general public. An affiliated company, Howey-in-the-Hills Service, Inc., was advertised as a service company able to provide for the cultivation and development of the groves. Prospective customers were not obligated to contract with both companies, but Howey Company stressed the superiority of its affiliate in providing service and told customers that it was not feasible to invest in a grove unless service arrangements were made. Because it was impractical for most purchasers to participate in the development of their own land because of their lack of sophistication, absenteeism, and the economic difficulties of piecemeal farming, eighty-five percent of the acreage sold was covered by service contracts with Howey-in-the-Hills Service, Inc.

In determining that such an arrangement constituted an investment contract, the Court examined and relied upon early "blue sky" laws and reinforced the method of analysis used in *Joiner*. The Court called for "a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[13] However, the Court ventured beyond *Joiner*, instituting a controversial and much discussed standard:

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby [1] a person

BLACK'S LAW DICTIONARY 608 (4th ed. 1968).

10. The mention of one is the exclusion of the other. *Id.* at 692. In this particular instance, Joiner Corporation argued that sales of leasehold subdivisions by the acre should be excluded from the definition of security because the statute expressly included sales of leasehold subdivisions by undivided shares. 320 U.S. at 350.

11. 320 U.S. at 352-53.

12. 328 U.S. 293 (1946).

13. *Id.* at 299.

> invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[14]

This black letter test was readily adopted by the lower courts. Early cases in the Ninth Circuit were quickly resolved by a literal application of the test, despite its incorporation of vague concepts such as "common enterprise."[15] However, the mechanical application of the test drew increased criticism as financial schemes grew increasingly complex. Many critics contended that the courts had created an arbitrary definition of investment contract that had become rigid and fixed through judicial interpretation, and had failed to expand with the financial schemes of the day.[16] It soon became readily apparent that some modifications in the application of the test would be required if the test were to remain a useful tool in defining securities.

Evolving modifications to the *Howey* test can be identified in the two subsequent cases decided by the Supreme Court regarding investment contracts. In *SEC v. Variable Annuity Life Insurance Co.* (VALIC),[17] the Court had to decide whether a variable annuity contract was a security under the 1933 Act. A standard fixed annuity contract offers the annuitant a specified amount per annum. Such contracts are exempt from the 1933 Act.[18] However, the variable annuity contract at issue entitled the annuitant to fluctuating amounts based upon pro rata participations in the company's investment portfolios and in the gains and losses thereon.

In a five to four decision, the Court held that the transaction did involve an investment contract. The importance of the decision lies in the means of analysis, which, for the first time, focused on the economic reality of the transaction in terms of the allocation of risk assumed by the investor.[19] The Court found that a variable annuity

14. *Id.* at 298-99.

15. *E.g.*, Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961) (evidence including terms of defendants' offer, plan of distribution, economic inducement held out to prospects and common enterprise supported finding that defendants' sales of second trust deeds constituted sales of securities).

16. *E.g.*, Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367 (1967); Long, *An Attempt to Return Investment Contracts to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

17. 359 U.S. 65 (1959).

18. Under 15 U.S.C. § 77c(8) (1977), conventional life insurance and annuity packages are exempt from the 1933 Act, with sole control being delegated to the states.

19. Justice Harlan's dissent, which was joined by Justices Frankfurter, Clark, and Whit-

contract places all of the investment risk on the annuitant and none on the company. This placed the contract outside of the conventional concept of "insurance" which involves some investment risk on the part of the company.

Having decided that some investment on the part of the company was required, the Court was next confronted with the problem of what degree of risk or investment was necessary to place the transaction within the concept of "insurance," rather than "security." In *SEC v. United Benefit Life Insurance Co.*,[20] a Flexible Fund Annuity contract was involved that was similar to the transaction in VALIC. The contract provided for a deferred or optional annuity plan, under which the purchasers agreed to pay a fixed monthly premium for a certain number of years, the funds being invested in common stocks to produce capital gains as well as interest return. The cash value of the purchaser's interest could be withdrawn before maturity, or at maturity could be used to purchase a conventional fixed dollar annuity. The purchaser was also entitled to an alternative guaranteed minimum cash value which gradually increased from fifty percent of the net premiums the first year to one hundred percent of the net premiums after ten years.

Rejecting arguments that the guaranteed minimum provision in shifting part of the risk from the purchaser to the company brought the transaction within the insurance exemption, the Court found that the accumulation provision of the Flexible Fund constituted an investment contract. The Fund appealed to the puchaser "not on the usual insurance basis of stability and security but on the prospect of 'growth' through investment management."[21]

The importance of these two cases lies in the reasoning of the Court. Rather than mechanically applying the relevant statute, the Court gave an indication that it might be willing to expand its means of analysis by examining the economic reality of the transactions rather than the labels that were placed upon them. Specifically, the Court focused its concern upon the undisclosed risk of loss to the participants in the plans. This focus allowed for the broader and more pervasive means of analysis that was to follow in applying the *Howey* test to future cases.

A significant segment of the evolutionary process away from the

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taker, urged a more mechanical application of the statute so as to protect the tradition of state regulation and federal abstention in this area. 359 U.S. at 93.

20. 387 U.S. 202 (1967).

21. *Id.* at 211.

literal application of the test and toward a broader approach has occurred in other courts. In the landmark California case of *Silver Hills Country Club v. Sobieski*,[22] Justice Traynor first articulated the concept of "risk capital," a concept that was to be a crucial element in subsequent cases.

Silver Hills involved the promotion of a country club in which funding was sought through the sale of memberships. The promoters of the club had provided a downpayment of $400.00 on a contract to purchase a twenty-two acre ranch for $75,000.00. The remaining funds were to be procured through the sale of memberships that entitled members to the use of all club facilities. The promoters contended that the memberships did not constitute securities, in that membership was not a beneficial interest in property since it offered no rights in either the assets or income of the club. Rather, the promoters asserted that the memberships were purchased for the use and enjoyment of the purchaser, not for investment purposes.[23]

Had the California Supreme Court employed a strict application of the *Howey* test, the plan would have failed to qualify under the classic definition of security, because the members of the public who had invested their money had no expectation of profit. However, choosing substance over form in applying that state's definition of security,[24] the court focused upon the newly created concept of "risk capital." In deciding that "the act extends even to transactions where capital is placed without expectation of any material benefits,"[25] the court ruled that the Act's "objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another."[26] In departing from *Howey*, the court stated that since "the act does not

22. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

23. *Id.* at 814, 361 P.2d at 907, 13 Cal. Rptr. at 187.

24. CAL. CORP. CODE § 25008 (West 1960) defined a security as follows:

"Security" includes all of the following:

(a) Any stock, including treasury stock; any certificate of interest or participation; any certificate of interest in a profit-sharing agreement; any certificate of interest in an oil, gas, or mining title or lease; any transferable share, investment contract, or beneficial interest in title to property, profits, or earnings.

(b) Any bond; and debenture; any collateral trust certificate; any note; any evidence of indebtedness, whether interest-bearing or not.

(c) Any guarantee of a security;

(d) Any certificate of deposit for a security.

This section was subsequently repealed by statute in 1968 Cal. Stats. ch. 88, § 1. The subject matter of the amended section is now covered in CAL. CORP. CODE § 25019 (West 1977).

25. 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.

26. *Id.* 361 P.2d at 908-09, 13 Cal. Rptr. at 188.

make profit to the supplier of capital the test of what is a security," the court would not be bound by that criterion.[27] Thus, the court refused to conform to the rigid, mechanical application of the *Howey* criteria, preferring to employ their own flexible standards that examine the substance of the transaction in light of the relevant circumstances.

The erosion of the *Howey* test expanded into the federal courts with the decision in *SEC v. Glenn W. Turner Enterprises*[28] and its companion case, *Hurst v. Dare to Be Great, Inc.*[29] In *Turner*, a strict construction of the *Howey* requirement that there be "an expectation of profits solely from the efforts of a promoter or third party" was rejected in favor of a flexible, "realistic" analysis. *Turner* involved a pyramid plan in which self-improvement contracts were offered to buyers, who, in return, had the opportunity of earning commissions on the sale of contracts to others. After an initial investment of their own money, the buyers were obligated to contribute their own efforts in procuring other prospective buyers, and bringing them to sales meetings, where, in a revival meeting atmosphere, they were shown the "true ways" to make easy money.

In analyzing the status of this venture, the court was troubled with the word "solely" that served to qualify that segment of the *Howey* test dealing with the expectation of profits to come from the efforts of others. Contrary to the facts of *Howey* (where the investor's role began and ended with the purchase of the citrus groves), in *Turner*, "the investor, or purchaser, [had to] exert some efforts if he [were] to realize a return on his initial cash outlay . . . [thus] the returns or profits [were] not coming 'solely' from the efforts of others."[30] If the investor did not use his own initiative and skills to attract new investors, he would receive no commissions. Originators of the plan contended that under a strict application of the "solely from the efforts of others" criterion, the plan was excluded, since the investor was forced to use his own efforts as well, if he were to make a profit. In rejecting the literal limitations of the original *Howey* test, the court in *Turner* chose to "adopt a more realistic test—whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[31]

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27. *Id.*

28. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

29. 474 F.2d 483 (9th Cir. 1973).

30. 474 F.2d at 482.

31. *Id. But see* Chapman v. Rudd Paint & Varnish Co., 409 F.2d 635, 641 (9th Cir. 1969) (distributorship agreement wherein the investor was required to "carry on the sale and distribution of PRODUCT" was held not to be a security because the profits were not ob-

The court in *Turner* sought a middle-of-the-road course between a literal reading of *Howey* and the adventuresome "risk capital" approach of *Silver Hills*. In doing so, the court relied upon the then recently decided Supreme Court opinion in *Tcherepnin v. Knight*.[32] In *Tcherepnin*, the Court found withdrawable capital shares in a savings and loan association to be securities under the 1933 and 1934 Acts. In that decision, the Court reaffirmed the emphasis on broad construction of the securities "catalogue" found in the Acts, and on the adoption of a flexible standard in which "form should be disregarded for substance and the emphasis should be on economic reality."[33]

Similarly, in *Turner*, the Ninth Circuit, while criticizing strict construction of the test,[34] explicitly cautioned that its decision did *not* represent a "major attempt to redefine the essential nature of a security . . . [n]or [did it] represent any real departure from the Supreme Court's definition of an investment contract as set out in *Howey*."[35] The court made it clear that its decision was a restricted one, holding that "the requirement that profits come 'solely' from the efforts of others would, in circumstances such as these, lead to unrealistic results if applied dogmatically, and that a more flexible approach is appropriate."[36]

In 1975, the Supreme Court had the opportunity to re-examine the procedure for defining a security and to consider the numerous modifications that had been proposed. In *United Housing Foundation, Inc. v. Forman*,[37] eligible prospective tenants were induced to purchase certain shares of stock, which would entitle them to rent an apartment in a state subsidized non-profit housing development. When allegations of fraud arose, the Court was called upon to determine whether or not the transaction fell within the scope of the 1933 or 1934 Acts.

The United States Court of Appeals for the Second Circuit, in reversing the district court, applied a literal approach, holding that since the shares purchased were called "stock," they clearly fell within the Securities Acts which explicitly included "stock" in their definitional

tained "solely" from the efforts of others). Although it was decided only four years earlier, the court made no mention of the *Chapman* case in its decision in *Turner*.

32. 389 U.S. 332 (1967).

33. *Id.* at 336.

34. 474 F.2d at 482.

35. *Id.* at 483.

36. *Id.* The decision in *Hurst*, the companion case, summarily followed the *Turner* analysis.

37. 421 U.S. 837 (1975).

sections.[38] In reversing the court of appeals, the Supreme Court rejected such a literal reading of the Acts, urging an analysis of the "the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties."[39] While the name attached to an instrument should not be determinative, it could still play some role in the analysis along with the other factors. In returning to familiar language, the Court noted that "[t]he touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."[40]

Forman proved to be significant in many regards. For the first time, the Supreme Court had recognized a particular transaction as falling outside the ambit of "securities." Yet at the same time, the Court acted to explicitly reject employment of a strict literal approach.

However, many questions remained unanswered by the Court. *Forman* had provided the Court with its first opportunity to adopt the "risk capital" approach[41] as a replacement or alternative to the profit factor enunciated in *Howey*. However, the Court failed to comment on the approach, contending that it did not apply to the case at bar because "[p]urchasers of apartments in co-op city take no risk in any significant sense."[42] Thus, the exact status of the risk capital approach was left unresolved,[43] as was the status of the literal approach as formerly employed by the Second Circuit. The *Howey* test had been reaffirmed, along with an emphasis on the economic reality of the transaction in question. However, no firm standards had been elucidated, leaving the circuits free to continue their varied attempts at interpreting the test.

C. Recent Developments

1. The general reaction to *Forman*

Because the Supreme Court did not establish a narrow, definitive standard for application of the test, the circuit courts have adopted three different approaches in defining the scope of the early acts.

38. Forman v. Community Servs., Inc., 500 F.2d 1246 (2d Cir. 1974).
39. 421 U.S. at 851-52.
40. *Id.* at 852.
41. This approach, as first adopted in *Silver Hills*, had gained added support in El Khadem v. Equity Sec. Corp., 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974).
42. 421 U.S. at 857 n.24. The Court reasoned that if the purchasers were dissatisfied with their apartments, they could recover their initial investment in full.
43. *See generally*, 9 LOY. L.A.L. REV. 206 (1975).

The Second Circuit, in *Exchange National Bank of Chicago v. Touche Ross & Co.*,[44] refused to be rebuffed, declaring that "taking full account of the anti-literalist approach of the *Forman* opinion . . . the best alternative now available may lie in greater recourse to the statutory language."[45] In *Touche Ross*, a bank had purchased three unsecured long-term promissory notes from a brokerage firm to secure a loan. When the notes became worthless, the bank sought damages from Touche Ross claiming that the financial soundness of the brokerage firm had been represented and alleging that the notes were securities. The court held that since the 1933 Act included "notes" within its definition, this transaction involved a security.[46]

In making this determination, the Second Circuit focused on the prefacing clause of the 1933 Act, which provided that the catalogue of listed terms defining security was to be applicable "unless the context otherwise required."[47] In construing this clause, the Second Circuit served notice that it would reinstate its literal approach " 'unless the context otherwise required.' "[48] The court then proceeded to list six instances when the context would require that a note issued would not be deemed a security.[49] In this particular case, the party asserting that the note was not within the 1934 Act had not met "the burden of showing that the context did so require."[50] In formulating this literal, categorical approach, the court expressly rejected the commercial-investment note[51] and risk capital tests employed in other circuits, contending that while the literal "approach does not afford complete certainty . . . it adheres more closely to the language of the statutes and it may be somewhat easier to apply than the weighing and balancing of recent decisions of sister circuits."[52]

In contrast to the literal approach, an "investment-commercial" analysis has been adopted by the Third, Fifth, Seventh and Tenth Cir-

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44. 544 F.2d 1126 (2d Cir. 1976).
45. *Id.* at 1137.
46. *Id.* at 1137-38.
47. Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1977).
48. 544 F.2d at 1137 (quoting 15 U.S.C. 77b (1976)).
49. *Id.* at 1138. The list consists of a

> 1) note delivered in consumer financing; 2) note secured by a mortgage on a home; 3) short-term note secured by a lien on a small business or some of its assets; 4) note evidencing a "character" loan to a bank customer; 5) short-term note secured by an assignment of accounts receivable; 6) note which simply formalizes an open-account debt incurred in the ordinary course of business.

Id.

50. *Id.* at 1137-38.
51. See note 53 *infra* and accompanying text.
52. 544 F.2d at 1138.

cuits.[53] This dichotomous analysis views the 1934 Act as encompassing all investment notes no matter how long their maturity. The prime factor for consideration is whether the note was issued to facilitate the sale of property. If so, it is deemed to be commercial, and outside the ambit of "security." Thus, the commercial category generally includes notes issued to a bank as security for a loan or notes issued to purchase some asset. Both this approach and the literal approach look to context over form in making the final determination and the results are usually similar.[54]

2. The Ninth Circuit

In formulating its test, the Ninth Circuit opted for an approach that would "analyze the nature and degree of risk accompanying the transaction to the party providing the funds."[55] Although the Supreme Court had refused to explicitly employ such a standard in *Forman*,[56] the Ninth Circuit drew from the risk-focused analysis in the *VALIC*[57] and *United Benefit Life*[58] decisions, as well as from its own decisions in *El Khadem v. Equity Securities Corp.*[59] and *SEC v. Glenn W. Turner Enterprises*,[60] in devising a formula: the "ultimate inquiry is whether [the party providing funds] has contributed 'risk capital' subject to the 'entrepreneurial or managerial efforts' of" others.[61]

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53. *E.g.*, McGovern Plaza Joint Venture v. First of Denver, 562 F.2d 645, 647 (10th Cir. 1977) (neither a construction loan commitment nor a permanent loan commitment purchased by a real estate developer in the normal course of business were securities); C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354, 1362-63 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975) (notes secured by chattel mortgages given to bank by the buyer and not given to seller as an earnest money deposit were ordinary commercial paper and not securities); McClure v. First Nat'l Bank, 497 F.2d 490, 495 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) (one year promissory note and deed of trust issued for a bank loan alleged to be needed to pay the corporate obligations of a closely-held corporation held not to be securities); Lino v. City Investing Co., 487 F.2d 689, 694 (3d Cir. 1973) (promissory note to pay for purchase of franchise agreement not a security).

54. *E.g.*, Exchange Nat'l Bank v. Touche Ross, 544 F.2d at 1138 (the court, employing a literal approach, expressly stated that its decision would be the same under a "commercial-investment" analysis). *See also* Comment, *Commercial Notes and Definition of 'Security' Under Securities Exchange Act of 1934: A Note is a Note is a Note?* 52 NEB. L. REV. 478 (1973).

55. Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1256 (9th Cir. 1976).

56. 421 U.S. at 857 n.24 (risk capital approach not applicable because "[p]urchasers of apartments in Co-op City take no risk in any significant sense").

57. 359 U.S. at 71-72.

58. 387 U.S. at 210-11.

59. 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974).

60. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

61. 532 F.2d at 1257.

In *Great Western Bank & Trust v. Kotz*,[62] the defendant obtained a line of credit from a bank, executing an unsecured promissory note to the bank in return. When the defendant subsequently declared bankruptcy, the bank sued to recover a portion of its losses. In finding this transaction not to involve securities, the court identified six factors that were to aid in framing the ultimate question.[63] The first and most important of these was time (*i.e.*, the longer the funds were used by another, the greater the risk of loss). The second factor to be considered was the existence collateral and its extent. A third concern was the form of the obligation, which could aid in determining the circumstances of issuance of the obligation. The fourth factor was the circumstances of issuance. The fifth factor was based upon the relationship between the borrowed amount and the size of the borrower's business; thus the larger the amount, the greater the risk. Finally, an examination of the contemplated use of the proceeds was required. These factors were not held to be exclusive, nor was any one factor judged to be dispositive, but taken together, they formed the core for analysis in differentiating between a "risky loan" and "risk capital."[64] Thus, in framing the risk capital approach, the Ninth Circuit seemed to be using *Howey* as a basic foundation, while placing added emphasis upon the "profits solely from the efforts of others" criterion. It then employed the six listed factors to aid in narrowing the focus upon the "risk capital" element of the *Howey* requirement.

In *United California Bank v. THC Financial Corp.*,[65] the Ninth Circuit had its first opportunity to apply its new risk capital formulation. In *United California Bank*, the court found that a corporation's agreement to purchase on demand all notes accepted by a bank as security for credit advances extended to another business did not constitute a security. In discussing the six-prong risk capital analysis as developed in *Kotz*, the court characterized it as a combination of an "economic realities standard" with an emphasis on *Howey*'s expectation of profits from the entrepreneurial efforts of others.[66] After applying the various indicia of risk capital to the facts, the court determined that the notes were short-term, payable only to the payee, payable upon demand and limited in their distribution. Thus, the court was ultimately able to conclude that there was an absence of the risk capital

62. 532 F.2d 1252 (9th Cir. 1976).
63. *Id.* at 1257-58.
64. This is a distinction that the court finds analogous to the "commercial-investment dichotomy" employed by other circuits. *Id.*
65. 557 F.2d 1351 (9th Cir. 1977).
66. *Id.* at 1358.

necessary to constitute the existence of a security.[67]

A limitation on the expansiveness of the test soon appeared in *United States v. Carman*.[68] This was a criminal action involving the owner of a chain of vocational training schools. The schools were exclusively financed by direct federal grants and by the sale of packages of Federally Insured Student Loans (FISL) to various financial institutions. FISL packages were sold to several credit unions in excess of federal limitations that had been placed on the school's loan commitment. In addition, the credit unions had not been informed of the school's precarious financial position.

In the resulting action for fraud, the Ninth Circuit declined to utilize the risk capital test, limiting its application to situations "where the underlying question is whether the 'investor' actually *invested* in a security, or in essence made a commercial loan."[69] Retreating to a basic *Howey* approach, the court found that the FISL packages included both a service contract and repurchase agreements and were represented to the credit unions as an "integrated investment package." Declaring the *Howey* criteria to have been satisfied, the court concluded that the transaction was an investment contract within the Securities Act.

However, in the Ninth Circuit's next securities decision, *Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc.*,[70] the *Kotz* test resurfaced. The parties to the action had entered into a building loan agreement whereby a shopping center owner executed a promissory note to Amfac Mortgage Corp. (Amfac). Amfac was to make periodic advances on the principal amount of the promissory note depending upon the degree of completion of the shopping center. Guarantees for payment and for completion were also secured by Amfac. Upon default, Amfac brought suit, alleging that the note and the guarantees were each securities, and that the entire transaction taken together constituted an investment contract.

Applying the *Kotz* test, the court stated that although the note was due and payable twenty-four months after the date of execution, disbursements by Amfac were dependent upon the progress of construction. Thus, only a portion of Amfac's money was actually at risk for

67. *Id.* at 1359.
68. 577 F.2d 556 (9th Cir. 1978).
69. *Id.* at 563 n.9. Neither party contended that the purchase of FISL packages by the credit unions was actually a loan to the schools in that federal credit unions are prohibited by law from making loans to anyone other than their own members.
70. 583 F.2d 426 (9th Cir. 1978).

the entire twenty-four month period.[71] The court also found that the loan had been secured, thereby creating less risk since the lender could look to the collateral in the event of nonpayment. The form and circumstances surrounding the transaction supported the existence of a lender-borrower relationship. Thus, in its totality, the economic realities of the transaction failed to establish that the lender had contributed risk capital subject to the entrepreneurial or managerial efforts of others. Amfac had simply made a construction loan to finance a shopping center, and any note given to the lender in the course of such a commercial financing transaction was outside the scope of the federal securities laws.[72]

In the decisions following *Amfac Mortgage*, the Ninth Circuit again did not invoke the six-pronged *Kotz* test, opting instead for the *Howey* test. In *United Sportfishers v. Buffo*,[73] the court held that a land sale contract and promissory note given as consideration for the sale of a sportfishing vessel constituted a non-investment commercial dealing with no expectation that the land or holdings would increase in value as a result of the managerial skills of another. Thus, the federal securities laws were deemed inapplicable.

Peyton v. Morrow Electronic, Inc.[74] involved an employment contract whereby a marketing manager was to receive a cash salary as well as a percentage of gross sales for the year, in return for his services. The court, making an obligatory acknowledgement of *Howey*, summarily dismissed any notion that this agreement constituted an investment contract, noting that the "investment" was one of services, not money, and that appellant's own managerial efforts played a substantial role, contrary to *Howey*'s emphasis on expecting profits "solely" from the efforts of others.[75] This differentiation between cash and services is in contrast to dicta in *Forman*,[76] and has since been explicitly rejected by the Supreme Court.[77]

In *Brodt v. Bache & Co., Inc.*,[78] the Ninth Circuit determined the status of a discretionary commodities trading account that the appellant had with a national brokerage house. Once again relying solely on *Howey*, the court found that the only point of debate was whether or

71. *Id.* at 432.
72. *Id.* at 434.
73. 597 F.2d 658 (9th Cir. 1978).
74. 587 F.2d 413 (9th Cir. 1978).
75. *Id.* at 414-15.
76. See note 42 *supra* and accompanying text.
77. International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979).
78. 595 F.2d 459 (9th Cir. 1978).

not a common enterprise existed. In examining this question, the court embarked upon its first extended discussion of the virtues of "horizontal" commonality versus "vertical" commonality since its decision in *Turner*.

In *Turner*, the court had defined a "common enterprise" as one in which the "fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."[79] This definition was at odds with the concept of horizontal commonality that had developed in the Seventh Circuit, requiring a pooling of investments in order to comprise a common enterprise.[80]

The Ninth Circuit rejected any concept of horizontal commonality, preferring a vertical commonality that evolved from decisions in *Turner* and in *Hector v. Wiens*.[81] In *Brodt*, the court defined vertical commonality as requiring only "that the investor and the promotor be involved in some common venture without mandating that other investors also be involved in that venture."[82] The definition follows the lead of Fifth Circuit decisions that have also adopted this position.[83]

In applying the definition to the case at bar, the court determined that the enterprise was a "solitary" one. Profits were not shared, nor did the value of the investment depend upon the ability or the efforts of the brokerage house. "Merely furnishing investment counsel to another for a commission, even when done by way of a discretionary commodities account, does not amount to a 'common enterprise.' "[84]

This concept of common enterprise was further reinforced by the recent decision in *Smith v. Gross*.[85] Defendants solicited investment in an earthworm farm by representing that earthworms were easy to raise, would multiply at a rate of sixty times per year, and that defendants would repurchase the worms at a rate of $2.25 per pound. After investing, plaintiff discovered to his dismay, that earthworms multiplied only eight times per year, and that defendants' ability to repurchase the

79. 474 F.2d at 482 n.7.

80. *E.g.*, Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 276 (7th Cir. 1972); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 101 (7th Cir. 1977) (both cases held that a discretionary commodities account was not a security).

81. 533 F.2d 429 (9th Cir. 1976).

82. 595 F.2d at 461.

83. *See* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478 (5th Cir. 1974) (critical factor in the common enterprise test "is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts."); SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (discretionary commodities trading account is an investment contract).

84. 595 F.2d at 462.

85. 604 F.2d 639 (9th Cir. 1979).

worms at $2.25 per pound was dependent upon luring new investors into the scheme and selling to them at inflated prices. The court rejected defendants' contention that the arrangement was a franchise agreement and held the transaction to be an investment contract subject to the securities laws.[86]

In dealing with the question of common enterprise, the court found that although plaintiffs were free to sell the worms to any prospective buyer, they could realistically only realize a profit by selling them back to the defendants, who in turn depended upon selling them to additional investors at inflated prices. The court concluded that "the fortune of the Smiths was interwoven with and dependent upon the efforts and success of the defendants."[87] The court's further finding, that the efforts of those other than the investor were the undeniably significant ones, satisfied the remaining *Howey* criterion, establishing the transaction as an investment contract.[88]

3. *International Brotherhood of Teamsters v. Daniel*

In early 1979 the issue of whether pension plans as securities came to the forefront with the long awaited Supreme Court decision in *International Brotherhood of Teamsters v. Daniel*.[89] At issue was whether the 1933 or 1934 Act applied to a pension plan that came under a collective-bargaining agreement between the Teamsters and certain trucking firms. The plan was compulsory although employees did not make contributions to it. The employees did not have the option of receiving the employer's contribution directly. To become eligible, an employee was required to have completed twenty years of continuous service.

One month following his retirement, Daniel was informed that he was ineligible for any retirement benefits due to a four-month layoff period that had occurred twelve years earlier. He then proceeded to bring suit against the union and the pension plan trustees, alleging that they had misrepresented and omitted to state material facts with respect to the plan's vesting requirements, and that such misrepresenta-

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86. *Id.* at 643. The Ninth Circuit had held that franchise agreements are not securities. *E.g.*, Bitter v. Hoby's Int'l, Inc., 498 F.2d 183 (9th Cir. 1974). *Smith v. Gross* was distinguished from this case on the basis that the ultimate buyer was the offering party rather than the consuming public, and that the investors were not solely responsible for their own success. 604 F.2d at 643. Interestingly enough, this latter argument, taken from *Howey*, was often used by the court prior to the decision in *Turner* to exclude certain transactions from being considered securities.

87. 604 F.2d at 643.

88. *Id.*

89. 439 U.S. 551 (1979).

tions constituted violations of section 10(b) of the Securities Exchange Act of 1934, Securities and Exchange Commission's Rule 10b-5, and section 17(a) of the Securities Act of 1933. The district court, after denying defendants' motion to dismiss, found that the plan had created an investment contract, and thus, that the Securities Acts were applicable.[90]

On appeal, the Seventh Circuit affirmed, using a three-tiered analysis.[91] First, the court found that the plan satisfied the *Howey* requirements for establishing an "investment contract."[92] Second, the court noted that the economic reality of the circumstances supported this conclusion.[93] Finally, the court analyzed the prior legislative history of the 1933 and 1934 Acts and decided that it did not demand a contrary result, but rather, supported the decision.[94]

In applying *Howey*, the Seventh Circuit found that the requirement calling for an investment of money had been met due to the contribution to the plan, by the employer, of compensation that would otherwise have gone to the employee.[95] A common enterprise was achieved by the horizontal commonality among the various employees holding the pension interests.[96] The expectation of profit requirement was satisfied due to the employees reliance on retirement benefits.[97] The final requirement that profits be derived solely from the efforts of others was conceded by both sides, and thus was not discussed by the court.[98]

On certiorari, the Supreme Court took a different view of the situation, reversing the Seventh Circuit, and holding that the 1933 and 1934 Acts did not apply to a noncontributory, compulsory pension plan.[99] The means of analysis remained the same, but the results were radically altered.

Once again, the first analytical tool employed was the *Howey* test. In first determining whether there had been an investment of money,

90. 410 F. Supp. 541 (N.D. Ill. 1976), *aff'd*, 561 F.2d 1223 (7th Cir. 1977), *rev'd*, 439 U.S. 551 (1979).
91. 561 F.2d 1223 (7th Cir. 1977).
92. *Id.* at 1231.
93. *Id.* at 1235-37.
94. *Id.* at 1237-41.
95. *Id.* at 1232.
96. *Id.* at 1233.
97. *Id.* at 1236.
98. *Id.* at 1233 n.21. For an extensive analysis of the Seventh Circuit's decision, see, Note, *Interest in Pension Plans as Securities*: Daniel v. International Brotherhood of Teamsters, 78 COLUM. L. REV. 184 (1978).
99. 439 U.S. at 558-71.

the Court asserted that in all previous relevant cases, "the person found to have been an investor chose to give up a specific consideration in return for a separable financial interest with the characteristics of a security."[100] "In every case, the purchaser gave up some tangible and definable consideration in return for an interest that had substantially the characteristics of a security."[101] In *Teamsters*, the Court declared that the "purported investment [was] a relatively insignificant part of an employee's total and indivisible compensation package."[102] Since employees did not contribute money to the plan, their only "investment" was that of their labor. The Court concluded that based on the economic realities of the situation, an "employee is selling his labor primarily to obtain a livelihood, not for making an investment."[103] The Court also rejected the argument that employer contributions on behalf of the employee constituted the employee's "investment" in the fund, in that "there was no fixed relationship between contributions to the Fund and an employee's potential benefits."[104]

As to the requirements calling for an expectation of profits from a common enterprise, the Court found that the plan failed to meet the standard on two different levels. First, the greater share of the pension plan's income was derived from new employer contributions, a steady source that was in no way dependent upon the efforts of the fund's managers. Secondly, any "profit" that might be derived would "depend primarily on the employee's efforts to meet the vesting requirements, rather than the Fund's investment success."[105] Viewed in its entirety, "the possibility of participating in a plan's asset earnings 'is far too speculative and insubstantial to bring the entire transaction within the Securities Act.' "[106]

100. *Id.* at 559-60 (citing Tcherepnin v. Knight, 389 U.S. 332, 346 (1967) (money paid for bank capital stock); SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 210-12 (1967) (portion of premium paid for variable component of mixed variable and fixed annuity contract); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 71-72 (1959) (premium paid for variable annuity contract); SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (money paid for purchase of orange grove); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) (money paid for land and oil exploration)).

101. 439 U.S. at 560.

102. *Id.*

103. *Id.*

104. *Id.* at 561. The collective-bargaining agreement initially set employer contributions to the Pension Trust Fund at two dollars a week for each man-week of covered employment. An employee who had engaged in covered employment for twenty years would receive the same benefits as an employee who had worked for forty years and had induced a substantially larger employer contribution.

105. *Id.* at 562.

106. *Id.* (citing United Hous. Foundation, Inc. v. Forman, 421 U.S. 837, 856 (1975)).

The Court went on to examine the legislative history of several relevant acts that had been discussed in an *amicus curiae* brief submitted by the SEC, and that had been offered as evidence that pension plans were securities.[107] From its analysis, the Court was able to conclude that there was "no evidence that Congress at any time thought noncontributory plans similar to the one before us were subject to federal regulation as securities."[108]

The Court concluded, "If any further evidence were needed to demonstrate that pension plans of the type involved are not subject to the Securities Acts, the enactment of ERISA in 1974 . . . would put the matter to rest."[109] ERISA dealt specifically and in detail with pension plans, requiring disclosure to employees, establishing standards for plan funding and setting limits on the eligibility requirements an employee must meet. This "comprehensive legislation" was an indication to the Court that "Congress believed . . . it was filling a regulatory void when it enacted ERISA . . . ."[110] Thus, after a thorough application of the *Howey* test, supported by both an implicit and explicit Congressional mandate, the Court held that the Securities Acts do not apply to noncontributory, compulsory pension plans.[111]

The first Ninth Circuit case dealing with the decision in *Teamsters* was *Black v. Payne*.[112] Black had begun working for the state of California in December, 1970, at which time the mandatory retirement age was seventy years. As a state employee, Black was enrolled in the state's pension program, the Public Employees Retirement System (PERS).[113] In 1971, the California legislature enacted a bill lowering the mandatory retirement age for members of PERS to sixty-seven years.[114]

Black filed a class action against the Public Employees Retirement

107. 439 U.S. at 563-64. The Court discussed the rejection by Congress in 1934 of an amendment to the Securities Act that would have created an exemption for employee stock investment and stock option plans. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934); a 1970 amendment to the Securities Act extending an exemption to certain pension plans having an interest or participation in the fund in which its assets were held, 84 Stat. 1434, 1498, 15 U.S.C. § 77c(a)(2); and the Opinion of Assistant General Counsel, [1941 through 1944 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 75.

108. 439 U.S. at 563.

109. *Id.* at 569 (referring to the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 (1974)).

110. 439 U.S. at 570.

111. *Id.*

112. 591 F.2d 83 (9th Cir.), *cert. denied*, 100 S. Ct. 139 (1979).

113. CAL. GOV'T CODE § 20000 (West 1971).

114. Senate Bill 249, Stats. 1971, ch. 170, § 38 p. 231 was enacted, amending CAL. GOV'T CODE § 20981 (West 1972).

System, contending that the statutory change in the mandatory retirement age affected his pension plan interest and thus, was in violation of federal securities laws. The Ninth Circuit, relying on *Teamsters*, and the *Howey* test, rejected the argument that such a plan constitutes an investment contract.

Although PERS was a contributory plan,[115] the court found that Black's participation in the plan did not automatically involve a reasonable expectation of profits derived from the efforts of others.[116] "The California legislature's purpose in enacting PERS was not to provide an investment opportunity."[117] Rather, participation in the program was viewed as part of an employee's compensation for service to the state,[118] and benefits derived therein were "determined by a statutory formula and not by the income or 'profit' made by PERS."[119] In addition, Black's participation in the plan was compulsory, as was the plaintiff's in *Teamsters*. Finally, the court found that PERS lacked the element of economic risk usually associated with investments.[120] Thus, by employing the *Howey* analysis that had been recently reaffirmed in *Teamsters*, the court was able to conclude that the PERS lacked a reasonable expectation of entrepreneurial profit, and was thus outside the scope of the federal securities laws.

D. Conclusion

Following the initial decision in *Joiner*, the course of defining the extent and scope of the Securities Act of 1933 and the Securities Exchange Act of 1934 was an expansionist one, fueled by increasingly broad interpretations by the courts. The test first enunciated in *Howey* was straightforward and simple, and thus was easily applied by the lower courts. Although some modifications were adopted, it survived relatively unscathed, despite strong criticism on several fronts.

The expansionist trend was curtailed in *Forman*, when the Supreme Court found a type of transaction that it did not consider to involve security. The decision in *Teamsters* may indicate not only a slowing of the expanding definition of "security," but perhaps even a reversal of that trend. The courts seem to be recognizing that the fram-

115. CAL. GOV'T CODE §§ 20600-14 (West 1972).

116. 591 F.2d at 87.

117. *Id.*

118. *Id. See* Miller v. State, 18 Cal. 3d 808, 814-15, 557 P.2d 970, 973-74, 135 Cal. Rptr. 386, 389-90 (1977).

119. 591 F.2d at 87. *See* CAL. GOV'T CODE § 20611 (West 1972).

120. 591 F.2d at 88 (citing United Cal. Bank v. THC Financial Corp., 557 F.2d 1351, 1358-59 (9th Cir. 1977)).

ers of the 1933 and 1934 Acts did not intend to include every complex scheme developed in the comparatively sophisticated financial structure of the 1970's and 1980's. In the future, it will be essential for the courts to continue to establish boundaries and place restrictions upon access to the federal securities laws, or the laws will become so all-inclusive as to render them meaningless.

As for the Ninth Circuit, the continued vitality of the six-prong risk capital test created in *Kotz* is questionable. It has a close similarity to the less complex, dichotomous approach of "investment-commercial" while achieving almost identical results. Having originated as still another means of elucidating the *Howey* test, its six level approach is not as adaptable to as broad a range of securities transactions as is *Howey*, and its analytical focus may prove to be short-lived.

The forcefulness of the decision in *Black* indicates that the Ninth Circuit agrees with not only the law, but also the spirit of *Teamsters*, and will not strain to distinguish it from future cases. Although the decision in *Teamsters* may mark a continuing reversal of the expansionist trend in defining securities, it is important to note that the decision did not introduce any new concepts or means of analysis. While bolstering the decision with the commonly used judicial tool of measuring congressional intent, the core of the analysis in that case, and in every case, remains the *Howey* test. Having withstood numerous attempts to modify and change its focus, the test remains so firmly entrenched in securities analysis that future parties seeking to place themselves outside the reach of the securities laws will be relegated to making factual arguments rather than legal ones. The *Howey* analysis remains the test of the future, as well as the past.

II. Recent Ninth Circuit Developments Pursuant to Section 10(b) and Rule 10b-5

A. *Introduction*

Throughout the 1970's, the federal courts, including the Ninth Circuit, have been actively involved in the interpretation of section 10(b) of the Securities Exchange Act of 1934[121] and rule 10b-5[122] promul-

121. Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j) (1976), provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any

gated thereunder. Much of this activity stems from a handful of "landmark" United States Supreme Court cases, which have narrowly defined the statutory language.

Although Congress clearly stated in section 10(b) that certain activities are unlawful if done in connection with the purchase or sale of securities, Congress did not create an express private civil remedy for its violation. Nor is it clear from the legislative history that either Congress,[123] or the Commission,[124] when adopting section 10(b) and rule 10b-5, ever contemplated such a remedy. Nonetheless, the United States Supreme Court recognized the need for private enforcement under the securities laws,[125] and has in certain circumstances, permitted private actions under the statute and the rule.[126]

Most of the interpretation problems faced by the courts with re-

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> 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.

122. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979), provides:

> Employment of manipulative and deceptive devices.
>
> 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.

Relevant portions of both the statute and the rule are restated throughout this discussion.

123. *E.g.*, S. REP. No. 792, 73d Cong., 2d Sess., 5-6 (1934).

124. *E.g.*, SEC RELEASE No. 3230 (May 21, 1942).

125. In the 1960's, the Court recognized the need for a private cause of action under section 14(a) of the Securities Exchange Act of 1934 in J.I. Case Co. v. Borak, 377 U.S. 426 (1964). Private enforcement under section 10(b) of the Act was first recognized by the Supreme Court in 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 § 10(b)").

126. *See* Blue Chip Stamps v. Manor Drug Stores, Inc., 421 U.S. 723 (1975). The Supreme Court reiterated its conclusion in *Borak* and *Bankers Life* that "private enforcement of Commission rules may '[provide] a necessary supplement to Commission action.'" *Id.* at 730 (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)). *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1975) ("the existence of a private cause of action for violations of the statute and the Rule is now well established"). *Cf.* Touche Ross & Co. v. Redington, 442 U.S. 560 (1979), where the Supreme Court refused to imply a private cause of action under section 17(a) of the Securities Exchange Act of 1934. The Court stated, with reference to the express private actions set forth in §§ 9(e), 16(d), 18(a) and 20 of the 1934 Act, that "[o]bviously, then, when Congress wished to provide a private damage remedy, it knew how to do so and did so expressly." *Id.* at 2487. At least one commentator has suggested that the Supreme Court will have to reconcile this language with the Court's prior decisions which recognize a private cause of action under section 10(b). Freeman, *Implied Remedies Under Rule 10b-5: Are They Only for Defrauded Sellers?*, NAT'L L.J., Dec. 10,

spect to section 10(b) and rule 10b-5, have concerned the scope and meaning of the elements of a private cause of action thereunder. The courts have derived these elements from two sources: (1) the statute and the rule itself; and (2) traditional common law fraud actions. The statute and the rule, by their express terms, are vague with respect to exactly what must be shown to establish a violation. The traditional common law fraud elements, however, are too rigid to allow extensive private enforcement of the statute and the rule. In an effort to strike a balance between the statutory language and the common law elements, the courts have struggled to retain the basic structure of fraud actions, yet have injected enough flexibility to insure effective private enforcement.

The Supreme Court has voiced two countervailing policies regarding the interpretation of section 10(b) and rule 10b-5. On one hand, with respect to the element of reliance, the Court has reaffirmed its statement in *Superintendent of Insurance v. Bankers Life & Casualty Company*[127] that section 10(b) "must be read flexibly not technically and restrictively" in order to effectuate its remedial purposes.[128] On the other hand, the Court has been aware of the endless and vexatious litigation that could be brought under the guise of rule 10b-5 and thus, has narrowly limited the scope of the statute and the rule by placing restrictions on standing and the class of persons who can be held liable.[129]

The discussion that follows focuses on the elements which have been found by the courts to be essential to section 10(b) and rule 10b-5 actions. To establish a prima facie claim for damages, a plaintiff must show that:

1979 at 26, col. 1 (the author suggests that the Court can limit private actions under section 10(b) to defrauded sellers without reversing any of its prior decisions).

127. 404 U.S. 6 (1971).

128. *Id.* at 12. The Court recognized that the practices proscribed by section 10(b) may vary considerably, and that some practices that may be legitimate in one setting may be illegitimate in another. The Court found the ultimate question to be whether or not plaintiff had suffered an injury "as a result of deceptive practices touching its sale of securities as an investor." *Id.* at 12-13.

The Court cited this position with approval in Affiliated Ute Citizens v. United States, 406 U.S. 128, 151-52 (1972) (the lower court read rule 10b-5 too restrictively with respect to the reliance requirement). See text accompanying notes 295-97 *infra* for further discussion of the *Affiliated Ute* decision.

129. *E.g.*, Blue Chip Stamps v. Manor Drug Stores, Inc., 421 U.S. 723 (1975) (standing limited to purchasers or sellers of securities); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1975) (negligent misrepresentations and omissions are not actionable). Justice Blackmun, dissenting in both *Blue Chip Stamps*, 421 U.S. at 762, and *Ernst & Ernst*, 425 U.S. at 217, objected to the Court's departure from the flexible posture voiced in *Superintendent of Insurance*.

(1) *jurisdiction* exists under the federal securities laws;
(2) the plaintiff has *standing* to sue;
(3) the defendant has *misrepresented* or *failed to disclose* some fact;
(4) the misrepresented fact was *material*;
(5) the misrepresentation or omission was made *in connection with* a purchase or sale of securities;
(6) defendant possessed some degree of *scienter*; and
(7) plaintiff *relied* on the defendant's misrepresentation or omission.[130]

This discussion first examines each element and its treatment if any by the United States Supreme Court. Next, an examination is made of recent Ninth Circuit cases. In many instances, the Ninth Circuit has "stretched" the limitations set forth by the Supreme Court in an effort to reach those who clearly are in violation of the spirit of section 10(b) and rule 10b-5, even though the circumstances do not fit squarely within the scope of the elements as defined by the Supreme Court.

B. Elements of the Prima Facie Case

1. Jurisdiction

The initial inquiry with respect to any 10b-5 action is whether the court may properly hear the claim. This section deals with the jurisdictional requirements under section 10(b) and rule 10b-5, and with two common bars to suit: the running of the statute of limitations, and the doctrines of res judicata and collateral estoppel. In general, the Ninth Circuit has taken a liberal approach to each of these issues.

a. the jurisdictional requirement

Perhaps the most liberally interpreted element of a private cause of action for damages under section 10(b) and rule 10b-5 is the jurisdictional requirement: the alleged violation must occur "by the [direct or indirect] use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . ."[131] The Ninth Circuit has read this requirement broadly to in-

130. *See generally* 3 A. BROMBERG, SECURITIES FRAUD & COMMODITIES FRAUD §§ 8.1-8.9 at 193-223 (1979) [hereinafter cited as BROMBERG].

131. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j) (1976); Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979). See notes 121 and 122 *supra* for a full statement of the statute and the rule.

clude remote uses of an interstate instrumentality; almost any use is sufficient.

In *Matheson v. Armbrust*,[132] for example, the Ninth Circuit found that the alleged fraud was practiced in connection with the use of an interstate, long-distance telephone line. Even though the transaction was not actually consummated by means of the interstate telephone line, the court upheld the district court's finding that the fraud *commenced* with interstate negotiations over the telephone line.[133]

In *Ellis v. Carter*,[134] the interstate transportation of stock certificates from New York to Los Angeles via a commercial airline was held by the Ninth Circuit to satisfy the jurisdictional requirement. The court found that even though there was a substantial delay between the transfer of the stock certificates and the actual consummation of the sale, the use of the commercial airline was for the purpose of consummating the sale, and therefore, for purposes of rule 10b-5, was used in connection with the alleged fraudulent sale.[135]

The Ninth Circuit recently reached a similar conclusion in *Hilton v. Mumaw*,[136] when the court held that the mailing of a contract that was clearly prepared in furtherance of a scheme to defraud the plaintiff was enough to confer federal jurisdiction. The court stated, "The jurisdictional requirement of Rule 10b-5 is satisfied even if the use of the mails is not itself a fraudulent act. It suffices if [the mails were used] . . . in furtherance of the alleged fraud."[137]

Although these cases seem to indicate that the court will clutch at any jurisdictional "straw" when a fraudulent scheme with respect to a securities transaction is uncovered, the Ninth Circuit has at least on one occasion found no jurisdiction under the federal securities laws. In *Burke v. Triple A Machine Shop, Inc.*,[138] plaintiff alleged a violation under rule 10b-5 arising out of the defendant corporation's repurchase of plaintiff's stock. The court found that there was no federal question presented and therefore no jurisdiction under rule 10b-5:

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132. 284 F.2d 670 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961).

133. *Id.* at 673. Appellant argued that all of the fraud took place within the state of Oregon, after the interstate telephone call in question. The district court, however, found that defendant had engaged in a scheme to defraud plaintiff which *commenced* with the long-distance telephone call, and continued to the consummation of the transaction. Upon this finding, the Ninth Circuit concluded that the alleged fraud was practiced in connection with the use of the interstate telephone line.

134. 291 F.2d 270 (9th Cir. 1961).

135. *Id.* at 274.

136. 522 F.2d 588 (9th Cir. 1975).

137. *Id.* at 602.

138. 438 F.2d 978 (9th Cir. 1971) (per curiam).

> It [was] not contended that the mails were used. There was no interstate negotiation or purchase of the plaintiff's stock. We conclude that there was also no use of an 'instrumentality of interstate commerce' within the contemplation of the statute by reason of two *local* telephone calls to the companies' counsel who was also an assistant secretary.[139]

b. the statute of limitations

Since section 10(b) contains no express civil private cause of action, Congress obviously did not include a statute of limitations for actions brought under the statute or the rule. The Ninth Circuit, in accordance with federal policy,[140] has adopted and applied an appropriate local statute of limitations:[141] the state statute of limitations governing general fraud actions.[142]

In *Hilton v. Mumaw*,[143] the Ninth Circuit noted that although the state statute of limitations for fraud actions governs the statutory period within which rule 10b-5 claims may be brought, federal law determines when the period begins to run.[144] Federal law provides that the period commences when plaintiff discovers, or, in the exercise of reasonable diligence should have discovered the fraud.[145] Accordingly,

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139. *Id.* at 979 (emphasis added). The court did suggest, however, that there may still be a valid cause of action under state law. *Id.*

140. *See* Holmberg v. Armbrecht, 327 U.S. 392, 395 (1946) ("[a]s to actions at law, the silence of Congress has been interpreted to mean that it is federal policy to adopt the local law of limitation").

141. *See* Sackett v. Beaman, 399 F.2d 884, 890 (9th Cir. 1968) (citing Holmberg v. Armbrecht, 327 U.S. at 395) (Ninth Circuit applied the California statute of limitations for fraud actions).

142. *See* Douglass v. Glenn E. Hinton Invs., Inc., 440 F.2d 912, 914-16 (9th Cir. 1971) (the court applied the Washington statute of limitations pertaining to general fraud actions). In California, the appropriate statute of limitations for rule 10b-5 actions is the California statute of limitations for fraud actions set forth in CAL. CIV. PROC. CODE § 338(4) (Deering Supp. 1979) (three year period). *Cf.* Kirk v. First Nat'l Bank, 439 F. Supp. 1141 (D.C. Ga. 1977) (four-year limitation associated with Georgia's fraud remedy was appropriate in rule 10b-5 action). *See* Turner v. Lundquist, 377 F.2d 44, 46 (9th Cir. 1967); Sackett v. Beaman, 399 F.2d 884, 890 (9th Cir. 1968). In both *Turner* and *Sackett* the Ninth Circuit adopted and applied the California general fraud limitations period.

143. See notes 136-137 *supra* and accompanying text.

144. 522 F.2d at 601-02.

145. *Id. See* Holmberg v. Armbrecht, 327 U.S. 392 (1946), in which the Supreme Court stated that:

> this Court long ago adopted as its own the old chancery rule that where a plaintiff has been injured by fraud and 'remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not begin to run until the fraud is discovered, though there be no special circumstances or efforts on the part of the party committing the fraud to conceal it from the knowledge of the other party.'

the court in *Hilton* held that the question of when the Hiltons discovered or should have discovered the alleged fraud was an issue for the trier of fact, and that the district court had improperly directed a verdict that the Hiltons' claims were barred by the statute of limitations.[146]

c. res judicata and collateral estoppel

The Ninth Circuit is reluctant to preclude recovery under rule 10b-5 by using the doctrines of res judicata or collateral estoppel in cases when similar factual contentions are presented to state courts. In *Clark v. Watchie*,[147] for example, two complaints were filed, one in state court and the other in federal court. The state court complaint alleged breach of fiduciary duty and mismanagement of partnership affairs. The federal court complaint alleged material misrepresentations and omissions in connection with the sale of partnership units. The district court held that the doctrines of res judicata and collateral estoppel precluded the federal rule 10b-5 action which was heard subsequent to a report of the special master in the state action finding that defendant had acted in good faith.[148] The Ninth Circuit disagreed. Considering first the issue of res judicata, the Ninth Circuit stated that the doctrine would preclude a second suit only if the cause of action in the second suit is identical to that brought in the first suit.[149] In agreement with the Second Circuit, the court concluded that "a Rule 10b-5 claim 'is a different cause of action from the claim for breach of fiduciary duty, and is one which is cognizable only in federal courts.' "[150] The 1934 Act gives exclusive jurisdiction to the federal courts to consider rule 10b-5 claims.[151]

The court also held that two defendants, who were not parties to the prior state court action, could not collaterally estop plaintiffs from

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Id. at 397 (quoting Bailey v. Glover, 88 U.S. (21 Wall.) 342, 348 (1874)). *Accord*, Turner v. Lundquist, 377 F.2d 44 (9th Cir. 1967) (court looked to California law to determine when statute of limitations began to run); Errion v. Connell, 236 F.2d 447, 455-56 (9th Cir. 1956) (court also looked to state law). The Ninth Circuit explained in *Hilton* that *Errion* did not hold contrary since the state rule applied therein was identical to the federal rule. 522 F.2d at 602 n.13.

146. 522 F.2d at 602.

147. 513 F.2d 994 (9th Cir.), *cert. denied*, 423 U.S. 841 (1975).

148. *Id.* at 996.

149. *See* 1B MOORE'S FEDERAL PRACTICE ¶ 710.441[2], at 3777 (2d ed. 1974).

150. 513 F.2d at 997 (quoting Abramson v. Penwood Inv. Corp., 392 F.2d 759, 762 (2d Cir. 1969).

151. Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa (1976) provides in part that "[t]he district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder."

bringing a subsequent 10b-5 action when the factual issues in the two suits were not identical.[152] The Ninth Circuit found that while the state court suit resolved issues of nondisclosure with respect to operation of the partnership itself, in other words, that defendant acted in good faith, issues of nondisclosure with respect to the sale of the partnership units were not decided by the state court.[153] The court concluded that because the state action neither mentioned nor referred to issues under the federal securities laws, these issues could be relitigated in the federal action.[154]

2. Standing

Federal Rule of Civil Procedure 12(b)(6) provides for a motion to dismiss a complaint for failure to state a claim upon which relief can be granted.[155] The discussion that follows examines the elements necessary to state a claim upon which relief can be granted under section 10(b) and rule 10b-5.

a. individual actions

Standing to sue is a crucial element of any suit brought under section 10(b) and rule 10b-5.[156] In *Blue Chip Stamps v. Manor Drug Stores*,[157] the United States Supreme Court reaffirmed the so-called *Birnbaum* rule,[158] adopted almost unanimously by the lower courts, limiting standing in private damage actions under section 10(b) and

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152. The Ninth Circuit applied the 3-part test to determine collateral estoppel set forth by the Supreme Court in Blonder-Tongue Laboratories v. Univ. of Ill. Foundation, 402 U.S. 313, 323-24 (1971) (citing Bernhard v. Bank of America Nat'l Trust & Sav. Ass'n, 19 Cal. 2d 807, 122 P.2d 892 (1942)): Was there a final judgment on the merits? Was the party against whom the plea is asserted a party or in privity with a party to the prior adjudication? Was the issue decided in the prior adjudication identical with the one presented in the action in question? 513 F.2d at 998.

153. 513 F.2d at 998-99.

154. *Id.* at 999. The state court had made one finding mentioning the sale of partnership units, but this finding was unnecessary to the state court judgment. *Id.* at 999. The court further held that the legal standards to be applied to each case were substantially different. Although defendant was found not liable under state law because of his honest mistakes which did not amount to breach of his fiduciary duty, the court noted that rule 10b-5 liability could nonetheless be based on negligence. This standard of liability has been since negated by Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1975), which held that negligence would not support a rule 10b-5 claim; some degree of scienter is necessary. See notes 335-84 *infra* for a discussion of the scienter requirement.

155. FED. R. CIV. P. 12(b)(6), 28 U.S.C. Appendix at 407 (1976).

156. See text accompanying note 281 *infra* for a discussion of the close relationship between the standing, reliance and "in connection with" requirements.

157. 421 U.S. 723 (1975).

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

rule 10b-5 to *actual purchasers or sellers*.[159] The Court reasoned that adoption of this standing limitation was necessary to prevent potential nuisance or "strike" suits and potential abuse in discovery procedures:[160]

> In the absence of the *Birnbaum* doctrine, bystanders to the securities marketing process could await developments on the sidelines without risk, claiming that inaccuracies in disclosure caused nonselling in a falling market and that unduly pessimistic predictions by the issuer followed by a rising market caused them to allow retrospectively golden opportunities to pass.[161]

Problems have arisen among the lower courts with regard to the scope of the terms "actual purchasers" and "actual sellers." The definitional sections of the Securities Exchange Act of 1934 provide that the terms "buy" and "purchase" include contracts "to buy, purchase or otherwise acquire,"[162] and the terms "sale" and "sell" include contracts "to sell or otherwise dispose of."[163] The Supreme Court thus has recognized holders of such contractual rights or duties to purchase or sell securities as puts, calls or options as "purchasers" or "sellers" for purposes of rule 10b-5.[164] The Court, however, refused to find that plaintiffs in *Blue Chip Stamps* who alleged a "lost opportunity" to purchase stock were purchasers or sellers within the meaning of the Act.[165]

(1951) (a person who is neither a purchaser or seller of securities may not bring an action under section 10(b) or rule 10b-5).

159. 421 U.S. at 755. The Court refused to "leave the *Birnbaum* rule open to endless case-by-case erosion depending on whether a particular group of plaintiffs was thought by the court in which the issue was being litigated to be sufficiently more discrete than the world of potential purchasers at large to justify an exception." *Id.*

160. *Id.* at 740-41. The Court explained that its holding was based upon policy considerations. Recognizing that private actions under section 10(b) and rule 10b-5 have been judicially found to exist, the Court reasoned that these implied private actions could be judicially limited, unless or until Congress speaks on the subject. 421 U.S. at 749.

161. *Id.* at 747. The Court feared the possible breadth of rule 10b-5 actions:

> The manner in which the defendant's violation caused the plaintiff to fail to act could be as a result of the reading of a prospectus, as respondent claims here, but it could just as easily come *as a result of a claimed reading of information contained in the financial pages of a local newspaper*.

421 U.S. at 746. (emphasis added). *See also* Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979), discussed in detail in text accompanying notes 374-84 *infra*. In *Zweig*, the Ninth Circuit held a financial columnist liable under rule 10b-5 for nondisclosure to his readers of his personal interest in the stock he promoted in his financial column.

162. Section 3(a)(13) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(a)(13) (1976).

163. Section 3(a)(14) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(a)(14) (1976).

164. 421 U.S. at 751.

165. *Id.* at 732. The Court noted that in 1957, and again in 1959, the SEC proposed to Congress an amendment to section 10(b) to change the wording to "in connection with the

Prior to *Blue Chip Stamps*, the Ninth Circuit had adopted the *Birnbaum* doctrine, but had carved out exceptions to the rule where plaintiffs did not fit squarely within the definitional sections of the Act. In *Mount Clemens Industries, Inc. v. Bell*,[166] plaintiffs claimed that they were dissuaded from bidding on and purchasing certain securities at a sheriff's sale because of misrepresentations made by a corporate director that the securities were worthless. Although plaintiffs had never actually purchased or sold the subject stock, the court extended its inquiry to determine whether the alleged facts would fit any of the exceptions to the *Birnbaum* rule recognized by other circuits. One such exception was the "aborted purchaser-seller doctrine."[167] This doctrine was triggered in cases where a transaction entered into by plaintiffs, either as purchasers or sellers, was aborted due to fraud on the part of defendants.[168] The court reasoned that the "aborted purchaser-seller doctrine" is not a true exception to *Birnbaum* because, in each case where the doctrine has been applied, some contractual relationship existed between the parties, satisfying the statutory requirement that plaintiffs be either purchasers or sellers.[169]

The Ninth Circuit in *Mount Clemens Industries* also examined the "forced seller" exception to the *Birnbaum* rule.[170] This doctrine was applied by some courts to protect shareholders who were "forced" to sell their corporate shares because of fraudulent activity affecting the corporation in which they had an ownership interest. The Second Circuit applied this exception in *Vine v. Beneficial Finance Co.*[171] to protect

purchase of sale of, *or any attempt to purchase or sell*, any security." *Id.* (citing 103 Cong. Rec. 11636 (1957) (emphasis added)). *See also* SEC Legislation, Hearings on S. 1178-82 before a Subcomm. of the Senate Comm. on Banking and Currency, 86th Cong., 1st Sess., 367-68 (1959); S. 2545, 85th Cong., 1st Sess. (1957); S. 1179, 86th Cong., 1st Sess. (1959). Neither change was adopted by Congress. 421 U.S. at 732.

Apparently, however, the Court's decision in *Blue Chip Stamps* does not affect the Court's earlier decision in SEC v. National Sec., Inc., 393 U.S. 453 (1969), which established that the purchaser-seller requirement does not limit the standing of the SEC to bring actions under section 10(b) and rule 10b-5 for injunctive relief. 421 U.S. at 751 n.14.

166. 464 F.2d 339 (9th Cir. 1972). The Ninth Circuit found the *Birnbaum* limitation on standing not only a sound policy pursuant to section 10(b), but constitutionally mandated by article III of the United States Constitution, which restricts federal judicial power to "cases" and "controversies." *Id.* at 343 (citing Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970)).

167. *See generally* 6 L. Loss, Securities Regulation 3614 (2d ed. Supp. 1969).

168. *E.g.*, Opper v. Hancock Sec. Corp., 367 F.2d 157 (2d Cir. 1966), *aff'g* 250 F. Supp. 668 (S.D.N.Y. 1966) (a customer placed orders with a broker, but the orders were never carried out due to the broker's deception). *See also* A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967) (customer failed to carry out an agreement to purchase securities).

169. 464 F.2d at 346.

170. *Id.*

171. 374 F.2d 627 (2d Cir. 1967), *cert. denied*, 389 U.S. 970 (1968).

a shareholder whose interest was affected by a short-form merger designed to benefit others. As a result of defendant's fraudulent scheme, plaintiff was left with stock certificates in a non-existent corporation. Plaintiff had little choice but to exchange his shares for the price fixed by defendants, or seek his statutory appraisal rights. The court found that in effect, his stock had involuntarily been reduced to a claim for cash, and therefore, defendant's fraud resulted in a "sale" of stock by the plaintiffs.[172] The court reasoned that while "[i]t is true that appellant still has his stock; . . . requiring him to [surrender his stock for cash] . . . as a condition for suit seems a needless formality."[173]

The Ninth Circuit in *Mount Clemens Industries* found neither of these exceptions applicable. Plaintiffs therein possessed no contractual rights to either purchase or sell the securities in question. Further, plaintiffs had never owned the subject shares and because they chose not to bring a derivative action on behalf of the company which was the actual seller of the shares, the court refused to bootstrap them into the position of forced sellers.[174]

Subsequent to the Supreme Court's decision in *Blue Chip Stamps*, the forced seller doctrine was applied by the Seventh Circuit in *Daniel v. International Brotherhood of Teamsters*,[175] when union members were "forced" to contribute to a pension plan. The court held that the definition of "sale" under the 1934 Act does not require volition. Thus, forced contribution to the pension plan was found to be a "sale" for purposes of section 10(b) and rule 10b-5.[176]

The Ninth Circuit followed *Blue Chip Stamps* in *Williams v. Sinclair*.[177] *Williams* involved a class action brought by corporate shareholders against the corporation, which had allegedly issued a materially misleading prospectus in connection with a public offering

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172. *Id.* at 634.

173. *Id. See also* Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970) (plaintiff corporation was considered a forced seller when the acquiring corporation's manipulation of the market price of the target company's stock defeated plaintiff's tender offer, and, as a result, plaintiff was required to either sell its shares or those received in exchange pursuant to antitrust laws). *See also* Dudley v. Southeastern Factor & Fin. Corp., 446 F.2d 303, 307 (5th Cir.), *cert. denied*, 404 U.S. 858 (1971) ("a shareholder should be treated as a seller when the nature of his investment has been fundamentally changed from an interest in a going enterprise into a right solely to a payment of money for his shares").

174. 464 F.2d at 347 n.14.

175. 561 F.2d 1223 (7th Cir. 1977).

176. *Id.* at 1243-44. This suggests that the forced seller doctrine may survive *Blue Chip Stamps* in that "actual sellers" under the Act may include forced sellers. Neither the Supreme Court nor the Ninth Circuit has as yet faced this issue.

177. 529 F.2d 1383 (9th Cir. 1975), *cert. denied*, 426 U.S. 936 (1976).

of stock. Current shareholders were given the opportunity to purchase additional shares at a discount price through warrants issued to them. The class seeking relief consisted of: (1) those who were induced to exercise the warrants to purchase additional stock in reliance on the misleading prospectus; and (2) those who either sold their previously-held shares at a loss, or retained their shares in reliance on the prospectus. The court held that the shareholders who merely retained their previously-held shares after the prospectus was issued did not qualify as either purchasers or sellers under rule 10b-5, even though they were offered warrants to purchase additional stock. The court held, "The warrants offered to the existing shareholders . . . in the prospectus were neither contracts to purchase or to sell securities within the definition of 15 U.S.C. § 78c(a)."[178]

The Ninth Circuit's refusal in *Williams* to confer standing on potential purchasers of shares who refrained from purchasing in reliance on the misleading prospectus was fully anticipated by the Supreme Court in *Blue Chip Stamps*. The Court recognized that three classes of potential plaintiffs would be barred from suit under rule 10b-5 by the *Birnbaum* limitation.[179] The two sub-groups of plaintiffs barred in *Williams* fell within the second and third categories.[180]

In *Ohashi v. Verit Industries*,[181] the Ninth Circuit held that a plaintiff cannot establish standing under rule 10b-5 based upon his inability to sell or offer to sell his stock to third parties, even if such inability was caused by defendant's fraudulent or deceptive acts.[182] The plaintiff

178. *Id.* at 1389. See Securities Exchange Act of 1934, § 3(a)(13)-(14), 15 U.S.C. § 78(a) (1976) set forth in pertinent part in text accompanying notes 162-63 *supra*.

179. The three classes of potential plaintiffs that would be barred from suit under rule 10b-5 by *Birnbaum* are: (1) potential purchasers of shares who decided not to puchase because of omissions of favorable material; (2) actual shareholders of the issuer who allege they decided not to sell their shares because of omissions of unfavorable material; and (3) shareholders, creditors and others related to an issuer who suffered loss in the value of their investment due to corporate or insider activities in connection with the purchase or sale of securities which violate rule 10b-5. 421 U.S. at 737-38.

180. The Supreme Court commented that plaintiffs in categories (2) and (3), see note 179, *supra*, could frequently circumvent *Birnbaum* by bringing a derivative action on behalf of the corporate issuer if the latter was a purchaser or seller of securities. 421 U.S. at 738. The barred plaintiffs in *Williams*, however, fell within the second and third categories of plaintiffs barred by *Birnbaum*, and therefore, the derivative action route would not be available to them. However, although plaintiffs found themselves without a federal remedy, the same alleged conduct may have provided a basis for recovery under state law. In *Blue Chip Stamps*, a state court class action filed by respondent was held in abeyance pending the decision of the Supreme Court. *Id.* at 739 n.9 (citing Manor Drugs v. Blue Chip Stamps, No. C-5652 (Super. Ct., Los Angeles County)).

181. 536 F.2d 849 (9th Cir.), *cert. denied*, 429 U.S. 1004 (1976).

182. The private offering exemption of the Securities Act of 1933, 15 U.S.C.

sold his shares in one company in exchange for stock in the defendant corporation which was not reported under the Securities Act of 1933 in reliance on the private offering exemption.[183] As part of the exchange, plaintiff executed an agreement under which transfer of plaintiff's shares would be restricted until certain conditions were met. A few years after the exchange, when plaintiff sought to have these transfer restrictions removed, defendants allegedly falsely assured him that steps were being taken in that direction. Plaintiff sued, alleging a conspiracy to keep his stock off the market in an effort to artificially raise the price of the publicly-traded stock.

The Ninth Circuit determined that plaintiff fell within the third category of potential plaintiffs mentioned in *Blue Chip Stamps* who would be barred from suing under rule 10b-5 by the *Birnbaum* rule: "shareholders; creditors, and perhaps others related to an issuer who suffered loss in the value of their investment due to corporate or insider activities . . . ."[184] The court held, however, that although plaintiff could not sue as a frustrated seller, he might be able to sue as a defrauded purchaser if the alleged fraud had occurred in connection with his acquisition of the shares in the exchange.[185] The court ultimately found that Ohashi had standing to sue pursuant to this theory.[186] In finding that Ohashi did have standing to sue, the court expanded the purchaser-seller requirement to include fraud committed in connection with the still executory purchase agreements.[187]

b. derivative actions

In *Kidwell v. Meikle*,[188] the Ninth Circuit held that a shareholder who owned membership shares in a non-profit corporation which had transferred its assets to defendant corporation, could sue derivatively to redress the harm done to his corporation as a result of the allegedly fraudulent transfer.[189] The court found that the non-profit corporation was a "purchaser" of securities in that it transferred its assets to the defendant corporation in exchange for stock.[190] The court, however,

§ 77d(2)(1976), exempts "transactions by an issuer not involving any public offering" from the mandatory registration provisions of the Act.

183. *Id.* at 852.

184. *Id.* at 852-53. See note 179 and accompanying text *supra*.

185. *Id.* at 853.

186. *Id.*

187. See text accompanying notes 280-85 *infra* for further discussion of *Ohashi* and the "in connection with" requirement.

188. 597 F.2d 1273 (9th Cir. 1979).

189. *Id.* at 1290.

190. *Id.*

denied standing to plaintiff shareholders who sought to bring individual actions against defendant corporation. Two such shareholder members of the merged non-profit corporation claimed standing to sue as relators on behalf of the public based on a provision in the corporate by-laws requiring any surplus obtained on dissolution to be donated to non-profit charitable, recreational, or educational organizations. The court held that since the action was brought to enforce the public's rights, and not plaintiffs' own rights, plaintiffs were not the real parties in interest, and further, that plaintiffs could not force the attorney general, as the real party in interest, to join in the suit.[191] The court also denied standing to two corporate director plaintiffs who attempted to bring a director's derivative suit on behalf of the non-profit corporation.[192] The court held that plaintiffs were not purchasers or sellers under rule 10b-5, and more fundamentally, that the Federal Rules of Civil Procedure do not authorize a director's derivative action.[193]

c. class actions

The Ninth Circuit has taken a liberal view toward allowing class actions under rule 10b-5, especially when a broad pattern of fraudulent activity can be established. In *Blackie v. Barrack*,[194] the court allowed a class action brought on behalf of stock purchasers who were allegedly misled by misrepresentations in the corporation's annual financial report that falsely indicated that defendant corporation was in sound financial condition. Defendants appealed the district court's conditional certification of the suit as a class action on the ground that factors such as particular misrepresentations, degree of reliance, and proof of damages varied with respect to individual class members so that no common question was presented. The Ninth Circuit held that the class was united by a common interest in determining whether defendants' overall course of conduct was in violation of the securities laws. The court found that slight differences in the positions of individual class members should not serve to defeat an action that most profitably

191. The court noted that traditionally private parties can sue as "relators" in the name of the attorney general only if the attorney general expressly or impliedly consents. There was no such consent in *Kidwell*. *Id.* at 1287.

192. Actually, plaintiffs purported to sue on behalf of the corporation for the benefit of the corporation's "residual charitable, recreational and educational beneficiaries," notwithstanding the fact that plaintiffs made no request to certify the beneficiaries as a class; nor did they claim to be members of the group of beneficiaries they sought to represent. *Id.* at 1288.

193. *Id.*

194. 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

should be tried in a single suit.[195] In support of this holding, the court reasoned that rule 10b-5 liability can be predicated on a practice or course of business that operates as a fraud.[196] The court found in *Blackie* that defendants' misrepresentations were "interrelated, interdependent and cumulative,"[197] and therefore, all class members were deemed to share a common interest in the action.

In *Williams*,[198] discussed above in connection with the statute of limitations issue, the court also addressed the class action issue. The court found that if there are a sufficient number of common questions uniting a class, the individual issues concerning whether a particular plaintiff discovered or should have discovered the alleged fraud in security cases will not necessarily defeat certification of class actions.[199]

3. Misrepresentation and nondisclosure—the proscribed conduct.

Once jurisdiction and standing to sue under section 10(b) and rule 10b-5 have been established, a plaintiff must show that defendant has employed a "manipulative or deceptive device" in violation of the statute and the rule.[200] In most 10b-5 actions, the device employed in-

195. *Id.* at 902. The court found its position consistent with the Advisory Committee's views on rule 23 of the Federal Rules of Civil Procedure, the rule authorizing class actions. The Committee noted that "a fraud perpetrated on numerous persons by the use of similar misrepresentations may be an appealing situation for a class action . . . ." *Id.* at 903 (citing the Advisory Committee on Rule 23, Proposed Amendments to the Rule of Civil Procedure, 39 F.R.D. 69, 103 (1966)).

196. *Id.* at 903 n.19. The court noted that "the common question requirement should not be restrictively interpreted . . . particularly as to do so would eliminate the class action deterrent for those who engage in complicated and imaginative rather than straightforward schemes to inflate stock prices." *Id.*

197. 524 F.2d at 903.

198. 529 F.2d 383 (9th Cir. 1975). See notes 178-80 and accompanying text *supra*.

199. 529 F.2d at 388. The Ninth Circuit reiterated this position in Cameron v. E.M. Adams & Co., 547 F.2d 473 (9th Cir. 1976) wherein the court held that individual issues of compliance with the statute of limitations will not predominate over common issues regarding defendant's conduct. The court stated that a class action is the "superior means for a fair and efficient resolution of this controversy." *Id.* at 478.

200. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j) (1976) makes it unlawful to employ "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."

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979) provides that it shall be unlawful

(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.

volves the misrepresentation or nondisclosure of material facts.[201] The courts have found it necessary to draw the line between conduct in violation of the securities laws, and therefore subject to federal sanction, and internal corporate mismanagement, which is left to the state courts to remedy. This distinction was recognized by the United States Supreme Court in *Santa Fe Industries, Inc. v. Green*.[202] The plaintiffs were minority shareholders who claimed that defendant had violated rule 10b-5 by eliminating their stock interest in a short-form cash merger. The Court found that defendant's conduct was not deceptive or manipulative within the meaning of section 10(b) and rule 10b-5.[203] Under then-existing Delaware law, minority shareholders had the option either to accept the price offered by the merging corporation for their shares, or to reject the offer and seek appraisal rights pursuant to the state statutes.[204] The statute did not permit the shareholders to bring suit to block the short-form merger.[205] The Court concluded that plaintiffs were furnished with all of the information relevant to their choice of the available options,[206] and therefore disallowed the claim under rule 10b-5. In other words, the Court determined that because plaintiffs could not have acted differently had they known of the alleged misrepresentations and nondisclosures, they could not claim that they were misled by defendant's conduct for purposes of rule 10b-5.[207]

The decision in *Santa Fe Industries* reiterated the requirement that only conduct involving manipulative or deceptive devices is reached by section 10(b) and rule 10b-5. The Court found the short-form merger, which was carried out in accordance with state law, neither deceptive

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See notes 335-40 and accompanying text *infra* for a discussion of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), a recent decision handed down by the Supreme Court. In *Ernst & Ernst*, the Court interpreted the word "manipulative" as a term of art connoting "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Id.* at 199. This interpretation closely links the element requiring some manipulative or deceptive device to the scienter requirement under rule 10b-5.

201. See notes 232-71 and accompanying text *infra* for a discussion of materiality with respect to rule 10b-5 actions.

202. 430 U.S. 462 (1977).

203. *Id.* at 474.

204. DEL. CODE ANN., tit. 8 §§ 253, 262 (1975 ed. & Supp. 1976).

205. The Delaware courts did away with this rule and permitted actions to block short-form mergers shortly after *Sante Fe Industries* was decided. See notes 212-20 and accompanying text *infra* with respect to *Kidwell v. Meikle*, 597 F.2d 1273 (9th Cir. 1979). In *Kidwell*, the Ninth Circuit implied that *Santa Fe Industries* might have been decided differently under current Delaware law.

206. 430 U.S. at 474.

207. *Id.* See text accompanying notes 291-334 *infra* for a discussion of the reliance requirement.

nor manipulative. In so deciding, the Court refused to extend rule 10b-5 to reach breaches of fiduciary duty by a majority against minority shareholders not involving misrepresentations or nondisclosures. The Court reasoned that a contrary holding would bring within the scope of rule 10b-5 a wide variety of corporate conduct traditionally left to state regulation.[208] The Court stated that if plaintiffs' cause of action was permitted, there would be a "danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5[209] and possible overlap and interference with state corporate laws.[210] In effect, the Court adhered to its earlier policy decision that "Congress by enacting section 10(b) did not seek to regulate transactions which constitute no more than corporate mismanagement."[211] In 1979, in *Kidwell v. Meikle*,[212] the Ninth Circuit was faced with circumstances that were similar to those dealt with by the Supreme Court in *Santa Fe Industries. Kidwell* involved a rule 10b-5 action brought by members and directors of an Idaho non-profit membership corporation against fellow directors and others who had devised a fraudulent scheme concerning the sale of the corporation's assets and stock.[213]

While recognizing that the decision in *Santa Fe Industries* was intended to limit claims that could be brought under rule 10b-5, the Ninth Circuit stated that "*Santa Fe Industries* has *not* meant that every breach of fiduciary duty is necessarily immune from invocation of the

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208. 430 U.S. at 478. The Court found it:

> difficult to imagine how a court could distinguish, for purposes of Rule 10b-5 fraud, between a majority stockholder's use of a short-form merger to eliminate the minority at an unfair price and the use of some other device, such as a long-form merger, tender offer, or liquidation, to achieve the same result; or indeed how a court could distinguish the alleged abuses in these going private transactions from other types of fiduciary self-dealing involving transactions in securities.

Id.

209. *Id.* at 479. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975) (Supreme Court used similar language to limit standing under section 10(b) and rule 10b-5).

210. 430 U.S. at 479. The Court recognized that a factor in determining whether a federal cause of action was intended by Congress under the securities laws is "whether 'the cause of action [is] one traditionally relegated to state law . . . .' Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 40 (1977) (quoting Cort v. Ash, 422 U.S. 66, 78 (1975))." 430 U.S. at 478.

211. 430 U.S. at 479 (quoting Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) ("But we read § 10(b) to mean that Congress *meant* to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face." (emphasis added)). *See* Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700 (1974) (Professor Cary urges a "frontal" attack via a new federal statute for comprehensive federal fiduciary standards rather than extending the scope of rule 10b-5).

212. 597 F.2d 1273 (9th Cir. 1979). See text accompanying notes 188-93 *supra*.

213. See text accompanying notes 188-93 *supra*.

rule."[214] Indeed, other circuits have found deception when corporate directors have failed to disclose to shareholders conflicts of interest or unfair intentions concerning corporate transactions.[215] Deception and manipulation have been found even when shareholder approval of the corporate transaction in question was not required under state law.[216]

The key factor used by the *Kidwell* court to distinguish *Santa Fe Industries* from subsequent appellate cases recognizing rule 10b-5 liability for corporate mismanagement is the fact that in each of the appellate cases the injured shareholders could have, and most probably would have, brought suit in the state courts to enjoin the questionable transaction had they not been lulled into complacence by management's misrepresentations and nondisclosures.[217] In *Santa Fe Industries*, the shareholders were presented with a set of facts and given an active choice between accepting the offered stock value and seeking court appraisal. There were no misrepresentations or nondisclosures found in connection with this choice; the shareholders had available to them all the information relevant to decide whether to accept the short-form merger or seek appraisal.[218]

In *Kidwell*, defendants claimed that the shareholders had not been deceived by the directors who had voted for the sale of the corporate assets because, under Idaho law, if a corporation becomes unable to meet its matured liabilities, shareholder approval of the sale of all of the corporate assets is not required.[219] The Ninth Circuit, however,

214. 597 F.2d at 1291 (emphasis added).

215. *Id. See* Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978) (court held complaint alleging misleading disclosure in sale of parent corporation caused overvaluation of assets exchanged for additional stock of its controlled subsidiary, and lulled minority shareholders into security rather than into seeking injunctive relief under state law and therefore was sufficient to state a 10b-5 claim). *Goldberg* was disapproved to the extent that it differs from proper inquiry on the materiality question of what a reasonable shareholder would have considered significant. *See* Kidwell v. Meikle, 597 F.2d 1273, 1293 n.10 (9th Cir. 1979)). *See also* Wright v. Heizer Corp., 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978) (disclosure to shareholders two months after consumation of a pledge of the corporation's assets to another corporation was found to be deceptive and manipulative conduct).

216. Shareholder approval was not required under applicable state law for the transaction found in violation of rule 10b-5 in either *Goldberg* or *Wright*.

217. The Ninth Circuit in *Kidwell* adopted the *Goldberg* rationale that "it is precisely because there are state-law remedies for the shareholders that a deception can be found. Inadequate disclosures lull into security those shareholders who might bring derivative actions under state law to enjoin the securities transaction if all material facts were revealed." 597 F.2d at 1292.

218. Idaho Code § 30-145 (1967) (repealed 1979).

219. 597 F.2d at 1292 (citing Idaho Code § 30-142 (1967)). The court recognized that the Supreme Court's holding in *Santa Fe Industries* precluded derivative actions under rule 10b-

found that under Idaho law plaintiff-shareholders reasonably could have brought suit in state court to enjoin the sale of the corporation's assets on grounds of conflict of interest and unfairness, especially in light of the provision that holds corporate directors as fiduciaries who may not appropriate corporate assets for their own gain.[220]

Aside from derivative actions, recent Ninth Circuit cases have found misrepresentations and nondisclosures in violation of the statute and the rule in cases involving fraudulent activity by the corporation itself. In *Walling v. Beverly Enterprises*,[221] for example, the Ninth Circuit held that a corporation entering into a contract to sell securities with only a limited intention of performing, commits a fraudulent act cognizable under section 10(b) and rule 10b-5. In that case, shareholders in a Texas corporation[222] alleged that the defendant California corporation entered into an agreement for the exchange of all common stock of the Texas corporation for common stock of the California corporation with a secret reservation not to perform fully its obligations unless the California corporation later determined that it was in its best interests to do so. In furtherance of this scheme, the California corporation repeatedly raised ficticious excuses for not performing. The court found it to be well-settled that "to promise what one does not mean to perform, or to declare an opinion as to future events which one does not hold is a fraud."[223] As a result, the court reversed the district court's dismissal of the action and allowed the claim under rule 10b-5.

The court in *Walling* also found that plaintiffs' pleadings were sufficient to sustain a claim under rule 10b-5, despite defendant's contention that plaintiffs' complaint failed to allege circumstances constituting fraud with sufficient particularity. The court explained that Federal

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5 merely because the complaint in state court states a cause of action for breach of fiduciary duty. It is first necessary to establish that the minority shareholders "would have succeeded in getting permanent injunctive relief, or damages in excess of an appraisal remedy, in the state-law action." 597 F.2d at 1294. In *Santa Fe Industries*, an appraisal remedy was the only remedy available. 430 U.S. at 474 n.14.

220. See text accompanying notes 267-69 *infra* for a discussion of materiality with respect to *Kidwell*.

221. 476 F.2d 393 (9th Cir. 1973).

222. In this pre-*Blue Chip Stamps* decision, the court found that the shareholders in the Texas corporation had standing as purchasers or sellers pursuant to the "aborted puchaser-seller doctrine." 476 F.2d at 396 n.5. See text accompanying notes 41-45 *supra* for a discussion of this doctrine.

223. 476 F.2d at 396 n.6. *See* 3 L. Loss, Securities Regulation, 1436-47 (2d ed. 1961). *See also* A.T. Brod & Co. v. Perlow, 375 F.2d 393, 396-97 (2d Cir. 1967) (court found a fraudulent scheme perpetrated by several customers upon a broker, whereby the customers placed buy orders with the broker with the intention to pay for the orders only if the market value of the securities increased).

Rule of Civil Procedure 9(b)[224]

> does not require nor make legitimate the pleading of detailed evidentiary matter. . . . Nor does Rule 9(b) require any particularity in connection with an averment of intent, knowledge or condition of the mind. It only requires the identification of the circumstances constituting fraud *so that the defendant can prepare an adequate answer* from the allegations.[225]

From this the court concluded that while mere conclusory allegations of fraudulent activity would be insufficient, plaintiffs in *Walling* had alleged much more, including the time, place and nature of defendant's fraudulent activity,[226] and therefore, the court below erred in dismissing the action. The Ninth Circuit, however, returned the case on remand for a determination as to whether the allegations in the complaint could be proven. The court noted, "Not every breach of a stock sale agreement adds up to a violation of the securities law. Whether there is actionable fraud or a mere breach of contract depends on the facts and circumstances developed at the trial or on a motion for summary judgment."[227]

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224. FED. R. CIV. P. 9(b), 28 U.S.C. app. at 405 (1976) provides: "Fraud, mistake, condition of the mind.

In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

225. 476 F.2d at 397 (emphasis added) (citations omitted) (quoting Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 774 (D. Colo. 1964)).

226. 476 F.2d at 397. *See* Gottreich v. San Francisco Inv. Corp., 552 F.2d 866, 867 (9th Cir. 1977) (Ninth Circuit held a complaint alleging "the time, place and content of the false misrepresentation[s], the fact[s] misrepresented and what was obtained or given up as a consequence of the fraud" sufficient to state a cause of action under rule 10b-5. (quoting 2A MOORE'S FEDERAL PRACTICE ¶ 9.03, at 1927-28 (2d ed. 1975)).

227. 476 F.2d at 397. The Fifth Circuit, in Woodward v. Metro Bank, 522 F.2d 84 (5th Cir. 1975), recognized that a line must be drawn between violations of securities laws and other claims with respect to unfair business activities which are governed by state laws, such as the Uniform Commercial Code, or other federal laws, such as the antitrust laws. The Fifth Circuit explained:

> In the formulation of relief, however, concepts of fairness to those who are expected to govern their conduct under rule 10b-5 should be considered. Protection for investors is of primary importance, but it must be kept in mind that the nation's welfare depends upon the maintenance of a viable, vigorous business community. Considered alone, the sweeping language of Rule 10b-5 creates an almost completely undefined liability. . . . Without further delineation, civil liability is formless, and the area of proscribed activity could become so great that the beneficial aspects of the rule would not warrant the proscription. . . . In recognition of this problem, courts have sought to construct workable limits to liability under section 10(b) and Rule 10b-5 which will accommodate the interests of investors, the business community, and the public generally.

Id. at 91 (quoting Herpich v. Wallace, 430 F.2d 792, 804-05 (5th Cir. 1970)).

The Ninth Circuit again found a possible remedy for corporate misconduct under rule 10b-5 in *Bosse v. Crowell Collier & MacMillan*.[228] The plaintiff corporation in *Bosse* had assigned its controlling shares to the MacMillan Company as collateral for MacMillan's assistance in bailing the plaintiff corporation out of debt. Plaintiff eventually defaulted and MacMillan held a foreclosure sale of the stock, at which it was the prime buyer. Amidst other claims brought under the antitrust and federal securities laws, plaintiffs alleged a claim under rule 10b-5. The district court dismissed this claim for lack of subject matter jurisdiction.

The Ninth Circuit, however, upheld the claim on two levels. The court found plaintiff's complaint sufficient under Federal Rule of Civil Procedure 9(b) in that it met the *Walling* test—it identified enough circumstances constituting fraud to enable the defendant to prepare an adequate answer.[229] The court also found that the alleged facts gave rise to a possible claim for relief under rule 10b-5. Citing *Walling*, the court stated that "if there is a 'sale' of security and if fraud allegedly is used 'in connection with' that sale, there is possible redress under section 10(b), regardless of whether a remedy is available under state law."[230] The court found that MacMillan had employed a "manipulative or deceptive device" by establishing a debtor-creditor relationship with plaintiff with the underlying intention of gaining control. Accordingly, the court held that plaintiff's claim gave rise to a possible claim for relief under section 10(b) and rule 10b-5, and thus survived attack under Federal Rule of Civil Procedure 12(b)(6).[231]

4. Materiality

Not all misrepresentations or nondisclosures in connection with securities transactions are actionable under the securities laws. Rule 10b-5 makes it unlawful "[t]o make any untrue statement of a *material* fact or to omit to state a *material* fact. . . ."[232] In every claim brought under rule 10b-5, a question thus arises as to whether the misrepresentation or omitted fact was material.

The United States Supreme Court set forth a definition of materi-

228. 565 F.2d 602 (9th Cir. 1977).

229. *Id.* at 611.

230. *Id.* See text accompanying notes 272-93 *infra* for a discussion of the "in connection with" requirement.

231. *Id.* FED. R. CIV. P. 12(b)(6), 28 U.S.C. app. at 407 (1976), permits dismissal of the suit where plaintiff has failed to state a claim upon which relief can be granted.

232. Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b) (1978) (emphasis added), set forth in its entirety in note 122 *supra*.

ality in *TSC Industries, Inc. v. Northway, Inc.*[233] The Court held, "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[234] Although *TSC Industries* involved a claim brought under the federal proxy rules,[235] this definition has been adopted in rule 10b-5 actions as well.[236]

In *Robinson v. Cupples Container Co.*,[237] the Ninth Circuit applied the *TSC Industries* test: "whether 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question.' "[238] In *Robinson*, the plaintiff alleged that an acquiring corporation falsely represented that it would invest significant sums in the expansion of the acquired corporation. The court noted,

> Where the representation in question is a promise of one of the parties, the representation must be viewed in the light of the relationship of the parties, the context in which the statement was made, the experience and bargaining position of the investor and the nature of the transaction as well as the character of the underlying fact.[239]

233. 426 U.S. 438 (1976).

234. *Id.* at 449. The Court went on to explain:

> [Materiality] does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to *change* his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.

Id. (emphasis added).

235. The claim in *TSC Industries* was brought under section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(2) and rule 14a-9, 17 CFR § 240.14a-9 (1975), promulgated thereunder.

236. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474 n.14 (1977). The Supreme Court found that because respondents did not indicate how they would have proceeded differently if they had prior notice of the subject merger, it could not be found that the failure to give them advance notice of the merger was a material nondisclosure within the meaning of section 10(b) or rule 10b-5. *Id.*

237. 513 F.2d 1274 (9th Cir. 1975).

238. *Id.* at 1277 (quoting Marx v. Computer Sciences Corp., 507 F.2d 485, 489 (9th Cir. 1975) (earnings forecast a "material" fact under rule 10b-5)). *See generally* 3 BROMBERG, *supra* note 130, § 8.3 at 201.

239. 513 F.2d at 1277. *Cf.* Taylor v. Smith, Barney & Co., Inc., 358 F. Supp. 892, 895 n.9 (N.D. Utah 1973) (suggesting that in actions brought by the SEC, the measure of materiality is the prototype "reasonable investor," and in impersonal transactions, such as those accomplished through a stock exchange, courts may decline to examine the surrounding circumstances).

After carefully weighing these factors, the court concluded that no reasonable investor would have attached importance to the acquiring corporation's earlier statements regarding investment during negotiations, when the contract ultimately signed made no provision for investment by the acquiring corporation. Thus, the court concluded that the alleged misrepresentations were not material within the meaning of the rule.[240]

The issue of materiality has posed special problems in cases dealing with predictions and forecasts. In *G & M, Inc. v. Newbern*,[241] for example, plaintiff purchased stock from defendant in reliance upon defendant's statement that his expected earnings for the year would be around $155,000. The actual earnings for that year only amounted to $43,000. Defendant contended that his statement was a mere expression of opinion and therefore not actionable. The court held that although a "reasoned and justified statement of opinion" supported by a "sound factual or historical basis" is usually not actionable,[242] in this case, considering "the gross disparity between [the] prediction and [the] fact,"[243] and considering defendant's various other misrepresentations and nondisclosures,[244] it was not difficult to find this prediction actionable.[245]

The Ninth Circuit faced a similar situation in *Marx v. Computer Sciences Corp.*[246] The plaintiff alleged that defendant had violated rule 10b-5 by issuing an earnings forecast that was both "untrue" and misleading, in that it omitted material facts required to make it "not misleading."[247] In accordance with its previous decision in *G & M, Inc.*, the court recognized that a forecast may be regarded as a fact within the meaning of rule 10b-5.[248] The court further recognized that an

240. 513 F.2d at 1277. *See* Northwest Paper Corp. v. Thompson, 421 F.2d 137 (9th Cir. 1969) (per curiam) (although materiality is usually a question for the jury, in this case, a reasonable man would have attached no importance to the nondisclosed facts and therefore these facts were held immaterial as a matter of law).

241. 488 F.2d 742 (9th Cir. 1973).

242. *Id.* at 745-46. *See generally* 1 BROMBERG, *supra* note 130, § 5.3 at 97; § 7.2(1) at 147-48 and cases cited therein.

243. 488 F.2d at 746.

244. Defendant had also misrepresented facts concerning a prior lease. The court viewed defendant's conduct "as part of the larger picture of misrepresentations involved in the contract." 488 F.2d at 745.

245. *Id.* at 746.

246. 507 F.2d 485 (9th Cir. 1974).

247. *Id.* at 487.

248. 507 F.2d at 489. *Cf.* Franklin Sav. Bank v. Levy, 551 F.2d 521, 529-30 (2d Cir. 1977) (Van Graafeiland, J., concurring in part and dissenting in part) (suggesting that although an earnings forecast may be regarded as a material fact, a pure expression of opinion is not by

earnings forecast constitutes a "material fact" in that investors invariably rely on a company's earnings projections in estimating the worth of the company's stock.[249] This is especially true when such projections are issued towards the end of a fiscal year.[250]

The court next examined whether or not the forecast was an "untrue" statement. The court recognized the fact that a statement proves to be wrong when viewed in hindsight does not necessarily make it untrue when made. Nonetheless, if the forecast were not based on the maker's informed and reasonable belief at the time it was made, or if the maker did not engage in a reasonable method of preparation prior to making the forecast, such forecast could be viewed as untrue.[251] In other words, the court found an inquiry into the circumstances underlying the forecast essential to a determination of whether or not defendant could be held liable under rule 10b-5 for issuing an untrue earnings forecast.[252]

The Ninth Circuit in *Marx* discussed materiality in terms of fault, and thus "inextricably linked" materiality to the scienter requirement of rule 10b-5.[253] This requirement stemmed from the common law action for fraud which required some element of fault to be shown before a defendant could be held liable.[254] In an earlier decision,[255] the Ninth Circuit rejected stringent proof of fault as required by common law fraud actions, and substituted in its place an inquiry into whether or not the defendant owed a duty to the plaintiff not to issue statements involving misrepresentations or nondisclosures.[256] Applying this stan-

definition a statement of fact. "The 'material fact' in such instance is that the speaker honestly holds the opinion which he has expressed." *Id.* at 530).

249. 507 F.2d at 489.

250. *Id. See generally* 2 BROMBERG, *supra* note 130, § 7.2(1) at 149 ("Earnings reports for completed periods are of major importance to investors for their historical character and as a predictive base."). *See also* Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1197 (1970) (SEC opposition to forecasts of operating results filed with it).

251. 507 F.2d at 490.

252. *Id.*

253. The court stated:

> [W]e are clear that the determination of untruthfulness vel non of a statement is inextricably linked with the so-called 'scienter' requirement of a private 10b-5 action and involves an inquiry into the circumstances underlying the statement to ascertain whether or not the maker was guilty of some fault or otherwise culpable.

Id. at 490 (footnote omitted).

254. See text accompanying notes 335-84 *supra* for a discussion of the scienter requirement of rule 10b-5 actions.

255. White v. Abrams, 495 F.2d 724 (9th Cir. 1974).

256. "In this circuit, we have never adhered to the requirement of scienter in the common law fraud sense. . . . The proper standard to be applied is the extent of the duty that rule

dard, the court in *Marx* concluded that in light of the great importance an investor would attach to an earnings forecast, defendant's knowledge that investors would rely on the forecast, and defendant's superior knowledge of the circumstances surrounding the preparation of the forecast, a jury could reasonably find that the forecast was actionably untrue.[257]

The court next examined whether or not defendant's forecast omitted material facts necessary to make it not misleading. Plaintiff claimed that defendant should have publicized, in conjunction with the forecast, all or some of the problems the company was experiencing. The court noted that a company need not publicize every fact that might affect the accuracy of an earnings forecast, but only those facts considered to be material.[258] The court concluded that whether defendant's failure to disclose some or all of the problems facing the corporation in conjunction with the earnings forecast would have influenced the decision of a reasonable investor to invest, and, therefore, would be material, was a factual determination best left to the jury.[259]

By definition, materiality is more difficult to establish in cases involving nondisclosures than in those involving misrepresentations. The materiality of nondisclosures depends upon whether or not a statement, which may be truthful on its face, actually is misleading in light of a scheme to defraud the plaintiff. The Ninth Circuit found such a scheme in *Lewelling v. First California Co.*[260]

The controversy in *Lewelling* arose out of a scheme to enable in-

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10b-5 imposes on this particular defendant." *Id.* at 734-35. The so-called "flexible duty standard" announced in *White* has arguably been set aside by the United States Supreme Court's holding in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (proof of negligent conduct on the part of defendant will not sustain a claim under rule 10b-5). See note 375 and accompanying text *infra* for a more detailed discussion of *Ernst & Ernst* and the flexible duty standard.

257. 507 F.2d at 490. In light of this conclusion the court found that summary judgment for defendant had improperly been granted. *Cf.* Hughes v. Dempsey-Tegeler & Co., Inc., 534 F.2d 156, 176 (9th Cir.), *cert. denied*, 429 U.S. 896 (1976) (although the Ninth Circuit found a "heavy duty" owed by defendant to the plaintiff, defendant's comments which the district court characterized as "an over-simplified, self-serving hunch that everything would work out all right" were not actionable).

258. 507 F.2d at 491 (footnote omitted). See 3 BROMBERG, *supra* note 130, § 8.3 at 201 ("[t]he bigger and more diversified the company, the less material a given bit of information is.").

259. The court noted that material omissions might be actionable even if the earnings forecast on its face was correct if, due to these omissions, an erroneous picture of the company was conveyed. 507 F.2d at 492 n.12.

260. 564 F.2d 1277 (9th Cir. 1977).

siders to bail-out of failing corporations. As part of the scheme, securities were passed through several brokerage houses in an attempt to "launder" them and conceal the underlying "bail-outs" of the insiders.[261] Plaintiff brought an action under rule 10b-5 alleging that defendant brokerage firm had violated the rule by its failure to disclose to plaintiff either the insider source or the seller's reasons for disposing of the stock. The trial court found that the sales to plaintiff were part of a larger scheme to unload "bad" stock and, therefore, defendant's nondisclosure of the existence of the scheme was material.

On appeal, defendant contended that insufficient evidence was presented at trial to support a finding that insiders were actually bailing out of failing corporations. The Ninth Circuit dismissed this contention and found that the actual routing of the securities through the "laundering" process was in itself a material fact that should have been disclosed. The court concluded, "The *reason* for this 'laundering' attempt may not be as significant to an investor as the fact that the investment house with which he was dealing was engaging in the practice."[262] On this basis, the court found that the trial court's conclusion that the omissions were material, in other words, that "a reasonable man *would*[263] attach importance in determining his choice of action in the transaction in question" to the nondisclosed facts,[264] was not clearly erroneous.[265]

Materiality was also found by the Ninth Circuit in *Kidwell v. Meikle*,[266] and *Zweig v. Hearst Corp.*[267] Both cases involved the materiality of omitted facts. In *Kidwell*, the court followed a "shareholder-

261. *Id.* at 1279.

262. *Id.*

263. The Ninth Circuit noted that it considers the Supreme Court's definition of materiality in *TSC Industries* imprecise because confusion still exists as to whether the test for materiality is "would" or "might". *Id.* at 1279 n.3. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. at 447 n.9, wherein the Supreme Court indicated that in its discussion of materiality in the *Affiliated Ute* decision "[i]t was not necessary to articulate a precise definition of materiality, but only to give a 'sense' of the notion."

In any event, the Ninth Circuit found the definition in *Northwest Paper Corp.*, containing the word "would," controlling, at least until the Supreme Court speaks more precisely. 564 F.2d at 1279 n.3.

264. 564 F.2d at 1279 (quoting Northwest Paper Corp. v. Thompson, 421 F.2d 137, 138 (9th Cir. 1969)).

265. 564 F.2d at 1279. *Cf.* Ryan v. Foster & Marshall, Inc., 556 F.2d 460, 463 (9th Cir. 1977) (Ninth Circuit affirmed the district court's finding that defendant had not engaged in any act, practice or course of business in violation of section 10(b) or rule 10b-5 on the ground that the district court's findings were not clearly erroneous).

266. 597 F.2d 1273 (9th Cir. 1979).

267. 594 F.2d 1261 (9th Cir. 1979). See text accompanying notes 375-85 *infra* and where *Zweig* is discussed in greater detail.

focused" materiality analysis, which is essentially a variation of the reasonable investor standard. The focus in this analysis is upon whether a reasonable *shareholder* would have considered the omitted facts significant.[268] In *Kidwell*, the court found that a reasonable shareholder probably would have considered the undisclosed information material to any decision as to whether or not to block the allegedly fraudulent sale of the corporate assets.[269]

In *Zweig*, the Ninth Circuit again employed the objective test for materiality enunciated by the Supreme Court in *TSC Industries*. The court found that reasonable investors who read the defendant's financial column would have considered the motivations of its author to profit personally from his predictions an important factor in deciding whether to invest in the promoted company.[270] Similar to its finding in *Lewelling*, the court found in *Zweig* that defendant's conduct with respect to plaintiff was part of a larger scheme to defraud the public. Also, similar to its finding in *Marx*, the court in *Zweig* linked the question of materiality to the scienter requirement.[271]

5. "In connection with"

A particularly broad prerequisite to suit under section 10(b) and rule 10b-5 is that the alleged material misrepresentations or nondisclosures be made "in connection with" a purchase or sale of securities.[272] Two issues are inherent in this requirement: (1) whether there was a causal connection between the alleged misconduct and a sale or purchase; and (2) whether the misconduct occurred during what actually could be termed a sale or purchase. The Ninth Circuit, in dealing with these issues, has recognized the overlap of this requirement with its sister requirements of standing and reliance. Without an actual purchase or sale, a plaintiff cannot have standing to sue under the statute or the rule, and without establishing the element of reliance, a causal connection between the misconduct and the purchase or sale

268. 597 F.2d at 1293 n.10.

269. *Id.* at 1293.

270. 594 F.2d at 1266.

271. See text accompanying notes 335-84 *infra* for a discussion of *Zweig* and the scienter requirement.

272. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j) (1976) provides in relevant part: "It shall be unlawful . . . . (b) To use or employ, *in connection with the purchase or sale of any security* . . . any manipulative or deceptive device . . . ." (emphasis added).

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979) provides in pertinent part: "It shall be unlawful to make any material misrepresentations or employ any deceptive devices *in connection with the purchase or sale of any security*." (emphasis added).

cannot be shown. Considering this overlap, it is not surprising that the cases seldom discuss the "in connection with" requirement as a separate and distinct issue.

When this requirement is discussed, the courts have found little guidance in the statute and the rule itself as to proper resolution of these issues with respect to any particular case. In most cases, a determination of whether this requirement has been satisfied rests upon the answer to a basic policy question: Is this the kind of misconduct Congress intended to forbid under the securities laws?[273]

This reasoning was employed by the United States Supreme Court in *SEC v. National Securities, Inc.*,[274] in which the Court was faced with a novel situation: Whether fraudulent statements made in a proxy solicitation to shareholders, which affected their participation in a corporate merger, constituted misconduct "in connection with" a purchase or sale actionable under rule 10b-5. Respondents argued that pursuant to the 1933 Act, statutory mergers and corporate reorganizations were not to be considered sales, and, therefore, any alleged misconduct in connection with a merger could not have occurred "in connection with" a purchase or sale.[275] The Court, however, cautioned that the meaning of particular phrases used by Congress in various other sections of the securities laws do not necessarily carry over into other sections. Each phrase must be interpreted within the context of the section being examined.[276] The Court, therefore, narrowed its inquiry to determine the meaning of "sale" and "purchase" within the context of section 10(b).

An examination of the definitional sections of the 1934 Act proved virtually useless to the Court in determining whether a corporate merger could be considered a purchase or sale within the meaning of section 10(b). These sections merely state that the terms "purchase"

273. This basic question seems to permeate the other requirements under rule 10b-5 as well. *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (shareholder's derivative action for corporate mismanagement was not within the scope of rule 10b-5 where no material misrepresentation or nondisclosures could be shown).

274. 393 U.S. 453 (1969).

275. Respondents relied upon rule 133 promulgated under the Securities Exchange Act of 1933, 17 C.F.R. § 230.133 (1968), which provides in pertinent part that:

> (a) For purposes only of § 5 of the Act, no "sale," "offer to sell," or "offer for sale" shall be deemed to be involved so far as the stockholders of a corporation are concerned where . . . there is submitted to the vote of such stockholders a plan or agreement for a statutory merger or consolidation . . . .

276. 393 U.S. at 466.

and "sale" include contracts either to purchase or sell.[277] Likewise, neither section 10(b) itself, nor rule 10b-5 casts any light on the scope of the terms "purchase" and "sale."

Faced with the vague statutory language, the Court found it necessary to examine Congress' broad purposes behind section 10(b) to determine whether the alleged misconduct was "the type of fraudulent behavior which was meant to be forbidden by the statute and the rule."[278] The Court concluded that the purposes underlying the rule would be clearly furthered by holding that the shareholders in this case had "purchased" shares by exchanging their old shares for shares in the new company.[279]

This rationale was the basis for the Ninth Circuit's decision in *Ohashi v. Verit Industries*.[280] Although defendants in *Ohashi* were engaged in an alleged scheme to raise artificially the price of stock, and such scheme directly affected the plaintiff, the Court found it impossible to connect the fraudulent acts to plaintiff's purchase without looking way beyond the literal meaning of the "in connection with" requirement. The plaintiff, Ohashi, had signed a contract to purchase stock. The contract expressly contained certain restrictions on transfer of the stock. The alleged fraudulent activity occurred after Ohashi had

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277. Sections 3(a)(13)-(14) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78c(a)(13)-(14) (1976) provide:
"(13) The terms 'buy' and 'purchase' each *include* any contract to buy, purchase, *or otherwise acquire*. (14) The terms 'sale' and 'sell' each *include* any contract to sell *or otherwise dispose of*." (Emphasis added).

The Supreme Court found the word "include" vague because it does not precisely indicate which transactions are included. The Court also found the terms "or otherwise acquire" and "or otherwise dispose of" equally vague, in that they provide little assistance in determining whether or not a statutory merger or corporate reorganization could be considered a "sale" within the meaning of section 10(b) and rule 10b-5. 393 U.S. at 466-67, 467 n.8.

278. 393 U.S. at 467.

279. The Court rationalized that as a result of respondent's deception, the shareholders lost both their status as shareholders in the new company and valuable appraisal rights under state law. The Court found that "an alleged deception has affected individual shareholders' decisions in a way not at all unlike that involved in a typical cash sale or share exchange." *Id.*

Respondents argued that fraud in connection with proxy materials is to be regulated pursuant to section 14, and not section 10(b) of the 1934 Act. The Court explained, however, that:

> the existence or nonexistence of regulation under § 14 would not affect the scope of § 10(b) and Rule 10b-5. . . . Section 10(b) applies to all proscribed conduct in connection with a purchase or sale of any security [while] § 14 applies to all proxy solicitations, whether or not in connection with a purchase or sale. . . . [S]ome overlap is neither unusual nor unfortunate.

393 U.S. at 468.

280. 536 F.2d 849 (9th Cir.), *cert. denied*, 429 U.S. 1004 (1976).

actually purchased the stock, but during the period in which the transfer restrictions were in effect. The court reasoned that if the contract by which Ohashi acquired the stock was still executory when the alleged fraudulent activities occurred, and if those activities affected the unperformed part of the bargain, the fraud could be considered to have occurred "in connection with" Ohashi's acquisition of the stock.[281]

To determine whether the contract was still executory at the time the alleged fraud occurred, the court turned to the laws of California, where the contract was made. "Under California law, every contract contains an implied covenant of good faith and fair dealing."[282] The Ninth Circuit reasoned that even though the defendants did not have an express contractual duty to remove the transfer restrictions imposed on Ohashi, the implied covenant of good faith and fair dealing imposed by California law required their cooperation to permit removal of the restrictions as soon as was feasible in order for Ohashi to recover the full benefit of his bargain. Accordingly, the court found that the contract remained executory until the restrictions were removed. The court further found that because the restrictions were still in effect at the time of the alleged fraudulent activity, Ohashi had stated a claim under section 10(b) and rule 10b-5.[283]

It is clear that the Ninth Circuit did not rely upon a literal reading

281. A favorable determination by the court on this issue also gave Ohashi standing to sue, for the court had already rejected Ohashi's contentions that his inability to sell to third persons, or his inability to sell at a higher market price due to defendant's misconduct, afforded him standing. The court noted that it had been well-settled in *Blue Chip Stamps* that standing cannot be established under the statute or the rule based on non-sales. It was therefore crucial to Ohashi that the court find he was still a purchaser at the time the alleged fraud occurred.

Although the Ninth Circuit did not expressly state that if Ohashi's claim satisfied the "in connection with" requirement it would also satisfy the "standing" requirement, the court's ultimate finding that Ohashi had stated a claim under rule 10b-5 suggests that the two requirements are intimately connected.

The Supreme Court in *National Securities, Inc.* did not have to reach the question of whether the shareholders could be labelled "purchasers" for purposes of standing pursuant to the *Birnbaum* rule, even though the Court viewed the exchange of stock as a "purchase" for purposes of the "in the connection" requirement. The purchaser-seller requirement was not an issue in *National Securities, Inc.* since the action was brought by the SEC itself. 393 U.S. at 467 n.9.

282. 536 F.2d at 853. *See* Crail v. Blakely, 8 Cal. 3d 744, 749-50, 505 P.2d 1027, 1031, 106 Cal. Rptr. 187 (1973); Berkeley Lawn Bowling Club v. City of Berkeley, 42 Cal. App. 3d 280, 286-87, 116 Cal. Rptr. 762, 766 (1974).

283. The court noted, however, that even though the alleged misrepresentations were considered to have been made in connection with the acquisition of stock, the trial court must determine from the facts whether defendant's misconduct constituted actionable fraud under the securities laws, or a mere breach of contract, more appropriately left to the state court's determination. The court stated:

of either section 10(b) or rule 10b-5, or the definitional sections of the 1934 Act in finding Ohashi had satisfied the "in connection with" requirement. Although the Ninth Circuit did not expressly follow the Supreme Court's reasoning in *National Securities, Inc.*, the *Ohashi* decision may ultimately rest upon a similar policy decision.[284] Defendants were engaged in a manipulative scheme to raise artificially the price of the corporation's publicly traded stock in an attempt to keep Ohashi's stock off the market.[285] Such conduct clearly fits within the sphere of the type of behavior that was meant to be forbidden by the statute and the rule.

Further evidence of the Ninth Circuit's lenient approach to the "in connection with" requirement, at least where a blatant manipulative scheme is evident, can be seen from the court's decision in *Lewelling v. First California Company*.[286] Lewelling had entrusted his investment account to an employee of a brokerage firm who purchased securities on Lewelling's behalf but without Lewelling's knowledge. Lewelling would first hear of each purchase when he received a slip from the firm confirming the transaction. Upon receipt of each slip, Lewelling would immediately call the broker for an explanation of the purchase. Prior to the suit, Lewelling had never tried to overturn a purchase. After two years of such dealing, however, Lewelling discovered that the brokerage firm with which he was dealing was engaged in a massive fraudulent scheme in which "bad" stock was being routed through various brokerage firms in an attempt to enable insiders to bail out of failing

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> Not every failure to perform a contractual covenant in a contract to sell or exchange securities can become a basis for a claim that a defaulting party has employed a "device, scheme, or artifice to defraud" within the meaning of Rule 10b-5 . . . . "[W]hether there is actionable fraud or a mere breach of contract depends on the facts and circumstances developed at the trial or on motion for summary judgment."

536 F.2d at 854 (quoting A.T. Brod & Co. v. Perlow, 375 F.2d 393, 398 (2d Cir. 1967)). The court further noted that although the alleged misrepresentations were made in connection with the covenant of good faith and fair dealing in the exchange agreement, the complaint failed to specifically relate the alleged fraud in connection with the exchange to identified out-of-pocket loss suffered by Ohashi as a consequence of the fraud. The court, however, suggested that on remand the complaint could be cured by amendment. 536 F.2d at 854.

284. *See* Niederhoffer, Cross & Zeckhauser, Inc. v. Telstat Sys., Inc., 436 F. Supp. 180, 186 (S.D.N.Y. 1977) (distinguishing *Ohashi* on the ground that it "raised issues of broad concern under the securities law"). *See also* Goodman v. Epstein, 582 F.2d 388, 411 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979) (*Ohashi* cited for the proposition that the "in connection with" requirement must be viewed with respect to the facts of the particular case at bar).

285. 536 F.2d at 852. Ohashi had in fact alleged in his complaint that defendants were engaged in such a conspiracy.

286. 564 F.2d 1277 (9th Cir. 1977).

corporations. This scheme to "launder" the stock was intentionally concealed from individual investors such as Lewelling.[287]

The defendants contended that the alleged nondisclosures did not occur in connection with either a purchase or sale of securities. The defendants reasoned that because Lewelling communicated only with the broker after each purchase had been consummated, Lewelling could not have been induced to purchase by the nondisclosures but rather was only induced to *retain* the stock. Thus, plaintiff would merely be an "aborted seller" and as such would lack standing to bring the subject suit.[288]

The Ninth Circuit disagreed with the defendants' reasoning. First, the court noted that the trial court had found that Lewelling retained the power to call off any purchase even after he received the confirmation slip. His decision whether or not to call off each purchase was guided solely by the information divulged by his broker. Thus, the defendants' nondisclosures were material to Lewelling's investment decisions. The court held that because Lewelling could have called off any purchase had he received complete information from the broker, the defendants' fraudulent scheme occurred in connection with each purchase.

The Ninth Circuit, however, qualified its reasoning, finding that the trial court's concern with exactly when each purchase could be deemed complete was totally unnecessary.[289] The important question, regardless of when the transactions were completed, remained whether the alleged omissions were "the type of fraudulent practice which the securities laws guard against."[290] The court found that the facts underlying the fraudulent scheme to launder the stock occurred well before any of the purchases in question, and thus, the overall pattern of fraud tainted each transaction with plaintiff.

287. The court inferred the required intent from the district court's use of the terms "scheme," "launder" and "bail-out" in connection with defendants' transactions. *Id.* at 1281 n.6.

288. *Id.* at 1279. See text accompanying notes 167-69 *supra* for a discussion of the "aborted seller" exception to the *Birnbaum* rule.

289. The Ninth Circuit had previously held that section 10(b) and rule 10b-5 do not require that the fraud occur prior to the consummation of a sale, but only that the fraud be directly related to the sale. Lanning v. Serwold, 474 F.2d 716 (9th Cir. 1973) (plaintiff was forced to pay nearly $4,000 more for shares he had purchased due to defendant's misrepresentations). Although the court in *Lanning* did not specifically state that its decision was based on policy considerations, it did quote the Supreme Court's directive that "[s]ection 10(b) must be read flexibly, not technically and restrictively." *Id.* at 719 (quoting Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971)).

290. 564 F.2d at 1280.

It is clear from both *Ohashi* and *Lewelling* that the Ninth Circuit has stretched the "in connection with" requirement, finding the broad purposes underlying the securities laws a guiding factor in determining whether alleged misconduct occurred in connection with a sale or purchase. In *Ohashi*, the Ninth Circuit stretched the term "contract to purchase" to fit the period in which the fraud on plaintiff took place. In *Lewelling*, the court went one step further and stated in essence that the timing of the fraud in connection with a sale or purchase is not controlling.

The broadest use of the "in connection with" requirement by the Ninth Circuit is in *Zweig v. Hearst Corp.*[291] In that case, the Ninth Circuit found a causal connection between a financial columnist's non-disclosures and damages suffered by plaintiffs who had acquired stock in a merger in a market tainted by defendant's misleading column.[292] Circuit Judge Ely, in a dissenting opinion, stated:

> The majority effectively removes the substantive content in the requirement of "in connection with" when it holds that [the columnist] may be liable in damages under Rule 10b-5 to individuals who decided to acquire stock and executed a merger agreement months before the wrongful conduct occurred . . . . [M]y Brothers stretch section 10(b) and Rule 10b-5 beyond their breaking point . . .[293]

6. Reliance

Traditionally, a crucial element of any common law fraud action has been a showing that plaintiff relied to his detriment on defendant's misrepresentations or omissions.[294] This element, however, poses special problems when applied to the antifraud provisions contained in section 10(b) and rule 10b-5. In face-to-face securities transactions, proof of reliance may be established without much difficulty. In the context of open market transactions, however, it may be quite difficult to establish on "what" and on "whom" plaintiff relied. In addition, it is difficult to prove reliance on an omitted fact. Often, plaintiffs have suffered because they relied on what they believed to be an open and fair market. For this reason, courts have held that traditional proof of reliance is not essential in certain circumstances to recover under either the statute or the rule.

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291. 594 F.2d 1261 (9th Cir. 1979).
292. See text accompanying notes 375-82 *infra* for a more detailed discussion of *Zweig*.
293. 594 F.2d at 1272 (Ely, J., dissenting).
294. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 685-86 (4th ed. 1971).

In *Affiliated Ute Citizens v. United States*,[295] the United States Supreme Court held that it would not read rule 10b-5 so restrictively as to preclude recovery if reliance were not proven at trial. The issue rose out of a claim brought by members of the Ute Indian Tribe against a bank which held certain shares of stock in a tribal corporation. Plaintiffs alleged that employees of the bank were engaged in a scheme to acquire stock from mixed-blood Indians at a price substantially below market value and then sell the stock to non-members of the tribe for a substantially higher price. This was done without making full disclosure of the scheme to plaintiffs.

Although the record contained no evidence that plaintiffs had actually relied on defendant's nondisclosures, the Court held:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.[296]

In reaching this conclusion, the Court redefined causation with respect to rule 10b-5 actions involving material omissions. It moved away from requiring a common law showing that plaintiff relied to his detriment on defendants' nondisclosures and substituted in its place a test which presumes causation from proof of defendant's deception and proof of plaintiffs' purchase or sale "in connection with" that deception.[297]

In *Blackie v. Barrack*,[298] the Ninth Circuit concluded that "subjective reliance is not a distinct element of proof of 10b-5 claims."[299] *Blackie* involved the consolidated appeal of several class actions brought by persons who had purchased Ampex securities between May 2, 1970, the date on which Ampex had issued its annual report showing a $12 million profit, and August 3, 1972, the date on which the company had reported a loss of $90 million. Plaintiffs alleged that Ampex had misrepresented its financial condition in its 1970 annual report and

295. 406 U.S. 128 (1972).

296. *Id.* at 153-54. *See also* Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 384 (1970). The Court stated that

> where the misstatement or omission in a proxy statement has been shown to be material . . . that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote.

297. See text accompanying note 272 *supra* for a discussion of the interrelation between the "in connection with" and reliance requirements.

298. 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

299. *Id.* at 905.

in subsequent interim reports and had failed to disclose factors necessary to avoid making the reports misleading.

The Ninth Circuit relied in *Blackie* on two theories to support its conclusion that proof of reliance is not necessary in rule 10b-5 cases. The first theory reflected the reasoning in *Affiliated Ute* that if defendant's omissions were material, it could be presumed that plaintiffs would have acted differently had they known of the omissions.[300] The second theory went far beyond the rationale expressed in *Affiliated Ute*. The Ninth Circuit reasoned that, in the context of an open market, proof of reliance was not essential, even in cases of positive misrepresentation, when it could be shown that such misrepresentations were material and that plaintiffs relied on an open, non-manipulated market.[301]

Other circuits have not read the *Affiliated Ute* decision as broadly as the Ninth Circuit did in *Blackie*. Some courts have limited the use of the reliance presumption to cases involving non-disclosures and omissions.[302] Other courts have reasoned that *Affiliated Ute* still requires some "general sense of reliance," even in nondisclosure cases.[303]

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300. *Id.* at 905-06.

301. *Id.* at 906.

302. In Vervaecke v. Chiles, Heider & Co., 578 F.2d 713, 717 (8th Cir. 1978), for example, the Eighth Circuit stated that it is not appropriate to apply the *Affiliated Ute* test to cases primarily involving misrepresentations, in that such cases closely resemble tort actions for deceit where reliance is not difficult to prove. The court stated that in affirmative misrepresentation cases, "the lack of barriers to proof permits the compensatory and deterrent purposes to be adequately served by testing causation directly." The Sixth Circuit read *Affiliated Ute* narrowly in Chelsea Assocs. v. Rapanos, 527 F.2d 1266, 1271 (6th Cir. 1975), where it found proof of reliance on the misstated or false fact essential in cases involving misrepresentations. The Sixth Circuit reasoned that "[t]he Supreme Court's presumption of reliance meets the conceptual difficulty of proof of reliance on a negative fact." *Id.* The court did not perceive this difficulty in cases involving misrepresentations.

303. *E.g.*, Rifkin v. Crow, 574 F.2d 256 (5th Cir. 1978), where the Fifth Circuit stated that even *Affiliated Ute* requires some element of general reliance in nondisclosure cases. *Id.* at 261. The Fifth Circuit noted that in *Affiliated Ute*, the Supreme Court found the presumption of reliance arose because of the "circumstances of the case." *Id.* at 261 n.1. These circumstances included the fact that plaintiffs "considered these defendants to be familiar with the market for the shares of stock and relied upon them when they desired to sell their shares." Affiliated Ute Citizens v. United States, 406 U.S. at 152. The Supreme Court noted that if defendants in *Affiliated Ute* "had functioned merely as a transfer agent, there would have been no duty of disclosure here." *Id.* Thus, the Fifth Circuit reasoned that the *Affiliated Ute* decision dictates that a showing of specific reliance is not necessary if the plaintiff can show general reliance in terms of a duty of disclosure owed by defendants to plaintiffs. 574 F.2d at 261 n.1.

The Sixth Circuit employed similar reasoning in Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977). The court suggested that because of prior dealings between the bank employees and the Indians in *Affiliated Ute*, defendants owed a duty of disclosure to plaintiffs. The Sixth Circuit found no similar relationship between the

The Ninth Circuit, however, refused to support this distinction between cases involving negative omissions and those involving positive misrepresentations, at least in situations involving open market transactions.[304] The court in essence based its analysis on a policy decision: "The statute and rule are designed to foster an expectation that securities markets are free from fraud—an expectation on which purchasers should be able to rely."[305] Often, a purchaser on the open market is unaware of specific misrepresentations or omissions affecting the marketplace.[306] The court reasoned that requiring a plaintiff to prove a "speculative negative"—that he would not have bought had he

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parties in *Fridrich* and, therefore, refused to recognize a civil remedy for open market transaction without proof of reliance. *Id.* at 319.

304. In a later decision, Little v. First Cal. Co., 532 F.2d 1302 (9th Cir. 1976), the Ninth Circuit discussed the dilemma faced in trying to distinguish between omissions and misrepresentations:

> The categories of "omission" and "misrepresentation" are not mutually exclusive. All misrepresentations are also nondisclosures, at least to the extent that there is a failure to disclose which facts in the representation are not true. Thus, the failure to report an expense item on an income statement, when such a failure is material in the *Affiliated Ute* sense, 406 U.S. at 153-54, can be characterized as (a) an omission of a material expense item, (b) a misrepresentation of income or (c) both. There is a true dilemma presented in a case in which there has been a general representation from when material facts are omitted and there is no independent alternative ground, such as an "open market" situation, that justifies dispensing with a requirement that plaintiffs show individual reliance. . . . On the one hand, if individual proof of reliance is required of plaintiffs who have in fact relied to their detriment, but whose claims are not large enough to support the costs of such proof, then these plaintiffs will go uncompensated. On the other hand, if proof of reliance is not required, defendants are forced either to compensate plaintiffs who have not relied and whose harm defendants did not cause or to attempt the difficult, and perhaps impossible, task of rebutting plaintiff's demonstration of causation by attempting to show no reliance. It is not clear to us that one horn of the dilemma is clearly preferable to the other. But in any event, we feel the conceptual problem should be explicitly recognized as one in which there is no completely just solution. *But see* Blackie v. Barrack, 524 F.2d 891, 905-06 (9th Cir. 1975). Fortunately, we do not have to resolve this issue.

523 F.2d at 1304 n.4.

305. 524 F.2d at 907.

306. The Ninth Circuit is not alone in recognizing this problem. The Fifth Circuit in Rifkin v. Crow, 574 F.2d 256 (5th Cir. 1978), recognized that there might exist a "fraud on the market" theory of action, but the court then decided it was unnecessary to pursue this theory to decide the issues before it. *Id.* at 263. Likewise, in Vervaecke v. Chiles, Heider & Co., 578 F.2d 713 (8th Cir. 1978), the Eighth Circuit noted that in the area of impersonal market transactions, cases under rule 10b-5 have gone beyond traditional limits of the law of deceit. *Id.* at 717. *See generally* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975) [hereinafter *Reliance Requirement* (suggesting the *Affiliated Ute* test is best suited to cases involving nondisclosure in impersonal market settings where traditional proof of reliance is difficult to demonstrate). *See also* 3 BROMBERG, note 130, *supra* § 8.6 at 212 (a person who trades during the period in question may be harmed by a deception that affects prices and conditions in the relevant market, regardless of whether he has relied on or even heard the deception).

known[307]—presents too great an evidentiary burden for plaintiff to carry. The court therefore concluded that the "causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock."[308] In other words, the court reasoned that it can be *inferred* from the fact that a reasonable investor would have relied on the material misrepresentations in question, that an individual would have done likewise.[309]

The *Blackie* court also discussed the weight to be given to the above inference. Although some courts have spoken of a *presumption* of reliance,[310] the Ninth Circuit preferred to give less weight to proof of materiality: "[W]e prefer to recognize that materiality directly establishes causation *more likely than not*, and that reliance as a separate requirement is simply a milepost on the road to causation."[311] The effect of the inference is to shift the burden of disproving causation to the defendant. The defendant may attack the inference in at least two ways: "1) by disproving materiality or by proving that, despite materiality, an insufficient number of traders relied to inflate the price; and 2) by proving that an individual plaintiff purchased despite knowledge of the falsity of a representation, or that he would have, had he known of it."[312] If defendant can produce evidence of non-reliance, it is

307. 524 F.2d at 908. The court found this parallel to requiring proof of "I would not have sold had I known," a requirement which was expressly found unnecessary in *Affiliated Ute* and *Mills*.

308. *Id.*

309. The court noted that its conclusion rested "on the assumption that the particular investor is more likely to act like the reasonable investor than not." *Id.* at 906 n.22.

310. *See, e.g.*, Chelsea Assocs. v. Rapanos, 527 F.2d 1266, 1271 (6th Cir. 1975) ("The Supreme Court's *presumption of reliance* meets the conceptual difficulty of proof of reliance on a negative fact." (emphasis added)). The Ninth Circuit correctly noted in *Blackie* that the word "presumption" does not appear either in *Affiliated Ute* or in *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375 (1970) (an earlier decision dealing with § 14(a) of the 1934 Act in which the Court held materiality to be the proper test of causation). 524 F.2d at 906 n.22. *Cf.* Kidwell v. Meikle, 597 F.2d 1273, 1293 (9th Cir. 1979) (later decision where the court stated that "[i]n a non-disclosure case under Rule 10b-5, a finding of materiality creates a *presumption* of reliance." (emphasis added)).

311. 524 F.2d at 906 n.22 (emphasis added). The court does not discuss other "mileposts" which may be encountered along the way. The author of this article suggests that the court is perhaps referring to the "in connection with" requirement. See text accompanying notes 272-94 *supra* for further discussion of this requirement.

312. *Id.* at 906. The second method has frequently been employed in other circuits to rebut the *Affiliated Ute* "presumption" of reliance. *See, e.g.*, Mason v. Marshall, 531 F.2d 1274, 1275 (5th Cir. 1976) (per curiam) ("The objective materiality of the omissions was overcome by the strong evidence of plaintiffs' reliance on other sources."); Titan Group, Inc. v. Faggen, 513 F.2d 234, 238 (2d Cir. 1975) (the inference drawn from materiality is overcome where sufficient evidence is presented that plaintiff did not rely); Moody v. Bache &

presented to the jury to weigh against the inference of reliance. The court stated, however, it is doubtful "that a defendant would be able to prove in many instances to a jury's satisfaction that a plaintiff was indifferent to a material fraud."[313] This position was confirmed by the Ninth Circuit in *Little v. First California Company*,[314] a decision handed down subsequent to *Blackie*. The court in that case noted that defendant's opportunity to counter the reliance inference is particularly meaningless where open market transactions are concerned.[315]

In *Keirnan v. Homeland, Inc.*,[316] the first 1980 rule 10b-5 reliance decision, the court avoided the issue of whether or not reliance by third parties on *material misstatements* may be presumed outside the open market setting considered in *Blackie*. The plaintiff alleged that defendants had induced him to puchase a partnership interest in a bankrupt real estate venture through the issuance of a materially misleading prospectus. The district court found, however, that plaintiff had paid little attention to the prospectus with respect to his decision to invest in the real estate company[317] and thus dismissed the case.[318]

Co., 570 F.2d 523, 528 (5th Cir. 1978) ("a specific finding of no causation may suffice to overcome findings of reliance and materiality.").

313. 524 F.2d at 906-07 n.22. *Cf.* Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), where the court stated that the presumption should not survive if the defendant is able to show that the plaintiff would have acted in the same manner had he known of the nondisclosures. The Third Circuit in *Rochez* stated:

> We do not read [the *Affiliated Ute*] decision to say that the question of reliance *vel non* may not be considered at all in a non-disclosure case, but only that proof of reliance is not required for recovery. If defendant is able to demonstrate that there was clearly no reliance . . . then the non-disclosure cannot be said to have caused the subsequent loss and under the ordinary principles of the law of fraud, recovery should be denied.

Id. at 410.

314. 532 F.2d 1302 (9th Cir. 1976).

315. The court stated that "[e]ven though *Blackie* nominally allows defendants to rebut causation by a showing of no reliance, it seems to us that such a concession is virtually meaningless, and perhaps nonsensical, in an open market situation." *Id.* at 1304 n.3. The court went on to state that "*Blackie*, however, did not decide that everyone who purchased on the open market was injured nor did it hold that any particular measure of damage was invariably proper with respect to those so injured." *Id.*

316. 611 F.2d 785 (9th Cir. 1980).

317. The district court found:

> Keirnan knew that the figures in the prospectus were mere projections. He concedes that he paid little attention to the profitability projections in the prospectus. He was not looking for a conservative investment. He was primarily concerned with a tax shelter for some of his sizable income. Keirnan decided to invest primarily because three other physicians, including his friend Dr. Fisher, whose judgment he respected, had invested in Golfside and not because of representations made by the defendants. Substantial reliance is necessary for recovery in a 10(b)-5 case.

Id. at 788.

On appeal, plaintiff argued additionally that the district court erred in imposing upon him the heavy burden of proving reliance in fact. The Ninth Circuit found that, assuming the *Affiliated Ute* presumption should be extended to cases involving affirmative misrepresentations,[319] there was nothing in the record to support the argument that the burden of proving reliance was placed on plaintiff. Further, there was little doubt that the district court had found that defendants had successfully rebutted the presumption.[320]

On appeal, plaintiff argued additionally that the district court erred in permitting defendants to rebut the prima facie showing of reliance. He unsuccessfully contended that when a deception occurs in the context of direct negotiations between the parties to a transaction, causation may *only* be disproved by evidence showing that plaintiff *knew* the true facts. The Ninth Circuit did not agree: "Causation may also be disproved by a showing, as the trial court found here, that plaintiff did not attach significance to the misrepresented facts, and would not have attached significance to the omitted facts, and therefore would have acted as he did if he had known the truth."[321]

Plaintiff next contended that under *Blackie*, causation is established and reliance presumed when materially misleading statements are made to third parties on whose actions or advice plaintiff subsequently relies.[322] The Ninth Circuit also rejected this argument, stating,

> [E]ven if we were to agree with Dr. Keirnan that reliance by third parties should be presumed from material mis-statements or omissions outside the open market situation, the burden remained on Dr. Keirnan to show that the third parties "received and arguably had read" a materially misleading

318. See text accompanying notes 365-71 *infra* for a discussion of the other ground for dismissal: failure to show the requisite scienter.

319. The court stated that "[w]e need not decide whether the rule established in [*Affiliated Ute*] that reliance is presumed in cases involving primarily a failure to disclose material facts, should be extended to cases such as this where affirmative misrepresentations played an equal or greater role." 611 F.2d at 788.

320. *Id.* at 789. *See* Crocker-Citizens Nat'l Bank v. Control Metals Corp., 566 F.2d 631, 636 n.3 (9th Cir. 1977) (sufficient evidence that plaintiff did not rely on the alleged misrepresentations, but instead relied on its own inadequate investigation of the stock involved).

321. 611 F.2d at 789.

322. The court labelled plaintiff's theory a "derivative reliance theory." *Id.* This theory stemmed from the *Blackie* holding that purchasers of stock in the open market claiming injury due to deceptive omissions from publicly issued financial reports need not show personal reliance. The court did not find it appropriate to decide in *Keirnan* whether this holding should be extended to non-market settings because plaintiff had not presented enough facts in either his pleadings or at trial to permit the court to resolve the issue.

> prospectus [citation omitted] or were in some other way exposed to materially misleading statements prior to Dr. Keirnan's reliance upon their advice or action.[323]

The court found that Dr. Keirnan neither alleged third-party reliance in his pleadings, nor presented evidence below that the third parties involved were given the same or another misleading prospectus upon which their reliance could be presumed. Accordingly, the court upheld the district court's finding that reliance was not established.[324]

The Ninth Circuit also examined reliance in *Kidwell v. Meikle*.[325] Unlike *Blackie*, *Kidwell* involved a stock transaction among a small, interrelated group of persons, and not an impersonal transaction over the open market. Also unlike *Blackie*, the alleged violation in *Kidwell* involved nondisclosures, not misrepresentations. Absent an additional problem discussed below, the *Affiliated Ute* presumption of reliance arguably applied in *Kidwell*.[326]

Kidwell involved a derivative action brought by minority shareholders against corporate directors who allegedly failed to disclose material facts in connection with a sale of the corporate assets and stock. In *Santa Fe Industries, Inc. v. Green*,[327] the United States Supreme Court had disallowed a derivative action brought under rule 10b-5 based solely on the corporate directors' breach of fiduciary duty. In light of *Santa Fe Industries*, the Ninth Circuit in *Kidwell* set forth a stringent test of causation, applicable in 10b-5 derivative actions.

The court found the corporate directors had failed to disclose material facts to the plaintiff minority shareholders in connection with the subject sale of corporate assets and stock. From this premise, the court presumed reliance in that had these shareholders known of the material nondisclosures, they would have brought suit under state law to block the transaction.[328] The court, however, did not find this presumption

323. 611 F.2d at 790.

324. *Id.*

325. 597 F.2d 1273, 1293 (9th Cir. 1979).

326. It has been suggested that the *Affiliated Ute* test should apply only in cases involving nondisclosure to and deception of many investors. See *The Reliance Requirement*, *supra* note 306.

327. 430 U.S. 462 (1977).

328. 597 F.2d at 1293-94. Similar reasoning was employed by the United States Supreme Court in *Santa Fe Industries* to defeat the suit. Then-existing Delaware law did not provide a mechanism whereby minority shareholders could block a short-form merger, and therefore the Court could not infer that had the shareholders known of the undisclosed facts, they would have brought suit in the state courts. The shareholders only could decide whether to accept the short-form merger or seek statutory appraisal value of their shares. The Court concluded that the shareholders had available to them all the information relevant to that

completely dispositive of the causation issue. In light of *Santa Fe Industries*, the court held that in order for minority shareholders to recover on the corporation's behalf under rule 10b-5, they must show that they would have *succeeded* in obtaining either injunctive relief or damages in excess of the state appraisal value.[329] This additional requirement seems to go beyond the dictates of *Santa Fe Industries*, where the Court failed to find any material nondisclosures from which to infer reliance. In *Kidwell*, the Ninth Circuit definitely found material nondisclosures. Yet, the formula for causation stated in *Kidwell* seems entirely unworkable. The Ninth Circuit failed to illustrate how a minority shareholder would show the court that he would have been successful in a hypothetical state court action concerning the facts presented in a federal 10b-5 action.[330] It seems that consideration of this issue would require a great deal of speculation on the evidence presented.

A different analysis of causation/reliance with respect to 10b-5 derivative actions was set forth by the Seventh Circuit in *Wright v. Heizer Corp.*[331] In *Wright*, the court adopted a "fairness analysis" whereby materiality is shown and reliance is presumed if defendant cannot demonstrate that the transaction was fair to the corporation.[332] The Seventh Circuit reasoned that this aproach afforded the minority shareholders "the same right they would have had if full disclosure had been made, *i.e.*, the right to obtain a judicial determination of the fairness of a transaction forced upon the corporation by a controlling shareholder with a conflict of interest."[333] In other words, the court determined that any causal link between the defendant's alleged nondisclosures and plaintiffs' reliance thereon, depends on the fairness of the transaction.

Although the Ninth Circuit in *Kidwell* cited *Wright* elsewhere in the opinion,[334] the court did not rely on *Wright* with respect to causa-

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decision. Thus, there were no nondisclosures in violation of rule 10b-5, and the Court did not actually have to reach the reliance question. See text accompanying notes 202-11 *supra* for further discussion of *Santa Fe Industries*.

329. 597 F.2d at 1294.

330. The Ninth Circuit stated that the question of whether the shareholders would have been successful is "essentially one of fact, but the federal trial judge should decide any legal issues that would have arisen in the hypothetical state suit as a matter of law in the Rule 10b-5 suit." *Id.* The court did not elaborate on how the judge would determine what legal issues would have arisen.

331. 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978).

332. *Id.* at 250 n.13.

333. *Id.*

334. 597 F.2d at 1291 (cited for the proposition that even where shareholder approval is not required by state law, failure by corporate directors to disclose unfairness to shareholders constitutes a violation of rule 10b-5).

tion/reliance, and did not discuss the "fairness" approach. It would seem that the Seventh Circuit's approach is more workable because the court would only be required to examine the evidence to determine whether or not the transaction was fair, rather than speculate whether or not plaintiffs would have succeeded had they been able to bring suit in the state courts.

7. Scienter

The second most crucial element of any 10b-5 action, surpassed only by the standing requirement, is the requirement of scienter. In general, scienter requires a showing that defendant possessed a certain state of mind which made his conduct actionable under the rule.

In 1976, the United States Supreme Court in *Ernst & Ernst v. Hochfelder*,[335] held that rule 10b-5 will not support a private cause of action for damages in the absence of an allegation of scienter. The Court re-examined the words "manipulative," "device," and "contrivance" as they appear in section 10(b) and concluded that the legislature, through the use of these terms, was clearly referring to *intentional* wrongdoing.[336] This conclusion precluded plaintiff's recovery under rule 10b-5 because plaintiff's cause of action in *Ernst & Ernst* rested solely on the theory of *negligent* nonfeasance.[337]

The Supreme Court's decision in *Ernst & Ernst* required the Ninth Circuit to rethink its prior rejection of scienter as a necessary element under section 10(b) and rule 10b-5. In a manner similar to that discussed with respect to the reliance requirement,[338] the courts have refrained from requiring that strict common law scienter be shown before finding a defendant liable. In *Ellis v. Carter*,[339] for example, the Ninth Circuit rejected the argument that proof of common law scienter or fraud was essential to recovery under the rule. The court explained:

> Section 10(b) speaks in terms of the use of "any manipulative device or contrivance" . . . . Had Congress intended to [proscribe] common-law fraud, it would probably have said so.

335. 425 U.S. 185 (1976).

336. The Court concluded that Congress addressed section 10(b) to practices that involve some element of scienter even though "the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent . . . ." *Id.* at 201.

337. Plaintiffs conceded in response to interrogatories that they did " 'not accuse Ernst & Ernst of deliberate, intentional fraud,' but merely with 'inexcusable negligence.' " *Id.* at 190 n.5 (quoted from Appellant's brief).

338. See text accompanying notes 295-333 *supra* for a discussion of the reliance requirement.

339. 291 F.2d 270 (9th Cir. 1961).

> We see no reason to go beyond the plain meaning of the word "any," indicating that the use of manipulative or deceptive devices or contrivances of whatever kind may be forbidden, to construe the statute as if it read "any fraudulent" devices.[340]

In *White v. Abrams*,[341] the Ninth Circuit examined the question of exactly *what* state of mind should be required before a court could impose liability for violation of rule 10b-5. In response to this inquiry, the court discarded the term "scienter"[342] and adopted in its place the so-called "flexible duty standard."[343] The primary focus of this standard was the extent to which a particular defendant owed a duty to the plaintiff to avoid the alleged misconduct in the disputed transaction. The court explained that the extent of the duty owed depends upon an examination of the goals of the securities fraud legislation and a number of key factors.[344] These factors include, but are not limited to:

> the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initating the securities transaction in question.[345]

The Ninth Circuit found this flexible duty approach far superior to the more "compartmentalized"[346] approach which required separate examination of each of the traditional elements of common law fraud, including materiality, scienter, reliance, and causation. As an example of the new standard's application, the court stated:

> Where the defendant derives great benefit from a relationship of extreme trust and confidence with the plaintiff, the defendant *knowing* that plaintiff completely *relies* upon him for information to which he has ready access, but to which

340. *Id.* at 274.

341. 495 F.2d 724 (9th Cir. 1974).

342. The court noted that "[t]he word 'scienter' has been used in so many varied meanings that for the sake of progressing jurisprudence it would be better if courts avoided using it altogether in connection with rule 10b-5 cases." *Id.* at 728 n.3. The court cited the eminent treatise on Securities law written by Professor Bromberg, wherein he notes the often imprecise and contradictory uses of the word "scienter," ranging from "traditional scienter" which means actual knowledge of falsity, to "modern scienter" which extends to constructive knowledge of falsity. 3 BROMBERG, note 130 *supra*, § 8.4 at 502-03 (1979).

343. 495 F.2d at 734-36.

344. *Id.* at 735.

345. *Id.* at 735-36 (notes omitted).

346. *Id.*

> plaintiff has no access, the law imposes a *duty* upon the defendant *to use extreme care* in assuring that all *material* information is accurate and disclosed.[347]

This overall view of the total transaction incorporated each of the elements of a rule 10b-5 action without individually examining any of them. The Ninth Circuit found this approach more suited to the various factual situations and relationships likely to arise under rule 10b-5.[348]

The *Ernst & Ernst* decision, like *Blue Chip Stamps v. Manor Drug Stores*,[349] served to narrow the scope of rule 10b-5, stultifying recovery for the victim. Negligent misrepresentations or nondisclosures on the part of defendants are no longer actionable under rule 10b-5, even when plaintiff relied on such conduct to his detriment. The Supreme Court concluded that rule 10b-5 required a more culpable state of mind. However, the Court failed to further define that state of mind beyond the point that it excluded negligence. The Court noted that the term scienter "refers to a mental state embracing intent to deceive, manipulate or defraud."[350] The Court found it unnecessary, however, to consider whether scienter embraces a fixed state of mind, or whether different shades and intensities of scienter can exist. For example, the Court expressly did not address the issue of whether plaintiff's claim in *Ernst & Ernst* would have been sufficient had it included allegations of reckless behavior.[351]

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347. *Id.* at 736 (emphasis added).

348. The Ninth Circuit again cited Professor Bromberg's treatise concerning whether a single standard of scienter is workable within the scope of possible 10b-5 actions. *Id.* at 733. Bromberg states that:

> A comprehensive *scienter* standard would have to fit the enormous variability of 10b-5 private suits, including:
>
> (1) Whether the violation is misrepresentation, non-disclosure or some more complex scheme or manipulation;
>
> (2) Whether there is privity, a lesser relationship (such as aiding-abetting or conspiracy) or not privity at all (as in insider trading cases); in the parlance of this text, whether the transactions are direct or indirect, personal or impersonal;
>
> (3) Whether there is one plaintiff or thousands;
>
> (4) Whether there is some special relationship between the parties, such as fiduciary-beneficiary or broker-customer;
>
> (5) Whether the relief sought is damages, rescission, injunction or something else.
>
> There is a real question whether a single standard can do the job adequately.

2 BROMBERG, note 130 *supra*, § 8A at 513 (1971).

349. 421 U.S. 723 (1975). See text accompanying notes 157-65 *supra* for a discussion of the limitations on standing imposed by *Blue Chip Stamps*.

350. 425 U.S. at 194 n.12.

351. *Id.* Perhaps if respondents in *Ernst & Ernst* had alleged reckless conduct as well as negligence, the Court would not have been able to draw the line at requiring scienter without further defining the term.

The Ninth Circuit, in *Nelson v. Serwold*,[352] recognized that *Ernst & Ernst* only eliminated negligence as a basis for liability under rule 10b-5; it did not go as far as to require strict common law intent. The Ninth Circuit therefore broadly interpreted scienter to include reckless or knowing conduct.[353]

The plaintiff in *Nelson* alleged that defendants failed to disclose, in connection with a purchase of stock, the existence of a control group, and that group's long-range plans to modernize and ultimately sell the acquired company for a substantial gain. The Ninth Circuit found that defendants' omissions were made, at the very least, *with knowledge*. Although the district court could not find from the evidence that defendants "deliberately and cold-bloodedly" set out to conceal information which rule 10b-5 required to be provided,[354] the court still found some modicum of scienter which involved conduct more culpable than mere negligence, yet short of a willful intent to defraud.[355] The Ninth Circuit reasoned that Justice Powell had apparently accepted a knowledge standard of scienter in *Ernst & Ernst* when Powell stated that the statutory language "strongly suggest[s] that § 10(b) was intended to proscribe *knowing* or intentional misconduct."[356] Thus, the Ninth Circuit concluded that knowledge on the part of the defendants was sufficient to sustain an action under rule 10b-5.[357]

352. 576 F.2d 1332 (9th Cir.) (per curiam), *cert. denied*, 439 U.S. 970 (1978).

353. *Id.* at 1337. Although the question of whether reckless behavior is included within the term "scienter" was expressly left open in *Ernst & Ernst*, other circuits have adopted a scienter standard which embraces reckless conduct. *See* Bailey v. Meister Brau, Inc., 535 F.2d 982, 993 (7th Cir. 1976) (although there was no direct evidence that defendant knew it was acting in violation of rule 10b-5, the court found defendant was "grossly negligent in failing to recognize the unfairness" of the transaction and that defendant, "blinded by a conflict of interest, wantonly ignored evidence of the unfairness" of the transaction. *See also* Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975) (rule 10b-5 requires something additional by way of conscious fault than mere negligence). *See generally* Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5*: Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213 (1977) [hereinafter cited as Bucklo].

354. 576 F.2d at 1337.

355. *Id.* The Ninth Circuit was required to determine whether the district court found defendants merely negligent or whether their conduct involved greater culpability. The court concluded that "[t]he fact that the district judge never used the word 'negligence,' or any of its derivatives, in any of his findings of fact, conclusions of law, or opinions tends to indicate the he did not base his decision on a negligence theory." *Id.* Furthermore, defendants knew of the control group and the tentative plans to improve and sell the company, and therefore, it appeared that defendants' omissions were at least made with knowledge.

356. *Id.* (quoting Ernst & Ernst v. Hochfelder 425 U.S. at 197) (emphasis added by the Ninth Circuit).

357. 576 F.2d at 1337-38. See Bucklo, note 352 *supra*, at 214 n.12: "[K]nowing misrepresentation generally is viewed as being a more stringent standard of culpability than recklessness but less stringent than intent. [*Ernst & Ernst*] therefore appears to have been imprecise

In holding "reckless and knowing conduct" actionable under rule 10b-5, the Ninth Circuit recognized a spectrum of conduct lying within the scope of scienter. In *Nelson*, the court dealt primarily with *knowledgeable* misconduct. Other circuits have dealt more directly with *reckless* misconduct. The Seventh Circuit, in *Sundstrand Corporation v. Sun Chemical Corporation*,[358] in distinguishing reckless behavior from mere negligence, may have stated the minimum threshold of liability under rule 10b-5:

> reckless conduct may be defined as . . . highly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[359]

This standard was adopted by the Third Circuit in *McLean v. Alexander*,[360] where the court suggested that *Ernst & Ernst* contemplated liability against accountants who prepared statements without a genuine belief that the information contained therein was accurate and complete.[361] The *Sundstrand* standard was also followed by the Sixth Circuit in *Mansbach v. Prescott, Ball & Turben*,[362] however, with the caveat that what constitutes reckless behavior is ultimately a factual determination which necessarily varies from case to case.[363] It may be presumed from *Nelson* that the Ninth Circuit will also recognize the *Sundstrand* standard. Although *Nelson* did not specifically define reckless behavior, the court did state, "We agree with those courts which have found that Congress intended the ambit of § 10(b) to reach a

when it decided intent and reserved recklessness but failed to discuss knowing misrepresentation." *See also* Bucklo, note 352 *supra*, at 219 (suggesting that since none of the cases or commentaries relied on in *Ernst & Ernst* require strict common law intent to deceive or defraud, actual knowledge of misstatements should suffice, irrespective of intent).

358. 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

359. *Id.* at 1045 (quoting Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719, 725 (W.D. Okla. 1976)).

360. 599 F.2d 1190 (3d Cir. 1979).

361. *Id.* at 1198. The Third Circuit stated that "[i]t seems to us that the purpose of footnote 12 of the *Hochfelder* opinion was to preserve, at least in the context of accountants' liability, the standards of scienter developed in *Ultramares* and *O'Connor v. Ludlam*." *Id. See* Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931); O'Connor v. Ludlam, 92 F.2d 50, 54 (2d Cir. 1937). The standard referred to by the Third Circuit found defendants liable only where they did not have an honest belief that the statements they made were true. Footnote 12 of the *Hochfelder* opinion leaves open the question of whether or not recklessness is included within the scope of scienter.

362. 598 F.2d 1017 (6th Cir. 1979).

363. *Id.* at 1025.

broad category of behavior, including knowing or reckless conduct."[364]

In *Keirnan v. Homeland, Inc.*,[365] the Ninth Circuit set forth a definition of "recklessness" for purposes of section 10(b) and rule 10b-5. Dr. Keirnan, plaintiff therein, brought an action under the statute and the rule arising out of a misleading prospectus issued by a real estate investment company. The district court dismissed the case[366] upon finding that the misrepresentations in the prospectus were not "deliberate," but "resulted from the speed with which the proposal was put together for sale before the end of the tax year."[367] The district court decided only that defendants had not acted "deliberately";[368] it did not decide whether or not defendants acted recklessly. If defendants had acted recklessly, pursuant to *Nelson*, scienter would be established. On the other hand, without a specific finding of recklessness, the dismissal could be sustained only if "on the evidence, a reasonable person could not have found that defendants acted recklessly."[369] The Ninth Circuit stated that "defendants acted recklessly if they had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although they could have done so without extraordinary effort."[370] Upon examination of the record, the Ninth Circuit found that the district court *could* have concluded that defendants failed to inform Dr. Keirnan of facts known to them or readily ascertainable and failed to investigate more thoroughly before issuing the prospectus. Thus, . . . "a reasonable person could not have found that defendants acted recklessly."[371]

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364. 576 F.2d at 1337.

365. 611 F.2d 785 (9th Cir. 1980).

366. The district court also dismissed the case on the ground that the reliance requirement was not satisfied. See discussion in text accompanying notes 316-24 *supra*.

367. 611 F.2d at 787.

368. *Id.* at 787-88.

369. *Id. See* Robesky v. Quantas Empire Airways Ltd., 573 F.2d 1082, 1086 (9th Cir. 1978) (district court's finding could not be affirmed unless, on the evidence, a reasonable person could not have found that the union had acted arbitrarily).

370. 611 F.2d at 788. *See* Lanza v. Drexel & Co., 479 F.2d 1277, 1306 n.98 (2d Cir. 1973) (en banc).

> "In determining was [sic] constitutes 'willful or reckless disregard for the truth' the inquiry normally will be to determine whether the defendants knew material facts were misstated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort. [citation omitted] The answer to the inquiry will of course depend upon the circumstances of the particular case, including the nature and duties of the corporate positions held by the defendants."

Id.

371. 611 F.2d at 788.

The *Ernst & Ernst* decision brought another major issue to the attention of the Ninth Circuit: whether the *White* flexible duty standard, which essentially replaced the scienter requirement, could survive. In *Ritzau v. Warm Springs West*,[372] the Ninth Circuit found the flexible duty standard explicitly rejected in *Ernst & Ernst*. In reaching this conclusion, the court relied on a footnote in the *Ernst & Ernst* decision which cited *White* as an example of a case which held in essence, that, negligence alone would be sufficient for liability under rule 10b-5.[373] This footnote, however, does not per se strike down the possible usefulness of the flexible duty standard in analyzing conduct that is demonstrably more culpable than negligence. The Ninth Circuit in *Ritzau* did not have to pursue this issue further. As the case was initially decided prior to the *Ernst & Ernst* decision, the district court failed to make specific findings as to the defendants' intent. The Ninth Circuit thus remanded *Ritzau* for determination of whether defendants acted in a manner actionable pursuant to *Ernst & Ernst*, in other words whether they acted with more culpability than mere negligence.[374]

The Ninth Circuit found the flexible duty standard a useful tool in determining scienter, as required by *Ernst & Ernst*, in another recent case, *Zweig v. Hearst Corporation*.[375] *Zweig* involved an action against a financial columnist who purposely bought shares in a small company, touted them in his column, and then sold them in the rising market which his column produced. Plaintiffs, parties to a corporate merger, alleged that the directors of the other merging corporation made material misrepresentations and omissions in an interview with defendant financial columnist with the hope that he would publish this information "puffing" the price of their shares. The columnist, in fact, did publish the information, but only after buying some 5,000 shares for himself at a substantial discount. Plaintiff alleged that defendant columnist violated section 10(b) and rule 10b-5 by publishing the information without disclosing to his readers that he had bought stock in the

372. 589 F.2d 1370 (9th Cir. 1979).

373. *Id.* at 1374. *See* Ernst & Ernst v. Hochfelder, 425 U.S. at 193 n.12, which states in part that "[a]lthough the verbal formulations of the standard to be applied have varied, several Courts of Appeal have held in substance that negligence alone is sufficient for civil liability under § 10(b) and Rule 10b-5. *See, e.g.*, White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974) ("flexible duty" standard).

374. 589 F.2d at 1374.

375. 594 F.2d 1261 (9th Cir. 1979). *But see* Ernst & Ernst v. Hochfelder, 425 U.S. at 191-92 n.7 wherein the Supreme Court found the flexible standard of liability used by the Seventh Circuit in Hochfelder v. Midwest Stock Exch., 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974), unnecessary to establish a claim under rule 10b-5 for aiding and abetting a securities fraud.

company at a discount rate and without disclosing that he intended to sell some of his stock upon the rise in market price he knew his column would cause.[376] The court held that although financial columnists have no duty to report about their personal financial affairs, defendant assumed such a duty when, with knowledge of the stock's market and an intent to gain personally,[377] he encouraged purchases of the securities in the market.[378] In doing so, he violated section 10(b) and rule 10b-5 by misleading his readers as to the reliance they could place on his column.

The Ninth Circuit expressly stated in *Zweig* that the decision conforms to the flexible duty standard previously enunciated by the court in *White*.[379] The court noted that although *White* had been overruled by *Ernst & Ernst* to the extent that it discussed liability without scienter, the *White* approach to the duty standard remains good law in the Ninth Circuit.[380] In applying the *White* duty standard to the facts of

376. 594 F.2d at 1263. Plaintiffs also alleged that defendant columnist should have revealed to his readers the fact that the column in question was likely to be republished as an advertisement in an investment periodical in which defendant owned a substantial ownership interest.

377. The court presumed an intent to profit on the part of the defendant. The court found it reasonable to infer that defendant knew that his column would temporarily run up the price of the stock. Further, the court strongly inferred an intent to profit from defendant's long history of previous dealings. *Id.* at 1265. During the prior two year period, defendant profited on 21 different occasions where he bought stock shortly before recommending such stock in his column. *Id.* at 1264 n.4.

378. The court noted that this case differed from the usual 10b-5 disclosure case in that most disclosure cases involve corporate insiders or tip receivers trading in a corporation's stock without disclosing material facts, which, if were publicly disclosed, might affect the stock's market value. *Id.* at 1266. *See, e.g.*, Shapiro v. Merril, Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). In *Zweig*, defendant's nondisclosures did not directly relate to the value of the merging firm's assets nor its potential growth. Nonetheless, defendant had a duty of affirmative disclosure to his readers to avoid misleading reliance on his column.

Several commentators have anticipated situations such as that in *Zweig*, and have referred to persons such as the columnist therein as "quasi-insiders." *See* ALI FED. SECURITIES CODE § 1603, Revised Comment 3(d) (March 1978 Draft) (cited in 594 F.2d at 1267 n.9). " 'Quasi-insiders' are people who obtain nonpublic information from a source outside a corporation about events or circumstances which will affect the market in the corporation's stock." An example of a quasi-insider would be a Federal Reserve Bank employee who trades with knowledge of an upcoming change in margin rate. 594 F.2d at 1267 n.9. *See also* Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*. 121 U. PA. L. REV. 798, 828-35 (1973); Peskind, *Regulation of the Financial Press: A New Dimension to Section 10(b) and Rule 10b-5*, 14 ST. LOUIS U.L. REV. 80, 92-96 (1969).

379. 594 F.2d at 1268.

380. *Id.* at 1268 n.13. *See* Crocker-Citizens Nat'l Bank v. Control Metals Corp., 566 F.2d 631, 636 n.2 (9th Cir. 1977), where the court stated that "[a]bsent the presence of liability

Zweig, the court found that the defendant columnist had greater access to the information that he owned stock in the recommended company and that he intended to sell it than did his readers; that defendant benefitted in his relationship with his readers in that his employment ultimately depended upon their readership; and that he was aware that his readers would rely on his column to make their investment decisions. Thus, the court found that under the *White* approach, defendant's duty to his readers was well established.[381]

It is interesting to note, however, that the readers of defendant's column, either separately, or as a class, were not parties to the action. The plaintiffs were shareholders in a company named RGC who had previously contracted to sell the corporate assets in exchange for a number of shares of ASI to be determined by the market value of ASI stock on a given date. ASI was the company which had been "puffed" in defendant's column. The Ninth Circuit found, however, that although plaintiffs did not specifically rely on defendant's column, they did rely on the existence of an honest, fully-informed market.[382] This market included the readers of defendant's column. Because of defendant's nondisclosures to his readers, plaintiffs were forced to sell in a manipulated market. The court found that each reader who was influenced by defendant's column to buy ASI stock at the inflated price, reduced the amount of shares ASI would have to issue to RGC in the merger.[383] On this basis, the court concluded that defendant intended to manipulate the market to plaintiffs' detriment, and, therefore, defendant was liable to plaintiffs for damages flowing from his conduct.[384]

The *Zweig* decision strongly indicates that the Ninth Circuit will continue to employ the flexible duty standard in determining whether alleged fraudulent conduct is actionable under section 10(b) and rule 10b-5. Although the Ninth Circuit has been forced by the Supreme Court's decision in *Ernst & Ernst* to require scienter in rule 10b-5 actions, the Ninth Circuit has chosen to follow the Supreme Court's lead

based upon negligence, *Hochfelder* is not inconsistent, on its facts, with the flexible duty standard established in *White v. Abrams*."

381. 594 F.2d at 1269. Plaintiffs contended that rule 10b-5 required defendant to inform his readers of facts so that they could judge for themselves whether defendant's personal motives for promoting the stock affected his objectivity. The court applied the *TSC Industries* test for materiality and found the facts regarding defendant's lack of objectivity material facts. *Id.* at 1266.

382. *Id.* at 1269.

383. *Id.*

384. *Id.* at 1270-71.

in leaving the term "scienter" undefined, save for the exclusion of negligent conduct. Unless and until the Supreme Court lays down more precise guidelines as to what constitutes scienter, the Ninth Circuit will probably continue to analyze scienter in terms of whether or not the defendant was under a duty to disclose material information to the plaintiff. If such a duty is determined to exist, the court will find that the defendant acted at least with constructive knowledge of his misrepresentation or omission.

C. Conclusion

The current scope and nature of section 10(b) and rule 10b-5 actions is clearly the product of active judicial interpretation. The Supreme Court, in shaping this private civil remedy, has attempted to balance the two countervailing policies of achieving a broad remedial device and simultaneously limiting the potential for abusive and vexatious litigation. This discussion has hopefully clarified the courts' treatment of the essential elements of a prima facie case and illuminated the Ninth Circuit's attempt to reach beyond the Supreme Court's limitations to catch those cases which violate the spirit of section 10(b) and rule 10b-5.

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