The "Purchase or Sale" Restriction of SEC Rule 10b-5 -- Judicial Extension of a Federal Remedy

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The remedies provided to shareholders of public corporations by the federal securities laws against inadequate disclosures and abusive or unfair practices in the issuance and trading of securities are extensive and pervasive.¹ For almost 35 years, investors have been afforded the protection of a comprehensive regulatory scheme by which Congress has declared that there shall be full and fair disclosure in the initial issuance² and in the subsequent trading³ of securities, as well as in the dealings of investment companies as trustees of other people's monies.⁴

The Securities Act of 1933 and the Securities Exchange Act of 1934 expressly grant to shareholders the right to sue the issuing corporation and, in most cases, "insiders⁵" and others such as underwriters⁶ and "experts,"⁷ for false or misleading statements or material omissions contained in various registrations.

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¹ Among the important remedies expressly conferred are (1) suit against the issuer and other participants in a securities distribution for false or misleading information contained in a registration statement (Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1964)); (2) suit against an issuer, seller or participant in a securities distribution for a false or misleading prospectus or oral communication (Section 12 of the 1933 Act, 15 U.S.C. § 77l (1964)); (3) suit against any registrant under the Securities Exchange Act of 1934 for false or misleading statements made in reports and other documents required to be filed with the Securities and Exchange Commission (Securities Exchange Act of 1934 § 18(a), 15 U.S.C. § 78r(a) (1964)).
and reports required by the two acts to be filed with the Securities and Exchange Commission. Congress confidently contemplated that these expressly granted remedies would provide shareholders sufficient redress and would constitute effective in terrorem proscriptions against unfair securities dealings.

In actuality, however, the most significant remedies by far now available to shareholders are those created by judicial decisions granting implied relief under those sections of the 1934 Act which do not expressly confer a right of action. Thus, for example, following a long line of lower court decisions, the Supreme Court sanctioned a shareholder's implied right to any appropriate relief (including injunction and, in the case of the merger, possible dissolution) against the issuer of false or misleading proxy statements under Section 14 of the 1934 Act and SEC Rule 14a-9.9

Without question—as every lawyer having anything to do with corporations or securities knows—one short subparagraph of one rule promulgated by the SEC under one subsection of the 1934 Act has spawned more litigation and more comment than all other shareholders' remedies combined—express or implied.10 That rule, which goes by the handle of Rule 10b-5,11 contains a broad prohibition against any fraud, scheme, misrepresentation or unfair practice “in connection with the purchase or sale of any security.” So many articles, seminars, tracts and tomes have been published about this rule that one is intimidated at the thought of contributing any new or meaningful kindling to the fire.

This article seeks only to focus on the expanding judicial interpretation of one aspect of Rule 10b-5, the requirement and limitation expressed in the rule that the wrongdoing proscribed be “in connection with the purchase or sale” of a security. Recent decisions of the Court of Appeals for the Second Circuit have vastly expanded the scope of the “in connection with” limitation to the point where a corporate or individual defendant may now be held accountable for


any misrepresentation, no matter how innocent, if the misrepresentation is “calculated” to “influence” trading in securities, even though the defendant's conduct is not accompanied by trading in the securities.12 Thus, a corporation may be liable to investors purchasing its stock if it issues a statement, such as a press release or annual report, containing misrepresentations of material facts which might influence investors' decisions. It is the submission of this article that the virtual abolition by the Second Circuit of the requirement that a defendant's conduct be “in connection with” his dealings in securities is unwarranted, unfounded and unfortunate. The extension by judicial decision of the implied remedy to a purchaser or seller of securities for any such corporate misstatement is far more than a mere “liberal” construction of Rule 10b-5 (which construction cannot be quarreled with in view of Congress' desire to promote fair dealings in securities), but it is in effect a jurisdictional expansion into an area not properly part of the federal jurisdiction granted to the courts—either expressly or by implication—by Congress. The new “construction” of the “purchase or sale” limitation is wrong for a variety of reasons: it is contrary to Congressional intent and judicial precedent; it is unwise as a matter of policy because it is uncertain in application and its dimensions tend to tread upon areas of management fiduciary duty and standards of prudent conduct heretofore comprehended only by state laws; and, most importantly, it is at odds with the express language of Rule 10b-5.13

**Introduction—The Regulatory Background**

In 1933, the Congress created the first federal regulatory scheme for dealings in public securities. The Securities Act of 1933 prohibits certain public corporations from issuing securities14 unless a registration statement is in effect and filed with the Securities and Exchange Commission15 disclosing all material aspects of the new security and of the issuer's business and financial condition.16 Although the Securities Act was directed specifically toward informing the public about a new issue of securities, Congress included in the Act, by Section 17, a

12. Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), cert. granted, 37 U.S.L.W. 3315 (U. S. Jan. 2, 1969) (No. 894); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). Certiorari was denied to two individual defendants, 37 U.S.L.W. 3395 (U.S. Apr. 21, 1969). As to the corporate defendant, the “press release” issue which is the subject of this article was remanded and no appeal has yet been taken.
13. A contrary view was espoused in Note, *The Purchaser-Seller Limitation to SEC Rule 10b-5*, 53 CORNELL L. Q. 684, 687 (1968), which took the view that the “purchase or sale” language does not lay down expressly a requirement that there be a purchase or sale.
15. Until 1934, the federal agency responsible for administering the 1933 Act was the Federal Trade Commission. The SEC was created in 1934 by the Exchange Act.
general prohibition against fraud or misrepresentation by sellers of a security,\textsuperscript{17} whether or not the sale is pursuant to a registered offering.

A year later Congress passed the Securities Exchange Act, which contains a comprehensive regulatory scheme for trading in issued securities listed on national securities exchanges and, to some extent, for securities traded over-the-counter.\textsuperscript{18} Certain manipulative trading practices such as matched purchases and sales creating false impressions of market activity are specifically outlawed,\textsuperscript{19} and trading over exchanges is subjected to regulation by requirements that the exchanges and the securities traded on exchanges be registered with the SEC.\textsuperscript{20}

In addition to specific provisions regulating securities practices, Congress enacted the now-famous Section 10b of the 1934 Act,\textsuperscript{21} which gave the SEC power to promulgate rules prohibiting any manipulative or deceptive device or scheme in connection with the purchase or sale of securities, whether traded on exchanges or over-the-counter. Section 10b was designed, in the words of the principal administration advocate of the 1934 Act, to be a "catch-all" provision to assure fair dealing in all securities trading practices not specifically dealt with in other provisions of the Act.\textsuperscript{22} Congress thereby gave the SEC a mandate not only to regulate market trading in certain specific ways, but to promulgate regulations to prevent other unspecified wrongdoings in securities trading.\textsuperscript{23} Section 10b contained no self-operative provisions but merely provided the authority under which the SEC could promulgate those prohibitions against false or deceptive trading practices which the Commission deemed unlawful within the general language of the Section.

Eight years after the enactment of the 1934 Act, the SEC promulgated Rule 10b-5, which implemented Section 10b by language as broad, comprehensive, and general as the statute itself; the Rule providing:

\begin{itemize}
  \item 23. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1964), provides as follows:
    \begin{itemize}
      \item 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 . . .
      \item (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 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.
    \end{itemize}
\end{itemize}
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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.24

At its inception, Rule 10b-5 was designed merely to supplement Section 17 of the 1933 Act by prohibiting fraudulent or misleading practices by purchasers of securities as well as sellers, since Section 17 prohibited only misrepresentation by sellers. The SEC in its public release explaining the new rule stated that the purpose of the rule was mainly to close the loophole of Section 17.25

A proper comprehension of the scope and intent of Section 10b and Rule 10b-5 requires that they be placed in their proper perspective vis-à-vis the overall purpose of the 1934 Act. That purpose was enunciated with unusual clarity by Congress in Section 2 of the Act,26 which introduces the Act by stating the necessity for federal regulation of “transactions in securities” because such transactions “are affected with a national public interest.” The letter and spirit of the 1934 Act were thus instilled into its provisions by Congress' explicitly stated purpose to regulate securities transactions.

Supplementary to the direct and specific regulation of trading by the 1934 Act, Congress passed Section 13,27 which requires corporations with securities listed on national exchanges to file periodic reports with the SEC containing current financial data and information about material business transactions. In Section 18,28 Congress provided that any shareholder injured by reliance on such reports may sue the corporation and its managers to recover his losses. Section 18, however, provides a remedy only with respect to misstatements contained in reports required to be filed with the Commission. It did not com-

25. SEC Exchange Act Release No. 3230 (1942). Pursuant to its rule-making authority under Section 15(c)(1) of the 1934 Act, 15 U.S.C. § 78o(c)(1) (1964), the Commission has also promulgated Rule 15c1-2, 17 C.F.R. § 240.15c1-2 (1968), which in similar language to Rule 10b-5 prohibits frauds by securities brokers and dealers. The 1934 Act did not expressly provide any remedy or right of action to shareholders for a violation of Section 10b.
27. Id. § 78m(a).
28. Id. § 78r.
prehend any private remedy for general misstatements made in other connections to purchasers or sellers of securities. Not surprisingly, therefore, it was not too long after the promulgation of Rule 10b-5 that shareholders began seeking redress on the basis of an asserted implied right to relief under Rule 10b-5 for alleged wrongs not covered by Section 18 of the 1934 Act or Section 17 of the 1933 Act.

The Judicial Background—Development of the Implied Remedy

In 1946, the United States District Court for the Eastern District of Pennsylvania held in *Kardon v. National Gypsum Co.* that certain plaintiffs, who sold securities to corporate insiders who did not reveal material facts which may have influenced the plaintiffs in their decision to sell, had stated a federal cause of action under Rule 10b-5. The court felt that a remedy under the rule can be implied from Congress' intent to provide investor protection, and from the general principle of tort law that the violation of a statute gives rise to a legal remedy in favor of those intended to be protected.

Few quarrelled with this decision, in large part because the action was brought by sellers of securities against the buyers, and thus the plaintiffs would have had no remedy under Section 17 of the 1933 Act, which protects only purchasers. Many were skeptical of extending the implied right beyond the *Kardon* situation, however, because they believed that purchasers were already sufficiently protected by Section 17. But it soon became generally held that purchasers could also seek relief under the rule.

Following those initial breakthroughs into an uncharted new area, the federal courts have grappled with many problems in seeking to define a correct and appropriate scope for federal jurisdiction in private actions seeking recovery under the rule. The courts have been required, for example, to articulate the boundaries between actions charging essentially corporate or insider mismanagement or waste, which are not in themselves cognizable federal claims, and claims made against directors by shareholders for wrongdoings which constitute breach of state law.

30. The court cited Section 286 of the *Restatement of Torts*, saying that "the [implied] right is so fundamental . . . that where it is not expressly denied the intention to withhold it should appear very clearly and plainly." *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946).
duty and also involve in some way a transaction in securities.\textsuperscript{33} Other problems of interpretation include whether the plaintiff must prove reliance on the defendant's alleged misstatements;\textsuperscript{34} whether the plaintiff must allege and prove that the defendant's conduct was fraudulent and intentional or merely negligent;\textsuperscript{35} and whether a plaintiff must show a relationship of privity as purchaser or seller with the defendant.\textsuperscript{16}

Most of these questions have gradually and generally been resolved in favor of plaintiffs, particularly the question of privity, for it is now well settled that the parties need not be in a direct or face-to-face relationship, and thus transactions over exchanges during comparable time periods are clearly covered by the ambit of Rule 10b-5.\textsuperscript{37} Problems still remain in the area of the degree of reliance which a private plaintiff must establish. The problem of innocent misrepresentation also still persists, although recently the Second Circuit in \textit{SEC v. Texas Gulf Sulphur Co.}\textsuperscript{38} decided that a defendant may be liable for good faith misrepresentations to the extent that he failed unjustifiably to exercise reasonable diligence.

\textit{The "Purchase or Sale" Limitation}

Another significant problem to which this article is addressed is the connection which must be shown between the alleged wrong and a securities transaction between the plaintiff and defendant. Rule 10b-5 requires that the prohibited conduct be "in connection with the purchase or sale of any security." This proviso is obviously a limitation on the scope and application of the rule, for it restricts the rule's coverage to wrongs arising out of securities transactions. It is a very important limitation because it prevents the rule from embracing any and all forms of wrongful conduct of corporate directors and officers, traditionally the subject of state laws requiring corporate fiduciaries to act reasonably and responsibly.\textsuperscript{39} Indeed, the "purchase or sale" limitation is an essential restriction

\textsuperscript{38} 401 F.2d 833 (2d Cir. 1968).
\textsuperscript{39} \textit{See, e.g., N.Y. Bus. Corp. Law} \textsuperscript{\textcopyright} 717 (McKinney 1963).
upon the scope of the rule, for otherwise there would be serious question
whether the rule is a valid subject of federal regulation under the 1934 Act.
The unified and pervasive theme of the act is to regulate and to promote fair-
ness in transactions in securities.

The "purchase or sale" restriction is not, however, self-explanatory, and, as
with almost any statute or regulation, it requires judicial definition and refine-
ment. Many questions arise: Must both the plaintiff and the defendant be
respectively purchaser and seller or vice versa? If not, is the plaintiff required
to show that he at least purchased or sold securities in a transaction connected
with the defendant's conduct? Does the rule reach any conduct in which some
securities transaction is tangentially involved? What is a "purchase" and what
is a "sale?" Is a false inducement to retain shares to the plaintiff's detriment "in
connection with" a purchase or sale? May a shareholder's derivative action be
maintained under Rule 10b-5 for injury to a corporation? Are third persons
associated with a defendant in his securities dealings liable as if they had them-
selves purchased or sold?

The problems of interpretation of the "purchase or sale" restriction are almost
as varied in application as the numbers of fact situations which can arise. Many
corporate transactional activities involve securities transactions—mergers, tender
offers,\textsuperscript{40} redemptions, issuance of treasury shares, purchase of investment shares,
etc. All of these activities may give rise to actionable 10b-5 claims if the wrong
complained of is "in connection with" a purchase or sale. All of
these problems have confronted the courts, and many variations will un-
doubtedly be considered in the future.\textsuperscript{41}

The extent of the nexus or "connection" between the asserted misconduct and
the securities transaction involved is one of the unifying and recurring prob-
lems common to most 10b-5 cases confronting the courts. The problem came to
the courts early in the life of Rule 10b-5.

\textit{The Birnbaum Case}

In \textit{Birnbaum v. Newport Steel Corp.},\textsuperscript{42} shareholders of Newport Steel brought
a 10b-5 action against the president of the company, who was also its chairman

\textsuperscript{40} For the latest information on relief available in connection with allegedly mis-
leading tender offers, see Electronic Specialty Co. v. International Controls Corp., No.

\textsuperscript{41} It should be noted by way of caveat at this point that most decisions on the
scope of Rule 10b-5 are rendered in the form of opinions on defendants' motions to dis-
mise the complaint for failure to state a claim for relief, made pursuant to FED. R. Crv.
P. 12(b)(6). In such cases, the court must assume the truth of all allegations in the
complaint, and courts give plaintiffs the benefit of any doubt because of any factual
determinations.

\textsuperscript{42} 193 F.2d 461 (2d Cir. 1952).
and controlling stockholder, and against other directors, alleging that the president sold out his 40 percent stock interest at a large premium. The plaintiffs, suing derivatively and individually, alleged that the premium was paid because the interest sold represented a controlling interest. The purchaser, Wilport Steel, subsequently did assume control of Newport. The plaintiffs claimed that this conduct violated Rule 10b-5 because the individual directors had made certain misrepresentations to shareholders about the inadvisability of Newport's merger with another company, Follansbee, even though the Follansbee merger was allegedly a highly desirable deal for Newport and its shareholders.

The Court of Appeals for the Second Circuit affirmed the district court's dismissal of the complaint, holding that the plaintiffs, as shareholders of Newport, had not stated a cause of action under Rule 10b-5 because neither they nor their corporation were purchasers or sellers of securities. The court held that the rule required the alleged misconduct to be "in connection with" a purchase or sale and that a plaintiff who did not buy or sell could not assert a claim for relief. As to the scope of the rule the court concluded: "that section was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10B-5 extended protection only to the defrauded purchaser or seller." 43

The Plaintiff as Purchaser or Seller

The sole and specific question raised in Birnbaum was whether a plaintiff who neither sold nor purchased could assert a private claim impliedly granted by Rule 10b-5. The court's obvious conclusion was that he could not. Although the court explained its result basically in terms of the unavailability of a federal remedy against corporate mismanagement, the result is more easily and readily justified. First, a private plaintiff who neither sold nor purchased securities simply cannot show that he was damaged, 44 and the absence of harm, in such circumstances, can be equated with the absence of a cause of action. Second, the limiting language—"in connection with the purchase or sale"—by its express terms requires that the plaintiff's damage be caused by his securities trading.

Birnbaum is also significant for what it did not hold. The court did not consider or decide anything at all about a defendant's connection with a pur-

43. Id. at 464.
44. One possible exception is a claim that the defendant wrongfully induced the plaintiff to retain shares that the plaintiff otherwise would have sold. It has been held that in this case the plaintiff has a basis for relief under the Rule, Stockwell v. Reynolds & Co., 252 F. Supp. 215 (S.D.N.Y. 1965). But see Greenstein v. Paul, 400 F.2d 580 (2d Cir. 1968), which may not allow a 10b-5 claim in such circumstances.
chase or sale. That issue was left wide open for later confrontation. Nor was *Birnbaum* based upon a requirement of privity. Nothing was decided about whether a plaintiff and defendant were required to be in a direct contractual relationship. Some courts have failed in later cases to comprehend that *Birnbaum* did not touch these points. Shortly after *Birnbaum*, the Second Circuit itself decided a case upon a misapprehension of the basis of the *Birnbaum* holding. In *Joseph v. Farnsworth Radio & Television Corp.*, *46* the facts established that the plaintiffs purchased shares on a national exchange some time after the defendant directors sold their shares over the exchange, allegedly pursuant to intentionally false misrepresentations of financial condition. The court affirmed a dismissal of the complaint on the authority of *Birnbaum* and on the opinion below, which held that the parties were not in a necessary relationship of “privity.” But as Judge Frank said in dissent, *Birnbaum* “lacks relevance here.” *46* In *Farnsworth*, both parties were purchasers or sellers of the same security. *Birnbaum* alone thus did not stand as a bar to the claim. If “privity” is to be a requirement for a 10b-5 claim, it is a doctrine that must be read into the rule, for the “purchase or sale” limitation does not address itself to “privity.” Later cases have taken almost all the life out of *Farnsworth*, recognizing its fundamental flaw. *47* “Privity,” if it means anything, is a doctrine requiring a showing that the plaintiff was on the other side of a transaction with the defendant involving the same securities. “Privity” would embrace the “purchase or sale” limitation of necessity, but the converse would not obtain.

In most cases the courts have understood and followed the real *Birnbaum*, and have done so in many different factual settings. It is clear, for example, that a corporation’s issuance of securities to a director or insider, if accompanied by misrepresentations or concealments, can give rise to a derivative claim by a shareholder for injury to the corporation. Likewise, the exchange of a company’s shares for shares of another company has been held a purchase or sale under Rule 10b-5. *48* It obviously matters not that the shareholder plaintiff was not a purchaser or seller, for he is asserting the claim of his corporation, which did the purchasing or selling. If there was injury to the corporation ac-

45. 198 F.2d 883 (2d Cir. 1952) (per curiam), aff’d 99 F. Supp. 701 (S.D.N.Y. 1951).
46. Id. at 887.
47. See cases cited note 37 supra. But in *General Time Corp. v. American Investors Fund, Inc.*, 283 F. Supp. 400 (S.D.N.Y.), aff’d on other grounds, 403 F.2d 159 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969), where the plaintiff was clearly not a seller, the court cited *Birnbaum* as enunciating a doctrine of privity falling into the same error as the court in *Farnsworth*.
accompanied by deceit in connection with a securities transaction,\textsuperscript{49} the courts may appropriately entertain federal jurisdiction because the shareholder is asserting derivatively the right of the corporation.\textsuperscript{50}

With almost no exceptions, the federal courts since \textit{Birnbaum} have adhered to the rather plain mandate of the "purchase or sale" limitation and have held that a private implied remedy is available only to a purchaser or seller.\textsuperscript{51} Two recent decisions of the Second Circuit created some confusion, however, as to the continuing viability of \textit{Birnbaum}. Some courts construed these holdings as "expanding" or "eroding" \textit{Birnbaum}. These decisions did neither, as the Second Circuit shortly thereafter made clear; they merely construed the "purchase or sale" limitation in unique factual circumstances.

In \textit{Vine v. Beneficial Finance Co.},\textsuperscript{52} a shareholder of Crown Finance had refused to sell his shares to Beneficial in a tender offer, but he was forced involuntarily to turn in his shares, after Beneficial had acquired a 95 percent interest in Crown, pursuant to a statutory "short-form" or "freeze-out" merger.\textsuperscript{53} The complaint alleged that the merger was effectuated pursuant to a fraudulent plan to prefer one class of Crown shareholders (directors holding "Class B" shares) over another (Class "A" shareholders such as the plaintiff). The district court agreed with the defendant's position that the plaintiff was not a purchaser or seller as required by \textit{Birnbaum}. The Second Circuit reversed, and decided that an involuntary seller is just as much a "seller" as any other kind for

\textsuperscript{49} O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964).

\textsuperscript{50} In \textit{SEC v. National Sec., Inc.}, 393 U.S. 433 (1969), the Supreme Court held that shareholders of a life insurance company "purchased" shares in another insurance company when they exchanged their shares for the new ones. This decision was the first opinion ever written by the Supreme Court under Rule 10b-5. The Court held that insurance companies were not exempted from the rule by a federal law providing in effect that states have exclusive jurisdiction to regulate the insurance business. The Court, per Mr. Justice Marshall, took pains to note that it was not deciding any question about private remedies under the Rule since the case was brought by the Commission which of course can enforce the 1934 Act without being a purchaser or seller. \textit{Id.} at 467 n.9. However, the Court noted significantly that even the Commission is required to show that the challenged conduct was "in connection with the purchase or sale," in order to establish a violation. \textit{Id.} at 466.


\textsuperscript{52} 374 F.2d 627 (2d Cir.), \textit{cert. denied}, 389 U.S. 970 (1967).

\textsuperscript{53} Typically, such statutes provide that the directors of a corporation which owns 90 or 95 percent of a subsidiary may authorize the merger of the subsidiary into it without seeking approval of the subsidiary's board or shareholders. \textit{See, e.g., Del. Gen. Corp. Law} \$ 253 (Supp. 1968); \textit{N.Y. Bus. Corp. Law} \$ 905 (McKinney 1963).
the purposes of Rule 10b-5: "Since, in order to realize any value for his stock, appellant must exchange the shares for money from appellee, as a practical matter appellant must eventually become a party to a 'sale,' as that term has always been used." This result is clearly no departure from Birnbaum, and it should not have come as a great surprise to anyone. Yet some courts believed that Vine was a step beyond Birnbaum.

The second decision that proved unnecessarily troublesome was A.T. Brod & Co. v. Perlow. The plaintiff, a brokerage house, sued a customer who allegedly ordered the plaintiff to purchase shares for him with the fraudulent intent not to pay for them unless the market went up. The plaintiff executed the order as broker, or agent, and had to sell out at a loss when the defendant failed to pay. The district court held that the broker was not a "purchaser" because it acted as agent and not as a principal or investor. The Second Circuit reversed what it conceived to be an overly narrow application of the "purchase or sale" language of Rule 10b-5. The court did not really expand or erode Birnbaum by this result, as it is difficult to support a distinction between a purchase as agent and a purchase as principal insofar as the "purchase or sale" limitation of Rule 10b-5 is concerned. No such distinction is drawn by the rule.

Vine should be viewed as nothing more than an application of Birnbaum in a peculiar situation; Brod may be criticized on some grounds, but it decided nothing contrary to Birnbaum. Unfortunately, however, Vine and Brod have been read by some courts as casting doubt on the viability of Birnbaum. In Entel v. Allen, shareholders of an investment company (Atlas) sued the company and others for allegedly concealing in a proxy statement that Atlas' sale of a large investment bloc of securities of Northeast Airlines was made to a company affiliated with Atlas by virtue of common control. The plaintiffs did not allege that they purchased or sold, and they sued in their own behalves. Initially, the district court dismissed the complaint, correctly so under Birnbaum.

55. 375 F.2d 393 (2d Cir. 1967).
56. This common occurrence ought ordinarily to be viewed as a simple breach of contract and not as a federally cognizable claim under Rule 10b-5. But, if the complaint alleges a fraudulent intent by the customer at the inception of the transaction, the court must assume the truth of the pleaded facts. Brod may be criticized as an unwise extension of federal jurisdiction, but not as wrong on its interpretation of the "purchase or sale" requirement.
57. The court also, significantly, held that the fraud need not be in connection with a representation as to the "investment value" of the security because Rule 10b-5 embraces any manipulative or deceptive device. See also Cooper v. North Jersey Trust Co., 226 F. Supp. 972 (S.D.N.Y. 1964), which reached the same conclusion.
58. A similar result, relying on Brod, was reached in Allico Nat'l Corp. v. Amalgamated Meat Cutters, 397 F.2d 727 (7th Cir. 1968).
because the claim was clearly not entertainable under Rule 10b-5 but was only for a breach of fiduciary duties or, at most, a violation of SEC proxy rules. However, the district court granted reargument six months later, during which time Vine and Brod came down. The court reversed itself, holding that in light of Vine and Brod the Second Circuit may no longer adhere to Birnbaum. The district court incorrectly read the direction of the Second Circuit’s opinions and failed to recognize that within the boundaries staked out by Birnbaum there is considerable room for movement. Entel, hopefully, will be treated as a piece of flotsam on the waters of 10b-5 law.

A recurring problem under Birnbaum is whether Rule 10b-5 confers a right of action on a shareholder who, though not selling, alleges that the insiders of a company deliberately depressed the market price to induce him to sell. Prior to Vine and Brod, the court in Stockwell v. Reynolds & Co., held that if a plaintiff proves that he held onto his shares because of the defendant’s false inducements, and later sold at a loss, the “purchase or sale” requirement is satisfied.

Following Vine and Brod, the same court which decided Stockwell, in another case, reached substantially the same conclusion on the ground that Birnbaum had been modified by Vine and Brod. The decision may have been correct, but the reasoning was wrong. The court aptly noted in Puharich v. Borders Electronics Co., that the defendants’ alleged scheme to depress the market price could only succeed by large scale selling. But the validity of this reasoning is not affected one whit by the supposed “erosion” of Birnbaum by Vine and Brod. The right of action recognized in cases where a plaintiff is wrongfully induced not to sell might be viewed as some broadening of Birnbaum, but at the most it is a minimal expansion of that doctrine into an area where the plaintiff must ultimately become a seller if he is to prove damage.

One further case is notable for its misunderstanding of the effect of Vine and Brod. In Condon v. Richardson, a shareholder complained, inter alia, that the directors of his company sold their bloc of shares to an affiliate at a premium. Although the court nevertheless felt that Birnbaum stood untarnished insofar as its particular fact situation was repeated and thereby dismissed the complaint, it stated in the opinion that Birnbaum had been substantially overruled by Vine and Brod.

The confusion and lingering doubts about Birnbaum were cleared up by the Second Circuit, hopefully finally, in Greenstein v. Paul. In Greenstein, the plaintiff was a shareholder of Sagamore, a corporation 80 percent owned by

63. This was the precise claim made in Birnbaum.
64. 400 F.2d 580 (2d Cir. 1968).
United Industrial. He alleged that Sagamore's directors and United Industrial conspired to mulct Sagamore's assets into United for the purpose of depressing the market price of Sagamore, all in order to force minority shareholders to sell out. This case is thus remarkably similar in its facts to *Puharich*, where the court asserted the questionable status of *Birnbaum*. But in *Greenstein*, the Second Circuit affirmed a dismissal of the complaint and unequivocally reaffirmed *Birnbaum*:

> It has long been the rule in this circuit that to maintain an action under § 10(b) of the Act and Rule 10b-5 of the Securities and Exchange Commission the plaintiff must have been a seller of the stock involved [citing *Birnbaum*].

* * *

Under existing law in this circuit the plaintiff is not a seller and cannot invoke the civil remedy afforded by the Act and Rule.66

Notably, the court stated that *Vine* does not hold to the contrary.67 Notably also, *Greenstein* appears somewhat inconsistent with *Stockwell* and *Puharich*. The only perceivable difference is that in *Greenstein* the plaintiff did not accept the inducement to sell and instead held onto his shares. *Greenstein* affirmed a principle that should never have been questioned. A plaintiff simply must show that he was a purchaser or seller in order to have standing to seek relief under Rule 10b-5.68

**The Defendant as Purchaser or Seller**

By far a more perplexing problem arises where a claimed 10b-5 violation is based on the conduct of a defendant which does not directly involve the defendant's own purchase or sale of securities. Whereas it is readily understood why a plaintiff in a private action must be a purchaser or seller, the question of what connection a defendant must have with a purchase or sale is much more complicated. To give a classic example: Is a director or officer who causes his company to purchase shares from stockholders in another company liable to such stockholders for misrepresentations made to them by the purchasing company? Many troublesome questions arise. Is an independent certified public accountant who reports on a company's financial condition liable with the company

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67. The court also noted that if minority shareholders were ultimately frozen out involuntarily they would have a claim under the holding in *Vine*. Ibid.
68. Perhaps the court's four-square and resounding reaffirmation of *Birnbaum* was prompted in part by its broad expansion of Rule 10b-5 three weeks earlier in *Texas Gulf*. *Greenstein* gave the court the chance to apply the brakes to its development of the rule. Whatever the motive, *Greenstein* was indeed an explicit infusion of life into *Birnbaum*.
and its management for misleading financial information inducing a plaintiff to purchase? Is a company liable for making any material misstatement about its business which induces a plaintiff to purchase its shares?

Only a handful of cases confronted the dilemma prior to two definitive decisions of the Second Circuit rendered in late 1968.\(^6\)\(^9\) One that did was *New Park Mining Co. v. Cranmer.*\(^7\)\(^0\) A corporation, New Park, sued former officers and directors alleging that the defendants, while in control of the company, caused it to purchase stock in Lucky Mc Uranium, which purchase was said to be a bad deal for New Park but a good deal for the defendants who got an emolument from Lucky Mc for their efforts. The defendants were themselves not purchasers or sellers, but were associated closely with the seller, Lucky Mc, as well as the purchaser New Park. The court held that the defendants were so intimately connected with the seller that they were subject to liability as if they themselves had sold:

A purchaser or seller of stock is not limited under Section 10(b) and Rule 10b-5 to an action against the other party to the purchase or sale; he can sue a third person if in connection with the [plaintiff's] purchase or sale that person defrauded him . . . . Were this not the rule, corporate officers and directors would possess an immunity from the consequences of their fraud under Section 10(b) and Rule 10b-5 which outsiders who may have collaborated with them in defrauding the corporation would not possess.\(^7\)\(^1\)

*New Park* introduced the courts to the problem of a defendant's connection with a purchase or sale in a limited way. The defendants were in effect on the other side of the transaction from the purchaser, and they benefitted from the transaction. The defendants were intimately associated with the sellers in the securities transaction. The purpose and intent of the securities transaction was to benefit the defendants at the expense of their corporation. In short, the defendants' conduct was in connection with a particular purchase and sale. Disregarding subtle analysis, it is clear that the defendants perpetrated a wrong on their own corporation in connection with a securities transaction by which they profited. It is difficult to dispute this decision.

Another early precedent was *H.L. Green Co. v. Childree.*\(^7\)\(^2\) The plaintiff corporation had issued its shares in exchange for the shares of another corporation, allegedly in reliance on materially misleading financial statements of the

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71. *Id.* at 266.
second corporation. The action was brought against the accountants of the second corporation for their part in reporting on the financial statements. The court determined with seemingly little difficulty that the accountants could be liable for violating Rule 10b-5 if their conduct was in fact the kind proscribed notwithstanding the absence of any purchase or sale by the defendants.73

As more fully explained later, the holding in *H.L. Green* can be justified without concluding that a defendant need never be a purchaser or seller. The rule should be that a defendant’s conduct must be in connection with a particular securities transaction—in *H.L. Green* it was an exchange of stock—and that a defendant must be associated with the transaction in an intimate manner. That is, someone connected with a defendant must be engaged in a securities transaction which violates Rule 10b-5. Thus, a company which issues misleading financial statements as in *H.L. Green* is a purchaser when it exchanges its stock for that of the plaintiff corporation, and an auditor engaged by such company may be intimately connected with the transaction. The line must be drawn in a case where a defendant’s conduct is not closely associated with someone who purchases or sells from or to a plaintiff.

Perhaps the more significant question in such a case is whether the accountants can be sued under Rule 10b-5 unless knowing wrong is alleged and established. A defendant such as an independent accountant cannot be put in peril of such possibly substantial liability unless his conduct was intimately and knowingly connected in purpose and design with a scheme violative of Rule 10b-5.

*Mooney v. Vitolo*74 draws the correct distinction. Shareholders of Bar Chris sued that company and its insiders, alleging that false financial statements induced the plaintiffs to purchase at inflated prices. Chief Judge Ryan held that the plaintiffs had no 10b-5 claim because the defendants’ conduct did not relate in any way to any securities transactions with which they were associated. That is, although the plaintiffs purchased on the basis of financial statements assumed to be false, the defendants’ issuance of the statements related in no way to their securities transactions or transactions by those connected with defendants. This is unlike *H.L. Green*, where an exchange of securities was effectuated. Judge Ryan in his significant opinion said:

> The statements made or acts done must have been in connection with a specific offer or purchase and not just during the time that the stock was on the market. The statute is clear; if it were otherwise then the statute could have made unlawful any such fraudulent or manipulative acts on behalf of a publicly owned corporation whose stock was being traded, without any regard to any particular trade. The language

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of Section 10(b) does not provide for such liability. . . . In short, the statute does not make actionable fraud in vacuo which causes stock to rise or fall to the detriment of anyone owning it.\textsuperscript{75}

\textit{Mooney} hit the nail on the head. There must be some person on the other side of a plaintiff's purchase or sale whose wrongful conduct relates to a particular purchase or sale of which such person is aware and associated with. Unfortunately, the Second Circuit later disagreed in \textit{Texas Gulf}.

A relatively early precedent which encouraged the Second Circuit to disagree with \textit{Mooney} was \textit{Miller v. Bargain City, U.S.A., Inc.}\textsuperscript{76} The plaintiffs alleged that they bought shares in Bargain City at a time when the company had on file with the SEC certain allegedly false reports. This is all that was alleged; nothing was said in the complaint about any purpose or conduct by the defendants relating to their securities transactions. The court held that at the pleading stage it could not dismiss the claim because facts adduced at trial might show a "connection" between the alleged wrong and the plaintiff's purchase. With due respect, this decision is wrong because on a motion to dismiss, the complaint itself must allege a sufficient "connection." Even assuming this holding was right, however, it provides slim precedent for the later sweeping opinions of the Second Circuit because the decision in \textit{Miller} was based almost solely on the court's peculiar concept of its role on a motion to dismiss.

Finally, the pre-\textit{Texas Gulf} history is rounded out by \textit{Cooper v. North Jersey Trust Co.}\textsuperscript{77} The plaintiff borrowed money from a lender, Discount, pledging as collateral certain securities. Discount discounted the loan with the Trust Company and re-pledged the securities to the Trust Company as collateral. The Trust Company allegedly wrongfully sold the collateral to the plaintiff's loss. The complaint alleged that the defendants originally made the loan pursuant to a scheme to convert the stock. The defendants asserted that no misrepresentation was made in connection with a purchase or sale because the alleged fraud did not relate to the value of the securities. The court sustained the complaint against a motion to dismiss, stating that "the outlawed activity is not limited to the portion of the transaction involving an exchange of consideration by the purchaser for the stock."\textsuperscript{78}

\textit{Cooper} provides little help in analyzing the dimensions of the purchase or sale limitation because the alleged fraud, ultimately, did relate to a sale made by the defendants. At the time of \textit{SEC v. Texas Gulf Sulphur Co.},\textsuperscript{79} therefore,

\textsuperscript{75} Id. at 96,549-50.
\textsuperscript{78} Id. at 978.
\textsuperscript{79} 401 F.2d 833 (2d Cir. 1968).
the question of a defendant's "connection" with a purchase or sale remained relatively open and dimensionless.

**Texas Gulf**

The central and main issue in *Texas Gulf* was essentially unrelated to the "purchase or sale" problem. The SEC's chief complaint was against "insider" officers and employees who purchased the company's stock (or accepted stock options) on the basis of material undisclosed information about a very valuable ore deposit discovered by the company. The information had not been disclosed publicly, and the court held that insiders cannot trade if they know of such material undisclosed information. Their duty, the court said, was either not to trade or, if they wanted to trade, to disclose the information publicly. Presumably, therefore, shareholders who sold during the time period when the insiders purchased could maintain a 10b-5 position.

However, a second major issue, which is probably more significant overall, was the so-called "press release" question, in which the Second Circuit, taking advantage of the squarely raised question of a corporation's liability for making misleading public statements *not related in any way to any defendant's trading activities*, held that Rule 10b-5 was violated if the statement was made (1) without the exercise of "due diligence" and (2) was "calculated" to "influence" market activity.

The complex facts surrounding the press release issue, reduced to their basics, are these: Between November 8, 1963 and April 10, 1964, Texas Gulf conducted exploratory mineral drilling of a promising area of land in Ontario, Canada. Early chemical assay results in December, 1963, indicated a very promising copper and zinc deposit, possibly of very high content, but requiring further drilling to establish the exact proven size of the strike. Test drilling was resumed in earnest in late March, 1964, after the company had completed acquisition of the land.

By the evening of April 10, geologists at the drill site were aware that the strike was of likely large significance. Canadian newspapers were reporting rumors of a major strike. On April 11, New York papers were reporting that Texas Gulf had made the "biggest ore strike since gold was discovered." The company's management took alarm at what they conceived to be exaggerated and premature reports. Texas Gulf president, Stephens, asked a vice president, Fogarty, to check on the situation, and Fogarty immediately consulted Mollison, a vice president of mining engineering, who had just returned from the drill site. Mollison reported the progress of the drills up through 7 p.m. of Friday,

April 10. Mollison advised Fogarty that he did not believe the explorations were sufficient to be conclusive as to the size and grade of the ore. He said he had no further news as of Sunday morning, April 12. Mollison was dispatched back to the site to continue drilling. Fogarty thereupon immediately drafted a press release with the aid of a public relations consultant and with the counsel of his lawyer. The release, dated 3 p.m., April 12, hit the press the next morning. It characterized the rumor as exaggerated, said that tests were not conclusive, and that more drilling was necessary. Extensive drilling operations were conducted through April 15, and on April 16 the company announced publicly the existence of an extraordinarily large deposit of high grade ore. It was undisputed that the market reaction and market price of Texas Gulf stock between April 13 and 16 were inconclusive to show the effect on the market of the April 12 release.

On the basis of these facts, the SEC charged that the April 12 release was materially misleading and deceptive in violation of Rule 10b-5. The Commission sought an injunction against the corporation to prevent the issuance of any further misleading information. The district court held that the release was not misleading, and that even if it was misleading, it was not issued in connection with the purchase or sale of any security. It was undisputed that (1) no defendant traded on the basis of the April 12 press release, and (2) the purpose of the press release was not to influence or manipulate the price of the company's stock.

The Second Circuit, sitting en banc, held that the corporation would violate Rule 10b-5 if the press release were misleading and reasonably calculated to cause investors to act in reliance on it, without any need whatsoever for finding that the defendants either traded in Texas Gulf stock or issued the release for the purpose of affecting the market. The press release issue was remanded to the district court for further proceedings because the court of appeals said that the record was inadequate to establish whether or not the release was misleading or calculated to influence investors. If a finding were reached that the release was misleading to a reasonable investor, the court said, the district court must then determine whether its issuance resulted from a lack of due diligence. If so, the court said that the district court in its discretion could give the Commission its injunction.

The key statements of the court in regard to the "purchase or sale" limitation are of immense significance:

81. This injunction was sought pursuant to the SEC's statutory authority to obtain injunctive relief against violations of the Securities Exchange Act of 1934 § 21(e), 15 U.S.C. § 78u(e) (1964).
We do not believe that Congress intended that the proscriptions
of the Act would not be violated unless the makers of a misleading
statement also participated in pertinent securities transactions in connection therewith, or unless it could be shown that the issuance of the statement was motivated by a plan to benefit the corporation or themselves at the expense of a duped investing public.

* * *

Congress intended to protect the investing public in connection with their purchases or sales on Exchanges from being misled by misleading statements promulgated for or on behalf of corporations irrespective of whether the insiders contemporaneously trade in the securities of that corporation and irrespective of whether the corporation or its management have an ulterior purpose or purposes in making an official public release.84

The consequences of this holding are, of course, readily perceived and pervasive. To hold a corporation liable for what Judge Friendly says may be a "slip of the pen"85 is only part of the Texas Gulf dilemma, for, inasmuch as Rule 10b-5(2) prohibits both affirmative misstatements and omissions to state material facts, must not any important corporate information be disclosed immediately? It would seem so, since Rule 10b-5(2) makes no distinction between misstatements and omissions as far as imposing liability. Thus, was not Texas Gulf obliged to disclose the facts of its first exploratory findings five months earlier, in December, 1963, since the court of appeals held that the information available in December was material? ("Material" meaning, according to Texas Gulf, "reasonably calculated to influence the investing public."86) Yet the Second Circuit, drawing a strange dichotomy, clearly held that the company was not obliged in December—or at any other time—to disclose its material information as long as no insider traded upon his knowledge of it.87 It seems, therefore, that an affirmative misstatement unrelated to a defendant's trading activity is a violation of Rule 10b-5, whereas an omission to state a material fact is actionable only if a defendant trades without disclosing the fact.

This incongruity is only one reason why the Texas Gulf decision on the press

84. Id. at 860-61.
85. Id. at 867. Judge Friendly concurred insofar as he felt the SEC could obtain an injunction but stated that private relief against a negligent press release should not be available. Judge Friendly stated that knowing misrepresentation was an essential element of a private claim.
86. Id. at 862.
87. Id. at 848: "Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence . . . must abstain from trading . . . ." However, the New York Stock Exchange recently issued a statement that a corporation must "release quickly to the public any news or information which might reasonably be expected to materially affect the market for securities." N.Y.S.E. COMPANY MANUAL § A2.
release issue is wrong. The principal error was in the court's total misconception of the purpose and scope of Rule 10b-5, a misconception which led to the expansion of the applicability of the rule into areas not comprehended by the rule or by the 1934 Act. Imposing liability on a corporation for nothing more than a misstatement of fact is simply not within the federal jurisdiction conferred on the federal courts by the Exchange Act. A negligent misstatement, that is, one made without exercising "due diligence" in ascertaining the true facts, may well create tort liability arising from common law principles and the tort of negligent misrepresentation. But a federal remedy for such a wrong had never before been seriously suggested.

The majority in Texas Gulf purported to find support for their construction of the "purchase or sale" limitation in the legislative history behind the passage of Section 10(b) in 1934. The reliance on Congressional reports was both misplaced and disingenuous. In the first place, the House Report cited by Judge Waterman related not to Section 10 but to the sections of the 1934 Act requiring the filing with the SEC of periodic reports, such as Section 13, as to which liability for false statements was expressly imposed in the Act in favor of investors losing money in reliance on the reports.

In the second place, the House Report relied upon by the majority explains that the periodic reports were desirable disclosure devices to deter the "market operator and the recreant corporate official who speculate on inside information." (Emphasis added.) In fact, the legislative history is replete with references to "trading," "market manipulation" and "transactions." For example, a Senate Report explaining proposals to control market activity, including Section 10, said that the evil which was sought to be curbed was the "market activities" of corporate insiders.

Although legislative history is not fully conclusive on the meaning of the "purchase or sale" limitation, to the extent that legislative reports referred to it, they always did so in the context of a desire to curtail certain "market activities." Indeed, the Act itself, in its structure and language, sets forth its own purpose. It has already been noted that Section 2 announces rather clearly that the Act is to regulate market activities. The genesis of Section 10(b) was in the desire of Congress to supplement certain specifically outlawed trading practices, such as matched sales and purchases, wash sales, etc. Section 10(b) was passed in recognition by Congress that it could not be prescient enough to spe-

specifically proscribe each and every manipulative trading device which might be conceived; Congress knew that the new methods of deception might arise and delegated to the SEC authority to prevent them. But it is patent that Congress never intended to arrogate to federal jurisdiction any and all kinds of conduct which, however innocent and bona fide, might influence the market. Surely Congress never dreamed of making Section 10(b) a general regulatory provision to visit upon corporations which make misstatements in press releases. The dissent of Judge Moore and Chief Judge Lumbard in Texas Gulf, which is well worth reading as an enlightening statement of law and policy, demonstrated the inaccuracy of the majority's reading of legislative history.95

Acknowledging that legislative history is too sparse to be determinative, the next question is whether any other source provides an answer to the problem of a defendant's connection with a purchase or sale. One answer, favoring the Texas Gulf majority, is that a remedial statute such as the 1934 Act should be broadly construed. This is a salutary rule of construction, yet it is no answer because a remedial statute is designed to remedy a given evil, and even liberal construction requires reference to the nature of the evil. Things not designed to be remedied by a statute cannot (or at least should not) be brought within the ambit of the statute by "liberal" construction.

The purpose and policy of the 1934 Act, and hence Section 10(b), can be ascertained without resort to definitive comments of legislators. The policy which veritably pervades the Act is obvious from the structure of the Act itself. If Congress had wanted to gather in under federal jurisdiction all aspects of corporate conduct and management, it obviously would have done so in terms much more express.96 The 1934 Act never purported to be a comprehensive federal corporation law. Within its sphere—the regulation of market trading—it is comprehensive. But a judicial construction, such as the Texas Gulf holding on the press release issue, which thrusts the federal courts into an area uncharted by the federal statute, is an impermissible exercise of jurisdiction.

Texas Gulf's press release decision cannot be justified because Congress did not confer jurisdiction on the federal courts to enjoin corporate action merely because that action might have an effect on the market price of securities. Hopefully, therefore, courts in the future will not feel bound by all that the Texas

95. 401 F.2d 833, 870 (2d Cir. 1968).
96. In this regard we can agree with Professor Loss, who said in discussing the judicial expansion of insider's liability under Section 10b-5: "It is a development that, needless to say, I applaud. It was long overdue. But do we have to go on indefinitely basing this whole revolutionary change on a section in the Exchange Act that says it shall be unlawful for any person in the purchase or sale of any security to engage in any act or practice that the S.E.C. prescribes as manipulative or deceptive? How big a house of cards can we continue to build on that? This is backdoor jurisprudence with a vengeance." Loss, History of S.E.C. Legislative Programs and Suggestions for a Code, 22 BUS. LAW. 793, 796 (1967).
Gulf decision implies, recognizing that they have a responsibility—and the power—to exercise only that jurisdiction which the 1934 Act conferred upon them.

To the extent that federal courts follow Texas Gulf, they should at least distinguish between an action commenced by the SEC and private actions. Texas Gulf held that the SEC may obtain an injunction where a misstatement violates Rule 10b-5 if the issuer was negligent in failing to exercise "due diligence" to ascertain the true facts. Texas Gulf also said that a misstatement is actionable only if it was objectively "calculated" to affect the market. This rationale is essentially based on the principles of common law tort liability—i.e., foreseeability and the conduct of a "reasonably prudent man."

In private actions, courts should be reluctant to impose money damages on a corporation issuing a misleading statement unless they at least find that a defendant foresaw an effect on the market and should have inquired further into the facts behind his statement. If Rule 10b-5 is to create a federal law of torts in respect of corporate misrepresentation, federal courts must tread lightly. Hindsight is no test for imposing such questionable liability. A very strict standard of foreseeability should be applied.97

Heit v. Weitzen

If any doubt remained that the Second Circuit put to rest in Texas Gulf the requirement that a defendant be directly involved in a securities transaction, that court itself delivered the coup de grace to such doubts two months later in Heit v. Weitzen.98 In Heit, the court held that shareholders could recover under Rule 10b-5 for losses incurred from their purchases of stock in reliance on the company's misleading financial statements. In ruling on whether the complaints99 stated a cause of action, the court said in words that could not be more understandable, that trading by a defendant is not necessary. The company involved in Heit, Belock Instrument, allegedly included in its income statement for 1964 amounts representing overcharges to the government on contracts. The overcharges allegedly resulted in a material overstatement of income. The court assumed that the overcharges were concealed by the defendants for the purpose of keeping the government in the dark about the true amounts due, and not in any way to deceive purchasers of Belock's shares. Nevertheless, since the alleged

97. Judge Friendly, concurring in Texas Gulf, stated that the decision on the press release issue should not necessarily be taken as a sanctioning of the right of private plaintiffs to recover. 401 F.2d 833, 864 (2d Cir. 1968).
98. 402 F.2d 909, 913 (2d Cir. 1968).
99. The various complaints at issue below were consolidated on appeal.
overstatement of income was objectively calculated to affect the market price of Belock's shares, the court said that Rule 10b-5 offers a remedy to aggrieved purchasers:

There is no necessity for contemporaneous trading in securities by insiders or by the corporation itself.

* * *

It is reasonable to assume that investors may very well rely on the material contained in false corporate financial statements which have been disseminated in the market place, and in so relying may subsequently purchase securities of the corporation.

*Heit* merely reaffirms the error of *Texas Gulf*, and it is not surprising that the three-judge panel in *Heit* felt obliged to follow the en banc teaching of *Texas Gulf*. However, *Heit* was a private action by shareholders, so that we now unfortunately have failed to heed Judge Friendly's admonition in *Texas Gulf*.

Subsequent to *Texas Gulf* and *Heit*, the opened floodgates ushered in numerous district court opinions, allowing the maintenance of private actions against defendants who had nothing to do with any purchase or sale, again not heeding Judge Friendly's concurring caveat.

Thus the tale of the nontrading defendant is told. Salutary indeed is the principle that a shareholder should have a remedy against recreant directors or officers. Heretofore, such remedies have been fully available in actions in the state courts, and, in respect of fraudulent securities offerings or transactions, in the federal courts. Now the line is blurred. The original purpose of the 1934 Act, to fill in the interstices by supplementing state remedies, stands rejected.

**Conclusion**

However beneficial was the policy of providing shareholders with remedies against derelictions of corporate management, we have always understood previously that such remedies were adequately provided for by state laws, under which corporations were created and governed—except to the extent that federal law expressly afforded additional remedies because of peculiar national in-
terests such as trading in securities on national exchanges. Now, we have built up federal remedies by implication from federal law, and we have expanded the remedies into almost every area of management's conduct. If management is liable under federal law for any conduct affecting the market price of a company's stock, there is no perceivable end to the situations which might be actionable under Rule 10b-5.

Because Rule 10b-5 never was intended to be assigned the function of a general visitorial statute, recent cases, particularly Texas Gulf and Heit, which headed us in that direction, exceed the federal jurisdiction conferred upon the federal courts by Congress. We must at least recognize what has happened. Court decisions on Rule 10b-5 have now progressed beyond mere liberal construction. They have embarked upon a venture not tenable under the restrictions which legislation imposed upon them.

There is one small but hopeful sign that the Supreme Court is aware of the immense significance of Rule 10b-5 and of the need for federal courts to be cautious about applying it to so many aspects of corporate conduct. On January 27, 1969, the Court construed the rule for the first time and held that insurance companies are not exempt from its provisions. In doing so, the Court noted that it was entering into a novel area and took pains to say that its decision was a narrow one. "We enter this virgin territory cautiously" said Mr. Justice Marshall for the six-judge majority.103 The Court expressly eschewed any effort to resolve questions of private remedies under the rule. It is a safe prediction to say that the Court would undoubtedly acknowledge the private right of action, and it is to be hoped that the Court might back away from the broad applications of the rule adopted in Texas Gulf.

The story of the non-trading defendant is a remarkable example of the far-flung consequences resulting from the promulgation by a federal agency of a regulation under its rule-making power. It is undeniable that the promulgation of Rule 10b-5 by the SEC in 1942 had consequences far beyond any dreamed of at that time. It has created an enormous and comprehensive body of federal law governing corporate and management conduct under such standards as "due diligence" heretofore the province of state corporation law.

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