

January 1976

Securities

Edward L. Knapp

Follow this and additional works at: <http://digitalcommons.law.ggu.edu/ggulrev>

 Part of the [Securities Law Commons](#)

Recommended Citation

Edward L. Knapp, *Securities*, 6 Golden Gate U. L. Rev. (1976).
<http://digitalcommons.law.ggu.edu/ggulrev/vol6/iss2/18>

This Note is brought to you for free and open access by the Academic Journals at GGU Law Digital Commons. It has been accepted for inclusion in Golden Gate University Law Review by an authorized administrator of GGU Law Digital Commons. For more information, please contact jfischer@ggu.edu.

SECURITIES

INTRODUCTION

This past term the Ninth Circuit covered a wide range of securities issues in a relatively few cases. The court established new guidelines for the vicarious liability of controlling persons¹ and, in a decision which was affirmed by the Supreme Court, discussed what constitutes a statutory "insider."² The court also held that the liability of the Federal Deposit Insurance Corporation in securities cases is determined by the Federal Tort Claims Act rather than the federal securities laws.³

Issues relating to federal and state jurisdiction in securities cases were the subject of decisions holding that a federal court may abate an action identical with one being pursued simultaneously in state court⁴ (but that it is not required to do so if there is no risk of federal interference in the state proceeding),⁵ and that a finding of good faith in a state partnership mismanagement suit does not have a collateral estoppel effect on a subsequent federal securities fraud suit.⁶ Jurisdiction under federal securities law was held to be invoked through purely intrastate phone calls.⁷

In another case, the court indicated that it would be willing to entertain proof of consequential damages as a remedy in a securities fraud case.⁸ The continually evolving flexible duty

1. See *Zweig v. Hearst Corp.*, 521 F.2d 1129 (9th Cir. July, 1975) (per McNichols, D.J.), *cert. denied*, 44 U.S.L.W. 3342 (U.S. Dec. 9, 1975) (No. 573).

2. See *Provident Sec. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601 (9th Cir. Sept., 1974) (per Wallace, J.), *aff'd*, 96 S. Ct. 508 (1976), *noted in* 9 LOYOLA L.A.L. REV. 175 (1975).

3. See *Safeway Portland Employers Fed. Credit Union v. Federal Deposit Ins. Corp.*, 506 F.2d 1213 (9th Cir. Nov., 1974) (per Sneed, J.).

4. See *Weiner v. Shearson, Hammill & Co.*, 521 F.2d 817 (9th Cir. Aug., 1975) (per Chambers, J.); *McGregor Land Co. v. Meguiar*, 521 F.2d 822 (9th Cir. Aug., 1975) (per Chambers, J.).

5. See *Hilton v. Mumaw*, 522 F.2d 588 (9th Cir. Aug., 1975) (per Wallace, J.).

6. See *Clark v. Watchie*, 513 F.2d 994 (9th Cir. Apr., 1975) (per Thompson, D.J.), *cert. denied*, 44 U.S.L.W. 3202 (U.S. Oct. 7, 1975) (No. 1651).

7. See *Spilker v. Shayne Laboratories, Inc.*, 520 F.2d 523 (9th Cir. July, 1975) (per Tuttle, J.).

8. See *Foster v. Financial Technology, Inc.*, 517 F.2d 1068 (9th Cir. Apr., 1975) (per Chambers, J.).

standard which the Ninth Circuit has recently applied in rule 10b-5 actions⁹ was further developed by its application to a case of misrepresentation of future corporate earnings,¹⁰ and to a case of misrepresentation of the value of stock used to determine a merger exchange ratio.¹¹ In light of the Supreme Court's recent decision in *Ernst & Ernst v. Hochfelder*,¹² however, it is doubtful that these decisions will serve an important role in developing future law in the 10b-5 area.¹³

The definition of a security was discussed in two cases. One held that a combination package of a bank Certificate of Deposit plus an interest bonus added by the broker was a security.¹⁴ The other dealt with the question of when a limited partnership interest would be considered a security.¹⁵

I. THE PARTIES

A. VICARIOUS LIABILITY

Under the common law principle of respondeat superior, an employer could be held liable for the torts of an employee.¹⁶ However, in the field of securities, Congress has established statutory liability for "controlling persons" in section 20(a) of the Securities Exchange Act of 1934 (1934 Act)¹⁷ which preempts common law. In *Zweig v. Hearst Corp.*,¹⁸ the Ninth Circuit reaffirmed its rule that section 20(a) precludes the common law remedy of respondeat superior,¹⁹ and established a new standard of

9. The flexible duty standard was announced in *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974), noted in 9 LOYOLA L.A.L. REV. 150 (1974). Rule 10b-5, promulgated by the Securities and Exchange Commission pursuant to section 10(b) of the Securities Exchange Act of 1934, is discussed at note 26 *infra*. For further discussion see 1 A. BROMBERG, SECURITIES LAW: FRAUD § 2.2 (410), at 22.6 (1974).

10. See *Marx v. Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. Nov., 1974) (per Koelsch, J.).

11. See *Robinson v. Cupples Container Co.*, 513 F.2d 1274 (9th Cir. Mar., 1975) (per Wright, J.).

12. 96 S. Ct. 1375 (1976).

13. See notes 125-32 *infra* and accompanying text.

14. See *Safeway Portland Employees Fed. Credit Union v. Wagner & Co.*, 501 F.2d 1120 (9th Cir. Aug., 1974) (per Beeks, D.J.).

15. See *McGreghar Land Co. v. Meguiar*, 521 F.2d 822 (9th Cir. Aug., 1975) (per Chambers, J.).

16. See W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 69 (4th ed. 1971).

17. Section 20(a) is codified at 15 U.S.C. § 78t(a) (1970).

18. 521 F.2d 1129 (9th Cir. July, 1975) (per McNichols, D.J.), cert. denied, 44 U.S.L.W. 3342 (U.S. Dec. 9, 1975) (No. 573).

19. This rule was first announced in *Kamen & Co. v. Paul H. Aschkar & Co.*, 382 F.2d 689 (9th Cir. 1967), cert. granted, 390 U.S. 942 (1968), cert. dismissed, 393 U.S. 801

care for "controlling persons" under section 20(a) which insulates certain employers from particular wrongs by their employees if the employer was unaware of and unable to prevent the wrongful act.

Federal securities law has two similar vicarious liability provisions: section 20(a) of the 1934 Act, which *Zweig* dealt with, and section 15 of the Securities Act of 1933 (1933 Act).²⁰ Under section 20(a), a controlling person is liable for the acts of a controlled person who violates the provisions of the 1934 Act, unless the controlling person acted in good faith and did not induce the controlled person's wrongful acts.²¹ Section 20(a)'s crucial good faith defense is not available to employers under the respondeat superior doctrine's absolute liability theory.²² The 1967 Ninth Circuit case of *Kamen & Co. v. Paul H. Aschkar & Co.*²³ held that section 20(a) provided the exclusive remedy against controlling persons for violations of the 1934 Act, thus foreclosing any cause of action under respondeat superior. In *Zweig*, the court surveyed the varied acceptance of the *Kamen* rule in the other circuits,²⁴ and, by reaffirming section 20(a) as exclusive, enabled the employer in *Zweig* to rely on the good faith defense. In applying the defense in *Zweig*, however, the court was faced with a novel situation without controlling precedent.

In *Zweig*, the Hearst Corporation was sued as a controlling person after a columnist in a Hearst Corporation-owned newspaper allegedly made misrepresentations in a financial column.²⁵

(1969), and has been followed repeatedly. See, e.g., *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970). However, the *Zweig* court acknowledged that not all circuits follow the rule. See 521 F.2d at 1132.

20. Section 15 is codified at 15 U.S.C. § 77(o) (1970). The application of this section is discussed in *Safeway Portland Employees Fed. Credit Union v. Wagner & Co.*, 501 F.2d 1120 (9th Cir. Aug., 1974), which is discussed at notes 136-38 *infra*.

21. In pertinent part section 20(a) provides:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter . . . shall also be liable, . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation

22. See W. PROSSER, *supra* note 16, § 69.

23. 382 F.2d 689 (9th Cir. 1967), *cert. granted*, 390 U.S. 942 (1968), *cert. dismissed*, 393 U.S. 801 (1969).

24. For a discussion of *Kamen* see note 19 *supra*.

25. *Zweig* involved a daily financial column in the *Los Angeles Herald Examiner*, a Hearst Corporation-owned newspaper. One of the columns praised the prospects of American Systems, Inc. What it failed to mention was that the columnist owned stock

In its search for an analogy to the *Zweig* facts, the court considered typical vicarious liability cases, including suits under section 10(b) of the 1934 Act²⁶ against a stock brokerage firm for actions by a salesman or agent which violate section 10(b).²⁷ The nature of an

in American Systems. After the column was published, the price of American Systems stock rose dramatically, and the columnist sold his shares at a profit. The price later fell and several disappointed investors sued the columnist under section 10(b) of the 1934 Act and rule 10b-5, and sued Hearst Corporation as a controlling person under section 20(a) of the 1934 Act. Hearst Corporation was granted a summary judgment dismissing the section 20(a) claim, and the plaintiffs appealed, claiming that respondeat superior should apply to the corporation as an alternate remedy. Plaintiffs' suit apparently also included additional allegations of negligence and fraud under state and common law theories, but they were not discussed on appeal. With the dismissal of the federal claim on appeal, the state and common law claims lost pendent jurisdiction. 521 F.2d at 1131.

26. Section 10(b) provides:

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

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national security 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.

15 U.S.C. § 78j(b) (1970). As a means of enforcing section 10(b), the Securities and Exchange Commission (SEC) promulgated rule 10b-5. Rule 10b-5 provides:

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

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

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

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

17 C.F.R. 240.10b-5 (1975). The SEC, upon publication of the rule, stated:

The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule [10b-5] closes a loophole in the protection against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.

SEC Sec. Exch. Act. Rel. No. 3230 (May 21, 1942).

27. The *Zweig* court discussed broker-dealer cases because plaintiffs had been forced to rely upon them when it was discovered that no precedent controlled the situation

employer's liability in such contexts is fairly well-settled, as are the elements of the defense of good faith. In order for a brokerage firm (controlling person) to show good faith, it must prove that it maintained and enforced a reasonable and proper system of supervision and internal control over the agent (controlled person).²⁸ But should this same standard be applied to newspaper owners and their employees? The court thought not, stating that to liken the almost fiduciary relationship between a stock broker and the investing public to the relationship between a newspaper and the reader is to "depart from reality."²⁹ A different standard was therefore created.

The three basic factors considered by the court in determining the section 20(a) liability of a newspaper as a controlling person over its columnists relate to the practical nature of the business involved. First, the newspaper must initially require its reporters to report fairly and accurately. Second, an article must be fair on its face so that a surface reading does not reveal any impropriety. The newspaper is not required to investigate each column and may anticipate compliance with its standards. Lastly, however, the employer may only continue to rely on the expected integrity of its reporters if it does not receive any notice or warning of a past or potential abuse.³⁰ These requirements were met by the Hearst Corporation to a sufficient extent to sustain the summary judgment absolving the newspaper of liability.

B. INSIDER LIABILITY

In order to prevent major stock holders from taking unfair advantage of inside information, section 16(b) of the 1934 Act³¹ creates a conclusive presumption—which applies to owners of more than ten percent of any class of equity securities—that profits produced by the purchase and sale of equity securities within

involved in *Zweig*. See 521 F.2d at 1134-35, citing *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970). For a discussion of other situations in which vicarious liability has been found in the securities area see Note, *The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U.L. REV. 1019 (1973).

28. See 521 F.2d at 1134-35, and authorities cited therein.

29. *Id.* at 1135. In another context, the Supreme Court has recently discussed those who obtain "information violative of Rule 10b-5 . . . in the financial pages of their local newspaper." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754 (1975) (reversing the Ninth Circuit and holding that a private 10b-5 action is confined to actual purchasers or sellers of securities).

30. These factors are discussed in 521 F.2d at 1135.

31. Section 16(b) is codified at 15 U.S.C. § 78p(b) (1970).

a six month period are derived from inside information.³² Consequently, any profits that such stock holders realize from the purchase and sale of equity securities within a six month period are recoverable by the issuer.³³ In *Provident Securities Co. v. Foremost-McKesson, Inc.*,³⁴ a Ninth Circuit panel applied a newly-established test for determining if an actual purchase or sale of securities sufficient to invoke "insider liability" had in fact occurred,³⁵ and clarified the definition of an insider under section 16(b) of the 1934 Act.³⁶ The Supreme Court, in a decision which specifically concerned only the last of these points,³⁷ affirmed *Provident* and resolved a conflict among the circuits by establishing that, in order to be classified as an "insider" under section 16(b), one must own more than 10 percent of a corporation's securities *before*, rather than contemporaneous with, the initial purchase that gives rise to the short-swing profit.³⁸ However, the Ninth Circuit opinion remains important because of its treatment of other issues not discussed by the Supreme Court in *Provident*.

Qualifying as an Insider

Provident Securities Co. (Provident) was a holding company seeking to liquidate its assets, and Foremost-McKesson, Inc. (Foremost) was a buyer willing to pay for the assets with its own debentures and a small amount of cash. The transaction which ensued made Provident a beneficial owner of more than ten percent of a class of Foremost securities. A week later Provident arranged to sell most of the Foremost debentures to an underwriter for a profit.³⁹ Provident then sought a declaratory judgment

32. *Id.* This presumption is discussed in 2 L. LOSS, SECURITIES REGULATION 1041 (2d ed. 1961); 9 LOYOLA L.A.L. REV. 175, 176-77 (1975). For a useful discussion of section 16(b) see Wentz, *Refining a Crude Rule: The Pragmatic Approach to Section 16(b) of the Securities Exchange Act of 1934*, 70 Nw. U.L. REV. 221 (1975).

33. 15 U.S.C. § 78p(b) (1970).

34. 506 F.2d 601 (9th Cir. Sept., 1974) (per Wallace, J.), *aff'd*, 96 S. Ct. 508 (1976), noted in 9 LOYOLA L.A.L. REV. 175 (1975).

35. 506 F.2d at 604-06. The new test was enunciated in *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973), and involves "a pragmatic approach that subjects short-swing transactions by an insider to section 16(b) scrutiny only if they involve the potential for speculative abuse of inside information." 506 F.2d at 604.

36. See 506 F.2d at 607-11.

37. See *Foremost-McKesson v. Provident Sec. Co.*, 96 S. Ct. 508, 514 n.8 (1976).

38. See *id.* at 512.

39. Provident's original plan was to distribute the newly acquired debentures to its shareholders and let the shareholders sell them to the underwriter. However, problems arose with this plan because some of Provident's shareholders were minors and others

regarding its liability under section 16(b), and Foremost counterclaimed for recovery of the profit.⁴⁰

In order for 16(b) liability to attach, an initial transaction (the purchase by Provident) and a closing transaction (the sale by Provident to the underwriter) must occur within six months of each other.⁴¹ The major issue before the court was whether the same purchase that made Provident an "insider" by giving it more than ten percent of Foremost securities may also serve as the initial transaction to determine section 16(b) liability.

There are several possible resolutions of this question, each having its own analysis of congressional intent for support. As noted in the Supreme Court opinion in *Provident*, some courts have held that the same purchase that first makes one a ten percent owner may count as an initial transaction under section 16(b).⁴² According to these cases, the language of the statute requiring one to own ten percent "at the time of the purchase" is construed to mean "immediately after" the purchase.⁴³ By permitting the transaction which makes one a ten percent owner to serve as the initial transaction for section 16(b) purposes, as many major stock holders as possible are subjected to liability, thus fulfilling the presumed intent of Congress in creating insider liability.⁴⁴ It is argued that to hold otherwise would weaken the statute. For example, owners of more than ten percent who sell their stock and reduce their holdings to just below the ten percent level could then repurchase any amount of stock and sell it within six months with impunity. Even though the entire transaction is tainted with inside information, section 16(b) liability would not

could not be contacted. For these reasons, Provident itself sold the debentures to the underwriters, and thus invited the instant suit. The district court opinion, 331 F. Supp. 787 (N.D. Cal. 1971), gave persuasive weight to the involuntary nature of the sale by Provident in entering a judgment in their favor. According to the district court, Provident sold a \$25,000,000 debenture for \$25,366,366.66, a profit the district judge characterized as "miniscule." *Id.* at 792.

40. For a fuller discussion of the transactions involved see 506 F.2d at 603-04.

41. 15 U.S.C. § 78p(b) (1970).

42. See 96 S. Ct. at 514 & nn.10-11, citing *Stella v. Graham-Paige Motors Corp.*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

43. See 96 S. Ct. at 514-15. The Court also acknowledged that some courts denominate the "immediately after" position as the "simultaneous with" position. *Id.* at 514 n.9. Regardless of the phrase used, the position is the same; the sale which makes an individual an "insider" by giving it more than a 10 percent interest may also serve as the initial transaction for the purposes of section 16(b) liability.

44. See *Emerson Elec. Co. v. Reliance Elec. Co.*, 434 F.2d 918, 923-24 (8th Cir. 1970), *aff'd on other grounds*, 404 U.S. 418 (1972).

attach to this type of transaction unless the "immediately after" position is adopted.⁴⁵

In *Provident*, however, both the Supreme Court and the Ninth Circuit analyzed congressional intent differently. They put paramount emphasis on the congressional presumption that an owner of over ten percent of a corporation's securities wields sufficient power to obtain access to inside information, and that such a person is conclusively presumed to use the inside information in any short-swing stock transactions.⁴⁶ The Supreme Court was particularly concerned with keeping the strict liability of section 16(b) within its narrow definitional confines,⁴⁷ and held that the law was not intended to include in the definition those purchasers who did not own ten percent of a corporation's stock before the initial purchase of a short-swing purchase-then-sale sequence.⁴⁸ The Supreme Court thus concluded that *Provident's* purchase of *Foremost* debentures was not an initial transaction which would invoke section 16(b) liability.⁴⁹ In other words, section 16(b)'s statement that one must own ten percent "at the time of" the sale or purchase is now interpreted by the Supreme Court to mean that one must own ten percent prior to an initial purchase. A person must therefore own ten percent prior to the initial purchase in a purchase-then-sale transaction in order for section 16(b) liability to attach. In a sale-then-purchase transaction, on the other hand, one does not have to own ten percent before the closing purchase as long as he obtains ten percent by way of the closing purchase.⁵⁰

45. The various arguments in support of the "immediately after" or "simultaneous with" position are discussed, along with relevant authorities, in 506 F.2d at 608.

46. See 96 S. Ct. at 516-21; 506 F.2d at 609-14.

47. See 96 S. Ct. at 519-20. *Foremost* argued that, where alternative constructions are available, the construction that best serves the statute's purposes should be favored. The Court responded that:

It is inappropriate to reach the harsh result of imposing § 16(b)'s liability without fault on the basis of unclear language. If Congress wishes to impose such liability, we must assume it will do so expressly or by unmistakable inference.

Id. at 520. This position, which the Ninth Circuit shares, has been criticized because it ignores the possibility of abuse in the kind of purchase-then-sell situation which *Provident* concerns. See *Wentz*, *supra* note 29, at 268-69.

48. See 96 S. Ct. at 519-20.

49. *Id.*

50. See 506 F.2d at 614-15; *Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc.*, 527 F.2d 335 (7th Cir. 1975). The Supreme Court in *Provident* expressly declined to offer an opinion regarding the semantically inconsistent manner in which section 16(b) must now be applied. See 96 S. Ct. at 515 n.15.

Qualifying as a Purchase

The Ninth Circuit opinion in *Provident* dealt with two issues that the Supreme Court did not discuss. The Ninth Circuit's opinion initially considered the definition of a "purchase" of securities under section 16(b). The recent Supreme Court case of *Kern County Land Co. v. Occidental Petroleum Corp.*⁵¹ set new guidelines in this area, and *Provident* was the Ninth Circuit's first opportunity to follow and interpret these guidelines.⁵² Due to the varying types of stock transactions, it is sometimes difficult to ascertain whether a transaction actually constitutes a purchase or sale. A simple exchange of cash for stock is obviously a purchase or sale of the stock. This type of transaction is labeled "orthodox" by the *Provident* court, and section 16(b) clearly applies.⁵³ If, however, a more complicated, "unorthodox" transaction such as a merger or conversion occurs, further analysis is required to determine if section 16(b) should apply. An unorthodox transaction will only be subject to section 16(b) liability as a purchase or sale if it involves the "potential for speculative abuse."⁵⁴ The *Kern* test for determining if there is a potential for speculative abuse involves two questions. First, could the defendant reasonably be expected to have had access to inside information? Second, did the defendant initiate the transaction voluntarily? An affirmative answer to both of these questions means that section 16(b)'s "purchase" requirement is satisfied even though an unorthodox transaction is involved.⁵⁵ In essence, it can be said that *Kern* transformed section 16(b)'s conclusive presumption that ten percent owners have access to inside information into a rebuttable presumption for the purposes of evaluating unorthodox transactions.⁵⁶

51. 411 U.S. 582 (1973), noted in 87 HARV. L. REV. 291 (1973).

52. The district court opinion in *Provident*, 331 F. Supp. 787 (N.D. Cal. 1971), was written before the *Kern* decision. The Supreme Court noted, however, that the district court's analysis, which the Ninth Circuit rejected, is compatible with *Kern*. See 96 S. Ct. at 513.

53. See 506 F.2d at 604.

54. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973); 506 F.2d at 604.

55. The *Provident* court's discussion and application of this two-step test is in 506 F.2d at 605.

56. *Id.* The *Provident* court explained:

Where . . . the hostility of the management of the corporation to the 10-percent shareholder precludes any real possibility of access to inside information, . . . the presumption may be rebutted

Id. It is not clear whether this is only one example of a circumstance which, if proved, would rebut section 16(b)'s presumption.

The exchange of Provident's assets in return for Foremost's debentures, convertible immediately into common stock, was characterized by Provident as an asset-for-stock transaction rather than a cash-for-stock transaction,⁵⁷ but it was nonetheless considered orthodox because the court saw no meaningful distinction between consideration in the form of cash and consideration in the form of a corporate asset.⁵⁸ The court went on to state, however, that section 16(b) would apply even if the transaction had been held to be unorthodox, because it nonetheless had the potential for speculative abuse.⁵⁹ This conclusion was based on the fact that Provident could not rebut the presumption that ten percent owners have access to inside information. Unlike the *Kern* situation, where the insider's access to information was hindered by a hostile management,⁶⁰ Provident and the Foremost management appeared to be on friendly terms.⁶¹

The second element of the *Kern* test was interpreted by the *Provident* court to amount to a presumption that, absent a contrary showing, the type of unorthodox security transactions dealt with in *Kern* and *Provident* are voluntary.⁶² Since Provident did not attempt to show that its actions were involuntary, no reason was seen to extend "the *Kern* rule of leniency" to a party who could have avoided section 16(b) liability without serious detriment.⁶³

Qualifying as a Sale

The second issue that the Ninth Circuit opinion discussed involved the proper method of deciding exactly when a "sale" takes place. The "purchase" in question took place on October 15, 1969, when Provident acquired 49.75 million dollars worth of Foremost debentures, making Provident a beneficial owner of more than ten percent of Foremost securities. However, there was a dispute over whether the "sale" occurred at the time of the signing of the sales agreement or when the debentures were actually transferred at the closing of the agreement. On October 21, 1969, Provident executed an agreement for the sale of 25 million dollars worth of those debentures to the underwriter but retained

57. *Id.*

58. *Id.*

59. *Id.*

60. *See* 411 U.S. at 598.

61. 506 F.2d at 605.

62. *Id.* at 606.

63. *Id.* at 605.

title to all of them until the agreement was closed. On October 24, Provident distributed another 22.25 million dollars worth of the debentures to its stock holders, and thereby ceased to be a ten percent owner. On October 28, Provident closed the October 21st agreement with the underwriter, transferred the debentures, and generated the disputed profit. Provident argued that the sale did not occur while it was a ten percent owner because the statutory "sale" of the debentures was not completed until the October 28th closing. The *Provident* court rejected this argument on the ground that the purchase agreement was sufficiently binding to be considered a statutory sale,⁶⁴ thus depriving Provident of any opportunity to use inside information to its advantage. Several conditions had to be met before the agreement could be closed,⁶⁵ but the court concluded that none of the conditions subjected Provident to any market risks after the date of the agreement. Thus, the statutory sale occurred at the time of the underwriting agreement's execution, *i.e.*, while Provident was a ten percent owner of Foremost securities.

C. FEDERAL AGENCIES

The issue of a federal agency's liability for securities violations was presented to the court in *Safeway Portland Employees Federal Credit Union v. Federal Deposit Insurance Corp.*⁶⁶ The *Safeway* court held that the FDIC was only amenable to suit under the Federal Tort Claims Act (FTCA),⁶⁷ and not the securities laws. In so doing, it rejected a claim by the Safeway Portland Employees Federal Credit Union (credit union) that the FDIC had violated section 17(a) of the 1933 Act⁶⁸ by aiding and abetting the Sharpstown State Bank of Houston in a scheme to defraud the

64. *Id.* at 607.

65. Although the district court, court of appeals and Supreme Court opinions all mention the conditions, they were never fully discussed. There were apparently four conditions—that: (1) the registration statement for the debentures filed by Foremost become effective on the date of the sale agreement, (2) no stop order be issued prior to closing, (3) Foremost produce an opinion letter on the legality of the transactions, and (4) no material unfavorable change in conditions occur before the registration statement became effective. The Ninth Circuit held that the last condition was negated because the registration statement was effective on the date of the agreement, so that there was never a time when the underwriters could have invoked that condition to avoid closing. *Id.* at 607. This last condition seems to be the only one bearing any relation to market risks. See 96 S. Ct. at 513 n.7.

66. 506 F.2d 1213 (9th Cir. Nov., 1974) (per Sneed, J.).

67. The Federal Tort Claims Act is codified at 28 U.S.C. §§ 1346(b), 2671-80 (1970).

68. Section 17(a) is codified at 15 U.S.C. § 77q(a) (1970).

public, and thus affirmed the trial court's dismissal of the complaint.

It is clear that suits against the FDIC are authorized under the FTCA,⁶⁹ but the issue presented in *Safeway* was whether the agency can also be sued under the Securities Act. In analyzing the issue the court invoked the general rule that a waiver of sovereign immunity must be clear and specific, and that a waiver cannot be inferred from ambiguous language.⁷⁰ Since the *Safeway* court could find no specific waiver in the language of the Securities Act of 1933, it held that the government's immunity was still intact. Accordingly, suit could only have been brought under the FTCA. However, since that Act specifically excludes claims, such as the credit union's, which are based on deceit and misrepresentation,⁷¹ the plaintiff was left without a remedy.

II. THE FORUM

A. FEDERAL JURISDICTION

In addition to refining concepts of who may sue, this past term the Ninth Circuit resolved some jurisdictional questions frequently raised in securities cases. Section 10(b) of the 1934 Act⁷² and rule 10b-5,⁷³ which the Securities and Exchange Commission (SEC) promulgated thereunder, both have jurisdictional clauses which require, in identical language, that the defendant must use "any means or instrumentality of interstate commerce" before a cause of action will lie. This requirement stems from Congress' constitutional power to regulate interstate commerce, but the scope of that power has been held extensive enough to allow Congress to regulate any activity that affects interstate commerce—even activity which itself is purely intrastate.⁷⁴

In *Spilker v. Shayne Laboratories, Inc.*,⁷⁵ defendants were sued under section 10(b) and rule 10b-5 for misleading statements made in connection with the sale of securities. During the course of the allegedly fraudulent sale, one of the defendants made two

69. See 28 U.S.C. § 2675(a) (1970).

70. 506 F.2d at 1216.

71. 28 U.S.C. § 2680(h) (1970).

72. Section 10(b) is codified at 15 U.S.C. § 78j(b) (1970). For the text of section 10(b) see note 26 *supra*.

73. Rule 10b-5 is codified at 17 C.F.R. § 240.10b-5 (1975). For the text of rule 10b-5 see note 26 *supra*.

74. See, e.g., Light, *The Federal Commerce Power*, 49 VA. L. REV. 717, 727-28 (1963).

75. 520 F.2d 523 (9th Cir. July, 1975) (per Tuttle, J.).

local San Francisco telephone calls. A district court dismissed the suit, holding that the two local calls alone were not sufficient to establish jurisdiction under federal securities law. The issue the court addressed in *Spilker* was not whether Congress has the power to regulate purely intrastate activities which affect interstate commerce, but whether in drafting section 10 it intended to regulate the intrastate activity in question.⁷⁶

The *Spilker* court relied heavily upon the recent Fifth Circuit case of *Dupuy v. Dupuy*,⁷⁷ which concluded, after examination of the language and legislative history of section 10, that Congress did intend for federal courts to have jurisdiction over cases involving the intrastate use of an interstate communications system in connection with a fraudulently induced purchase of securities.⁷⁸ The *Spilker* court found *Dupuy's* analysis persuasive, and thus reached the same conclusion.⁷⁹

B. STATE AND FEDERAL RELATIONSHIP

Securities law is complicated by the fact that jurisdiction is distributed between federal and state courts. The Securities Act of 1933 grants concurrent jurisdiction to both state and federal

76. See *id.* at 524.

77. 511 F.2d 641 (5th Cir. 1975).

78. The *Dupuy* court acknowledged that several other courts have arrived at the same conclusion. See *id.* at 643 n.3. The court found that a difference in language between the jurisdictional clauses of the 1933 and 1934 Acts was the most persuasive indication of congressional intent. The jurisdiction language of the 1933 Act requires the use of "any means or instrumentality . . . in interstate commerce." See, e.g., 15 U.S.C. § 77e (1970) (emphasis added). The 1934 Act, however, refers to "any means or instrumentality of interstate commerce." *Id.* § 78j (emphasis added). The court thus concluded that Congress intended to regulate the intrastate use of such instrumentalities of interstate commerce as the telephones. The *Dupuy* court was also of the opinion that their interpretation of the statutory language was in harmony with the 1934 Act's dominant purpose of preventing securities fraud to the fullest extent possible. See 511 F.2d at 643.

79. See 520 F.2d at 526. In doing so it distinguished *Burke v. Triple A Mach. Shop, Inc.*, 438 F.2d 978 (9th Cir. 1971), on the ground that, unlike the situation in *Spilker*, *Burke* did not deal with intrastate phone calls which were connected with a fraudulently induced purchase of securities. The *Spilker* court therefore intimated that the court in *Burke* did not consider whether two intrastate telephone calls satisfy section 10's jurisdictional requirement of use of an instrumentality of interstate commerce. See 520 F.2d at 525. This view only seems tenable if the *Burke* opinion is read selectively, for the *Burke* court did

conclude that there was . . . no use of an "instrumentality of interstate commerce" within the contemplation of the statute by reason of two local telephone calls . . .

438 F.2d at 979. This is dictum, however, and the *Spilker* court was therefore justified in adopting the more persuasive *Dupuy* analysis.

courts.⁸⁰ The Securities Exchange Act of 1934 grants exclusive jurisdiction to federal courts,⁸¹ but case law has held that a state court may adjudicate 1934 Act issues that are raised as matters of affirmative defense.⁸² As several cases decided this past term illustrate, such a jurisdictional scheme inevitably gives rise to issues concerning the interrelationship between the federal and state forums.

Stays of Federal Proceedings

Although federal courts can exercise original jurisdiction over securities cases arising under either act, the doctrines of abstention, abatement or *forum non conveniens* can be invoked in appropriate circumstances.⁸³ In *Weiner v. Shearson, Hammill & Co.*,⁸⁴ the plaintiff filed a complaint in federal district court shortly after filing an essentially identical complaint in a state court. Although the complaint stated claims under both the 1933 and 1934 Acts, the state court appeared to have jurisdiction to rule on all issues.⁸⁵ Accordingly, the district judge decided to abate the action by dismissing it.⁸⁶ The *Weiner* court reversed the decision to dismiss, but indicated that abatement in the form of a stay pending the outcome of the state action is usually appropriate when a plaintiff simultaneously prosecutes identical claims in both federal and state court.⁸⁷ If a stay is not appropriate, or if the conditions

80. Securities Act of 1933 § 22 (a), 15 U.S.C. § 77v(a) (1970).

81. Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa (1970).

82. See, e.g., *Shareholders Management Co. v. Gregory*, 449 F.2d 326 (9th Cir. 1971) (federal action stayed pending state court resolution of 1934 Act defense); *Aetna Bank v. Alzheimer*, 430 F.2d 750 (7th Cir. 1970). For a discussion of state court jurisdiction over defenses arising under analogous federal securities law concerning proxies see 2 L. Loss, *supra* note 32, at 977.

83. See *Weiner v. Shearson, Hammill & Co.*, 521 F.2d 817 (9th Cir. Aug., 1975).

84. 521 F.2d 817 (9th Cir. Aug., 1975) (per Chambers, J.).

85. The defendant had filed a counterclaim to which *Weiner*, the plaintiff, answered by alleging as an affirmative defense "the misrepresentations which form[ed] the core of his [claim under the 1934 Act]." *Id.* at 822. It thus appeared that the state court had jurisdiction over all claims. *Id.*, citing *Shareholders Management Co. v. Gregory*, 449 F.2d 326 (9th Cir. 1971).

86. 521 F.2d at 818.

87. *Id.* at 820-21. The court enumerated several considerations which, when present, support the use of the discretionary power to stay. The considerations are: (1) avoidance of friction created by the appearance that the second court is interfering with the first; (2) reducing duplication of judicial effort; (3) removing burdens from already overcrowded dockets; (4) preventing unfair strain on the litigating parties; and (5) preventing "an unseemly race to judgment." *Id.* at 820. For a general discussion see Note, *Stays of Federal Proceedings in Deference to Concurrently Pending State Court Suits*, 60 COLUM. L. REV. 684 (1960) [hereinafter cited as *Stays of Federal Proceedings*].

which made it appropriate cease to exist before the state action ends, then the plaintiff should be allowed to proceed in federal court.⁸⁸

In *McGreghar Land Co. v. Meguiar*,⁸⁹ the court also reversed a district court's dismissal of a complaint which had been filed shortly after the initiation of a similar action in a state court. Judge Chambers, who also spoke for the *Weiner* court, reiterated the view that abatement, although appropriate in such cases, should involve no more than a stay of the federal action.⁹⁰ *McGreghar* illustrates the need for district courts to retain jurisdiction even though they abate an action. At the time the plaintiff's complaint was dismissed, it appeared that a claim under the 1934 Act would be dealt with in the state action. After the dismissal in federal court, however, the state court dismissed the claim without prejudice.⁹¹ Thus, if the district court had merely stayed the federal action, rather than dismiss it, the action could have been revived if abatement ceased to be appropriate in light of the state court's dismissal.

Weiner and *McGreghar* are a reflection of a growing tendency among federal courts to utilize the abatement doctrine when essentially identical actions are pending in both federal and state courts.⁹² The two cases clearly indicate, however, that in the securities area the useful purposes served by the doctrine may only be advanced if it is used to stay rather than dismiss federal actions in deference to parallel state actions.

Collateral Estoppel

Another aspect of the interplay between state and federal courts is the res judicata and collateral estoppel effect one court's

88. This seems implicit in the *Weiner* court's statement that "even if abatement were proper in this case, dismissal of the action was not the appropriate method, . . . the district court should have stayed the action pending either the outcome of the state action or a timely suggestion by either party that the reasons which had prompted the stay had ceased to apply." 521 F.2d at 821.

89. 521 F.2d 822 (9th Cir. Aug., 1975) (per Chambers, J.).

90. *Id.* at 823.

91. The claim under the 1934 Act, alleged violations of section 10(b) of the Act and of rule 10b-5, was by stipulation dismissed without prejudice. Accordingly, "had the district court stayed [the] action, it would have retained jurisdiction to consider a suggestion that a stay was no longer appropriate" *Id.* at 824.

92. One writer has stated that stays of federal proceedings in situations like those existing in *Weiner* and *McGreghar* "have become increasingly commonplace" *Stays of Federal Proceedings*, *supra* note 87, at 710.

decision has. In *Clark v. Watchie*,⁹³ a class action was brought in a state court against the general partner in a large real estate syndicate for mismanagement of the partnership and breach of fiduciary duty. A suit was simultaneously filed in federal court under section 10(b) of the 1934 Act and rule 10b-5. While the district court was considering the question of the status of the class, the state court found that the defendant had not breached his fiduciary duty to the partnership.⁹⁴ A summary judgment was thus granted by the district court on the ground that the state and federal cases were similar, and therefore that, under "the doctrines of res judicata and collateral estoppel," the state court findings precluded further prosecution of the federal suit.⁹⁵

On appeal, the Ninth Circuit decided that the state court findings did not dispose of the federal action. Defendant's res judicata argument was dealt with summarily. Res judicata will only bar a later suit if the prior suit involved the same cause of action.⁹⁶ Since section 10(b) and rule 10b-5 actions arise under the 1934 Act, they can be initiated only in federal court.⁹⁷ The *Clark* court therefore reasoned that a state suit could not possibly embody a section 10(b) or rule 10b-5 cause of action.⁹⁸

The collateral estoppel argument was analyzed in greater detail, but the court found that established Supreme Court precedent controlled the issue. In *Blonder-Tongue Laboratories v. University of Illinois Foundation*,⁹⁹ the Court set out a three-part test for determining when collateral estoppel will apply in a later case.

93. 513 F.2d 994 (9th Cir. Apr., 1975) (per Thompson, D.J.), cert. denied, 44 U.S.L.W. 3202 (U.S. Oct. 7, 1975) (No. 1651).

94. It is not clear from the Ninth Circuit opinion exactly what the state court decided. Apparently, the state court found that the defendant-appellee acted in good faith in his management of the land syndicate's affairs, but nonetheless a money judgment was entered against him which equaled the amount by which fair market value had been exceeded in some land purchases defendant had made. *Id.* at 997. The district court relied on a special master, who had determined that, "since the issues in the state and federal cases are similar, the findings of the state court estopped the [plaintiffs] from further pursuing their federal claim." *Id.*

95. *Id.* at 996-97.

96. See 1B J. MOORE, FEDERAL PRACTICE ¶ 0.410[1], at 1151 (2d ed. 1974).

97. See authority cited at note 81 *supra* and accompanying text.

98. See 513 F.2d at 997.

99. 402 U.S. 313 (1971). *Blonder-Tongue* reversed *Triplett v. Lowell*, 297 U.S. 638 (1936), which had served to perpetuate the mutuality of collateral estoppel rule in patent litigation even though the rule had been discarded in other contexts. See 50 TEXAS L. REV. 559 (1972). However, the *Blonder-Tongue* test for determining when the collateral estoppel doctrine should be applied is adaptable to non-patent cases. See 60 GEO. L.J. 1126, 1133 (1972).

First, is there a final judgment on the merits in the first suit? Second, if the party against whom the claim of collateral estoppel is asserted a party (or privy to a party) in the first suit? Third, is the issue decided in the first suit identical with the issue in the second? If all three questions are answered affirmatively, then the collateral estoppel doctrine will bar an adjudication of the issue in the second suit. The first two questions were easily answered in the affirmative in *Clark*, but the third part of the test was not met because the issues were not identical.¹⁰⁰ Since the state suit concerned alleged non-disclosure by the defendant with respect to the partnership management, while the federal suit alleged non-disclosure by the defendant with regard to the sale of partnership units, the *Clark* court found that the two actions were not identical factually.¹⁰¹ The court also stated that the theories of liability in the two suits—and thus the standard of conduct against which the defendant would be judged—differed in the two actions.¹⁰² The collateral estoppel argument was therefore rejected.

III. THE REMEDY

The problems inherent in proving speculative damages have recently helped convince the Supreme Court, in *Blue Chip Stamps v. Manor Drug Stores*,¹⁰³ to deny a cause of action to a plaintiff.¹⁰⁴ In *Foster v. Financial Technology*,¹⁰⁵ the Ninth Circuit discussed similar proof problems, but nevertheless indicated that trial courts can entertain evidence of consequential damages.

The suit in *Foster* arose out of negotiations to settle a prior franchise dispute. In settlement of the dispute, plaintiffs agreed to

100. 513 F.2d at 998.

101. *Id.* The court found that only one finding of fact in the state court dealt with the sale of partnership units, and that that finding was not necessary to the state judgment. Only those issues which are necessary to a prior judgment will be given collateral estoppel effect in a later action. See 1B J. MOORE, *supra* note 96, ¶ 0.441[2], at 3777 & n.17.

102. 513 F.2d at 999.

103. 421 U.S. 723, 734-35 (1975), noted in 89 HARV. L. REV. 262 (1975).

104. This aspect of the *Blue Chip* case is discussed in Gallagher, *10b-5 After Blue Chip Stamps: How Stands the Judicial Oak?*, 60 DICK. L. REV. 1, 26-27 (1975).

Blue Chip is said to be "as much a landmark in securities litigation as *Birnbaum*," *id.* at 3, because it signals at least a partial return to the strict rule of *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), which restricts standing to sue under rule 10b-5 to those plaintiffs who actually have purchased or sold securities involved in the alleged fraud. Many judicially created exceptions to the *Birnbaum* rule still remain, however, and the rule itself has been severely criticized. See Lowenfels, *Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 168 (1968).

105. 517 F.2d 1068 (9th Cir. Apr., 1975) (per Chambers, J.).

forebear suing on the franchise claim for 75 days, and then to execute permanent releases of their claims. In return, defendant agreed to convey to the plaintiffs a certain number of shares of a third corporation to be acquired in the interim. The stock was not acquired, and the plaintiffs filed suit,¹⁰⁶ claiming that the defendant's conduct under the settlement agreement violated certain provisions of the securities laws.

The first of plaintiffs' two claims alleged a failure to register the stock (which was to be conveyed to the plaintiffs) as required by section 5 of the 1933 Act.¹⁰⁷ The damages recoverable for a violation of section 5's registration requirement are set out in section 12(1) of the 1933 Act,¹⁰⁸ and, in the court's words, amount to "recovery of any consideration paid."¹⁰⁹ The district court was of the opinion that the plaintiffs did not actually execute the permanent release of their franchise claims against defendant, and thus that they paid nothing.¹¹⁰ However, the *Foster* court held that the plaintiffs had undertaken two distinct promises in their agreement—they promised to forbear suing for 75 days, and they promised to execute a permanent release after the 75 days. Since the plaintiffs had fully performed their agreement to forbear, the court held that they could recover the "reasonable value" of that forbearance.¹¹¹ The *Foster* court did not explain how "reasonable value" could be calculated, but it did indicate that damages under section 12(1) would include compensation for

106. *Id.* at 1070-71. Plaintiffs and defendant Financial Technology, Inc. (FTI) executed an agreement in settlement of a prior franchise dispute in which plaintiff agreed to forbear suing under the prior franchise claim for 75 days. The agreement further provided that, after the 75 days, plaintiffs would execute a permanent release of their claim. In return, FTI would then deliver certain stock it was to acquire in the interim from a third party, Basic Resources, Inc. (BRI). Plaintiff did not sue for the 75 days, but meanwhile FTI had failed to acquire the stock from BRI and thus had nothing to transfer to plaintiffs on the closing date. Plaintiff then brought suit, alleging federal securities law violations by both FTI and BRI. The damages sought were the entire amount of the original franchise dispute. *Id.* at 1074. During the pendency of the suit, FTI entered Chapter XI bankruptcy. The district court granted summary judgment dismissing plaintiff's suit holding that, even if the securities violations were proven, plaintiffs were not entitled to any damages. *Id.* at 1075. The Ninth Circuit reversed the summary judgment and remanded. *Id.* at 1073.

107. Section 5 is codified at 15 U.S.C. § 77e (1970).

108. Section 12(1) is codified at *id.* § 77l(1). For a discussion of how section 12(1) operates see 3 L. Loss, *supra*, note 32, at 1692-94.

109. 517 F.2d at 1071, quoting 15 U.S.C. § 77l (1970).

110. 517 F.2d at 1071.

111. *Id.*

“assumption of the risk that the amount they could realize on their claims would diminish over [the 75 days].”¹¹²

The *Foster* court next considered damages under the other claim in the suit, which arose under section 10(b) and rule 10b-5. The court noted that plaintiffs may be able to obtain rule 10b-5 damages, or “out-of-pocket” damages. These are equal to the difference between the value of the consideration paid and the value received, and were thus considered to be the equivalent in amount of recovery under section 12(1).¹¹³ Although equivalent in amount, 10b-5 damages would constitute “further relief.”¹¹⁴ The court also suggested that the recovery of consequential damages might be appropriate in cases like *Foster*, and observed that this new area of damages has found support in recent cases in the Second and Seventh Circuits.¹¹⁵ One of the problems with considering consequential damages, which the court characterized as “opportunity lost” damages, is their speculative nature. Unfortunately, the court’s discussion of opportunity lost damages, which seem similar to “assumption of risk” damages under section 12(1), provides little guidance regarding a method of computing such damages. The *Foster* court did emphasize, however, that plaintiffs who seek to prove consequential damages bear a heavy burden. They must prove:

[F]irst, that defendants’ misrepresentations violated rule 10b-5; second, that but for these misrepresentations plaintiffs would have

112. *Id.* at 1072. In speaking of damages under section 12, the court also did not mention any residual value of the plaintiff’s franchise claim, although that amount should be subtracted from the amount of the consideration paid if it is considered “income” since the wording of section 12 states that a purchaser may recover the consideration paid “less the amount of any income received thereon.” 15 U.S.C. § 77l (1970).

The value of the original franchise claim was \$10,000, for each of two plaintiffs. The amount of the bankruptcy settlement (discussed at note 106 *supra*) was approximately \$1,000 each. The court’s discussion of section 10(b) out-of-pocket damages stated that the residual value of the franchise claim would be subtracted from such damages. It also stated that section 10(b) damages were equivalent to section 12 damages. This implies that the residual value should also be subtracted in calculating section 12 damages. The court further noted that the residual value of the claim may not be equal to the actual bankruptcy settlement. 517 F.2d at 1072. The residual value of the claim is determined at the time that plaintiffs first learned of the alleged fraud, or should have known of it, and is equal to the amount that would have been recovered if the suit had been pursued at that time.

113. 517 F.2d at 1071.

114. *Id.*

115. *Id.*, citing *Madigan, Inc. v. Goodman*, 498 F.2d 233, 238-40 (7th Cir. 1974); *Zeller v. Bogue Elec. Mfg. Co.*, 476 F.2d 795, 802-03 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).

brought suit on their claim against defendant at the earlier date; and third, that any losses plaintiffs incurred were a reasonably foreseeable consequence of these misrepresentations.¹¹⁶

It should also be added that from any consequential (opportunity lost) damages a plaintiff can prove should be subtracted "any portion of the amount [plaintiff] may recover under section 12(1)" that represents "assumption of the risk" damages.¹¹⁷

IV. THE STANDARD OF CARE

A. FLEXIBLE DUTY

Although section 10(b) and rule 10b-5 prohibit fraud in connection with the purchase or sale of any security, courts have found it difficult to articulate what state of mind the defendant must possess before liability can be found.¹¹⁸ Courts have fashioned a scienter standard, a negligence standard, and even a strict liability approach to the state of mind issue, but none has proved entirely satisfactory.¹¹⁹ In light of this fact, in 1974 the Ninth Circuit enunciated a new "flexible duty" standard with its decision in *White v. Abrams*.¹²⁰ In adopting the new standard the *White* court flatly stated that "we reject scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action."¹²¹ The flexible duty standard is intended to permit the normally complex facts of each separate 10b-5 case dictate what the standard of care should be under the circumstances.¹²² In other words, *White* is basically a call for "due care under the circumstances,"¹²³ and the court enumerated several factors which bear on the issue of what constitutes due care in a given case.¹²⁴ These factors, and the flexible duty standard itself, have

116. 527 F.2d at 1072.

117. *Id.*

118. See 2 A. BROMBERG, *supra* note 9, § 8.4(000), at 203.

119. Several articles discuss the various standards and the ways in which they have proved unsatisfactory. See, e.g., Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. REV. 1206 (1970).

120. 495 F.2d 724 (9th Cir. 1974), noted in 9 LOYOLA L.A.L. REV. 150 (1975).

121. 495 F.2d at 734.

122. See *id.* at 734-35. The *White* court referred to a "sliding scale" by which the standard of care will be allowed to vary in relation to a case's particular facts. *Id.* at 734.

123. See 9 LOYOLA L.A.L. REV. 150, 161 (1975).

124. See 495 F.2d at 735-36. The court stated:

[T]he [trial] court should, in instructing on a defendant's duty under rule 10b-5, require the jury to consider the relationship

been discussed and applied in several recent Ninth Circuit opinions.¹²⁵

It now appears that the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*¹²⁶ has deprived all of these decisions of the support they originally derived from *White*. Unlike *White*, which expressly rejected the need for scienter, the *Ernst* Court declared that "[t]here is no indication . . . that § 10(b) was intended to proscribe conduct not involving scienter."¹²⁷ *Ernst* involved an accounting firm, Ernst & Ernst, which had been retained by a small brokerage firm. The president of the brokerage firm had devised a scheme to defraud those who invested in the firm, and he kept knowledge of the scheme to himself. After the brokerage firm's bankruptcy and disclosure of the scheme, some of those who had invested in the firm sued Ernst & Ernst, alleging that the scheme would have been discovered at the outset if Ernst & Ernst's audits of the brokerage firm had not been negligently performed, that it therefore "aided and abetted" the scheme, and that it was thus liable under section 10(b) of the 1934 Act and under rule 10b-5.¹²⁸

Ernst & Ernst's motion for summary judgment was granted by the trial court on the ground that there were no genuine issues of material fact.¹²⁹ The trial court was apparently not of the opinion that liability under section 10(b) and rule 10b-5 required sci-

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 initiating the securities transaction in question.

Id. (footnotes omitted). The court stressed that this list of factors was illustrative rather than exclusive. *Id.*

125. See, e.g., *Robinson v. Cupples Container Co.*, 513 F.2d 1274 (9th Cir. Mar., 1975) (per Wright, J.); *Marx v. Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. Nov., 1974) (per Koelsch, J.).

Robinson approved a jury instruction which stated that the defendant in question could be found liable under section 10(b) if it had "negligently misrepresented or failed to declare" certain facts relating to a security transaction. 513 F.2d at 1278. This is no longer the law. *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976). The *Marx* court's discussion of the applicable standard of care has also been outdated by the decision in *Ernst*. See 507 F.2d at 490.

126. 96 S. Ct. 1375 (1976).

127. *Id.* at 1385.

128. *Id.* at 1378-80.

129. *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1104 (7th Cir. 1974).

enter.¹³⁰ The Court of Appeals for the Seventh Circuit determined that genuine issues of material fact did exist, and thus reversed the trial court's decision to grant a summary judgment,¹³¹ but it also discussed the scienter issue and concluded that defendants' actions must be judged by "a flexible standard of liability which should be amplified according to the peculiarities of each case."¹³² By disapproving this language, and by reversing the Seventh Circuit, the Supreme Court has left no doubt that the flexible duty standard is no longer the law.

V. THE SECURITY

A fundamental concept in securities regulation is the definition of a security. The Securities Act of 1933 defines the term security to mean, among other things, an "investment contract."¹³³ This definition is helpful, but still rather broad, and it has been refined further judicially. One accepted interpretation of the phrase "investment contract" states that it would include a scheme involving an investment of money in a common enterprise with profits to come to the investor solely from the efforts of others.¹³⁴ A common enterprise has been held to be one in which the fortunes of the investor are interwoven with and dependent upon the efforts and sources of those seeking the investment.¹³⁵ This definition was applied in *Safeway Portland Employees Federal Credit Union v. Wagner & Co., Inc.*,¹³⁶ which involved a broker's sale of a "package" consisting of bank certificates of deposit (CDs) together with a bonus addition to the normal CD interest.¹³⁷

130. 96 S. Ct. at 1380.

131. *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974).

132. *Id.* at 1104.

133. Securities Act of 1933 § 2, 15 U.S.C. § 77(b)1 (1970).

134. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946), cited in *Safeway Portland Employees Fed. Credit Union v. Wagner & Co.*, 501 F.2d 1120 (9th Cir. Aug., 1974).

135. *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

136. 501 F.2d 1120 (9th Cir. Aug., 1974) (per Beeks, D.J.).

137. *C. H. Wagner & Co. (Wagner)* was a securities broker that also acted as a money broker through a subsidiary. The typical situation involving a money broker arises when a borrower wishes to take a loan from a bank, but the bank is not willing to make the loan because it has insufficient deposits. The frustrated borrower may engage the services of a money broker, and for a premium the money broker finds depositors for the bank. If sufficient deposits are obtained, then the borrower may have greater success in securing a loan from the bank. Since the situation usually only arises when money is "tight," it is not easy for the broker to find an investor willing to de-

The credit union's suit was based on section 5(a) of the 1933 Act, which, in part, makes it unlawful to use the mails to sell an unregistered security.¹³⁸ The broker, Wagner, did not deny that the mails had been used or that the package was not registered, it simply argued that the CD package was not a security. Wagner also contended that the package, even if found to be a security, was exempt from registration by statute because it had been issued by a bank.¹³⁹ The court found, however, that the "package was not issued or guaranteed by a bank."¹⁴⁰ The court then looked at the character of the entire transaction and held that the package constituted an investment contract and was therefore subject to the normal securities registration requirements.¹⁴¹

In holding that the CD package met the definition of a security, the court considered several factors. The credit union (buyer) did no more than put in its money—no further effort was required on its part. The success of the investment, at least for the payment of the bonus, depended on the efforts and future financial stability of Wagner, the broker. The CD plus the bonus was also sold as an integrated whole which differed fundamentally from a bare CD. The economic inducement for the purchase was the combined rate of interest. Thus, the two parts to the package

posit funds in a bank, so that the broker may have to pay part of his premium to the investor to give the deposit a more attractive return. *See* 501 F.2d at 1122 n.2. As a money broker, Wagner sold a total of approximately 4 million dollars worth of certificates of deposit (CDs) of the Sharpstown State Bank of Houston, Texas. Two one-year CDs totalling \$250,000 were sold to SPEFCU. The CDs paid 7 1/2 percent interest at maturity, but as a further inducement for the purchase Wagner added from their commission an extra 5/8 percent in addition to the normal 7 1/2 percent return on the CD. Wagner's usual procedure was to pay the 5/8 percent bonus at the time of the purchase, but in this instance the 5/8 percent was to be paid at maturity.

Wagner alleged that it agreed to pay the additional 5/8 percent at the time of maturity of the CD, rather than at the time of purchase, at the request of SPEFCU. Wagner asserted that SPEFCU requested this method of payment in order to circumvent federal regulations applicable to credit unions. The district court opinion noted that Wagner merely alleged this, but does not cite the regulations SPEFCU was attempting to avoid. 335 F. Supp. at 117. Wagner's defense of unclean hands failed at the trial level, and on appeal it was only mentioned in a footnote. 501 F.2d at 1122 n.3. The Sharpstown State Bank subsequently failed, and SPEFCU sued Wagner for the full face amount of the CDs plus interest. Wagner was willing to pay the 5/8 percent bonus, but no more. *Id.* at 1123.

138. Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (1970).

139. The exemption provision relied upon by Wagner is codified at 25 U.S.C. § 77c(a) (1970).

140. 501 F.2d at 1124. The court did not explain how it arrived at its conclusion.

141. *Id.* at 1123.

were economically inseparable, and the whole package constituted a security.¹⁴²

Edward L. Knapp

142. These factors are discussed at *id.* A concurrence by Judge Sneed was careful to limit the decision to its facts, and expressed reluctance to extend it too far. The case may be a unique one, as the majority opinion pointed out, because money brokers are most active during periods of "tight money," so that the practice of adding a bonus from their commission may not be prevalent at other times.