Golden Gate University Law Review

Volume 7
Issue 1 *Ninth Circuit Survey*

Article 14

January 1976

Securities

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SECURITIES

INTRODUCTION

The majority of securities cases decided during this past term involved alleged violations of section 10 and 10(b) of the Securities Exchange Act of 1934.[1] The Ninth Circuit established new guidelines for the maintenance of class actions and for proof of reliance in such actions brought under rule 10b-5.[2] In addition, the circuit examined the requirements of a purchase or sale for an action brought under section 10(b)[3] and considered whether the New York Stock Exchange had violated its regulatory duties under section 6 of the Securities Exchange Act of 1934.[4]

I. OVERVIEW

A. LIABILITY UNDER SECTION 10(b) ABSENT A PURCHASE OR SALE

In *Ohashi v. Verit Industries*,[5] a Ninth Circuit panel addressed the question of whether liability can be imposed on defendants under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5, absent a purchase or sale.[6] In *Ohashi*, the plaintiff, a

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1. *See* United States v. Charnay, 537 F.2d 341 (9th Cir. May, 1976) (per Jameson, D. J.), *cert. denied*, 97 S. Ct. 528 (1976); Rochele v. Marine Midland Grace Trust Co., 535 F.2d 523 (9th Cir. May, 1976) (per Hufstedler, J.); Great W. Bank & Trust v. Kotz, 532 F.2d 1253 (9th Cir. Mar., 1976) (per curiam), *cert. denied*, 96 S. Ct. 1252 (1976); Hayden v. Walston & Co., 528 F.2d 901 (9th Cir. Dec., 1975) (per curiam); Klaus v. Hi-Shear Corp., 528 F.2d 225 (9th Cir. Dec., 1975) (per Choy, J.).

2. *See* Blackie v. Barrack, 524 F.2d 891 (9th Cir. Sept., 1975) (per Koelsch, J.), *cert. denied*, 45 U.S.L.W. 3249 (U.S. Oct. 4, 1976).

3. *See* Ohashi v. Verit Indus., 536 F.2d 849 (9th Cir. May, 1976) (per Hufstedler, J.), *cert. denied*, 97 S. Ct. 538 (1976).

4. *See* Hughes v. Dempsey-Tegeler & Co., 534 F.2d 156 (9th Cir. Mar., 1976) (per Renfrew, D.J.), *cert. denied*, 45 U.S.L.W. 3306 (U.S. Oct. 13, 1976).

5. 536 F.2d 849 (9th Cir. May, 1976) (per Hufstedler, J.), *cert. denied*, 97 S. Ct. 538 (1976).

6. For a recent Ninth Circuit decision discussing a related issue, namely whether a plaintiff suffered an injury in connection with a purchase or sale, see Rochelle v. Marine Midland Grace Trust Co., 533 F.2d 523 (9th Cir. May, 1976) (per Hufstedler, J.). In *Rochelle*, the court dismissed a rule 10b-5 claim because the plaintiff bankruptcy reorganization trustee who was suing on behalf of the corporation could not claim any damages in connection with the alleged fraudulent market debentures. The investors who purchased the debentures suffered the injury, not the corporation. The court con-

major stockholder of a corporation that was being acquired by the defendant corporation, exchanged his shares for shares of the defendant corporation pursuant to the acquisition agreement between the corporations. The defendant Verit Industries did not register the shares, which the plaintiff Ohashi had received, with the Securities and Exchange Commission because they were issued pursuant to the private offering exemption of section 4(2) of the Securities Exchange Act of 1933.[7] In order to comply with the private offering exemption, Verit Industries imposed transfer restrictions on the plaintiff's shares.[8] An integral part of the exchange agreement was an explicit understanding that Verit Industries would remove the restrictions when its counsel determined that a transfer by Ohashi would not violate federal securities regulations or "he had received a 'no action' letter from the SEC."[9] The plaintiff repeatedly inquired about the removal of the restrictions, but the defendant took no action, falsely assuring plaintiff of its intent to remove the restrictions. Due to the defendant's lack of cooperation, Ohashi was only able to sell his stock on a piecemeal basis until more than four years later when the restrictions were removed. Over the next year and a half, the plaintiff sold one-third of his stock for a price considerably lower than the market value prevailing at the time of the original transfer agreement.[10] Consequently, the plaintiff charged that defendant's misrepresentations as to its efforts to lift the restrictions were part of a conspiracy by the defendants to artificially raise the market price of the stock. It was further alleged that the defendant was effectuating this conspiracy by limiting the public availability of the securities by keeping the plaintiff's shares off the market.

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cluded that the fact that the full value received by the corporation for the debentures was later lost due to corporate mismanagement did not mean that a compensable loss under the federal securities laws had been suffered.

7. Section 4(2) of the Securities Exchange Act of 1933 is codified at 15 U.S.C. § 77d(2) (1970). It specifically exempts "transactions by an issuer not involving any public offering" from the registration requirements of the Act.

8. The legend placed on the stock certificates stated:

> No sale, offer to sell or transfer of the shares represented by this certificate shall be made unless a registration statement under the Federal Securities Act of 1933, as amended with respect to such shares is then in effect or an exemption from the registration requirements of such Act is then in fact applicable to such shares.

536 F.2d at 852.

9. *Id.*

10. At the time of the original transfer agreement, the defendant's common stock was selling at $14 per share, but at the time the plaintiff was able to sell his shares, the price had fallen to $1.50 per share.

The district court had held that the *Birnbaum* Rule[11] foreclosed the section 10(b) and rule 10b-5 claims.[12] Briefly stated, the *Birnbaum* Rule requires that the plaintiff must have been either a purchaser or seller of stock in order to recover damages under rule 10b-5.[13] The Ninth Circuit followed the Rule and held that it barred relief when the damages alleged are based on the diminished value of stock that occurs while plaintiff is unable to sell even if the inability to sell is caused by the defendant's deceptive conduct. The court reasoned that since the alleged deception ceased prior to plaintiff's sale of the shares to third persons, there was no fraud in connection with the purchase or sale of securities with respect to the transactions between plaintiff and third parties.

However, the court was able to construct a theory by which plaintiff could recover under section 10(b) and rule 10b-5. Although there was no fraud in connection with plaintiff's sale to third parties, Judge Hufstedler asserted that the district court's dismissal of the federal securities laws claims for failure to state a claim upon which relief could be granted was improper because there was fraud in connection with the existing executory contract between plaintiff and defendant. Although the fraud complained of occurred after the actual exchange as embodied in the original exchange agreement, a covenant of good faith and fair dealing, implied in every contract under California law,[16] can keep an otherwise completed exchange of stock executory. Thus, any fraudulent acts that affect the unperformed part of the bargain may satisfy the "in connection with purchase or sale" require-

11. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1951).

12. 536 F.2d at 851.

13. Not all commentators believe that the *Birnbaum* Rule should be mechanically applied in all rule 10b-5 cases. *See, e.g.*, Note, *Rule 10b-5: Elements of a Private Right of Action*, 43 N.Y.U.L. REV. 541, 550 n.56 (1968), wherein the author suggests that the *Birnbaum* Rule should be replaced with a "reasonably foreseeable" test in appropriate circumstances. When the injury plaintiff suffers is not in connection with a purchase or sale, but the circumstances tend to establish that defendant reasonably foresaw that his fraudulent conduct would injure the plaintiff or those similarly situated, then recovery seems appropriate. Utilization of this "reasonably foreseeable" test, the author notes, would alleviate the necessity of the present judicial trend of circumventing the *Birnbaum* Rule through broad construction of the terms "purchase," "sale" and "in connection with."

14. 536 F.2d at 852.

15. *Id.*

16. *See, e.g.*, Crail v. Blakely, 8 Cal. 3d 744, 749-50, 505 P.2d 1027, 1031, 106 Cal. Rptr. 187, 191 (1973); Berkeley Lawn Bowling Club v. City of Berkeley, 42 Cal. App. 3d 280, 286-87, 116 Cal. Rptr. 762, 766 (1st Dist. 1974).

ment of rule 10b-5. The court concluded that since the original exchange agreement was executory during the period of the alleged deceptive conduct, the complaint was sufficient to withstand the defendant's motion to dismiss.

District Judge Skopil entered a brief dissent. He believed that the express terms of the executory agreement had been fully performed when the alleged misconduct occurred. However, contrary to the majority's view, he found no implied duty sufficient to keep the contract executory and would have upheld the district court's dismissal.

B. Enforcement Duties Under the Securities Exchange Act

A Ninth Circuit panel, in *Hughes v. Dempsey-Tegeler & Co.*,[17] considered the scope of a stock exchange's obligation to enforce its rules when it becomes aware of a violation of the Securities Exchange Act of 1934 and the regulations promulgated thereunder. The Ninth Circuit, in an opinion written by District Judge Renfrew, held that the New York Stock Exchange's decision to lift previously imposed restrictions from Dempsey-Tegeler & Co., which was a brokerage firm found to be in violation of the exchange's net capital and accounting rules, constituted a breach of the exchange's registration duties as imposed by section 6 of the Securities Exchange Act of 1934.[18] However, the court concluded that plaintiff Hughes was barred by the doctrine of waiver from recovering for any losses that he might have suffered as a result of the exchange's breach of these duties.[19] The court further held that the defendant officer of Dempsey-Tegeler & Co. did not breach his duty of disclosure under rule 10b-5 and therefore was not liable for losses sustained when the securities subordinated by plaintiff Hughes in favor of defendant Dempsey-Tegeler & Co. were sold for the benefit of creditors upon liquidation of the firm.[20]

Factual Setting

Dempsey-Tegeler arose out of a complex factual setting. Defendant Dempsey-Tegeler & Co. was one of many brokerage

17. 534 F.2d 156 (9th Cir. Mar., 1976) (per Renfrew, D.J.), *aff'g* [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,133 (C.D. Cal. 1974).

18. Section 6 of the Securities Exchange Act of 1934 is codified at 15 U.S.C. § 78(f) (1970). The section details requirements for registration as a national securities exchange, circumstances which warrant denial of membership with an exchange, disciplinary sanctions and proceedings of an exchange, and permissible commissions, allowances, discounts and other fees of members of an exchange.

19. 534 F.2d at 174-75.

20. *Id.* at 177.

firms overcome by the substantial increase in trading volume that occurred in the late 1960s. Due to inadequate accounting systems, Dempsey-Tegeler & Co. and many other brokerage firms were unable to process transactions as they occurred. The decline in stock prices that resulted from this operational crisis compounded the problem. Capital reserve accounts decreased as the value of the securities declined and the decrease in trading volume, which accompanied the price decline, hampered the commission income of brokerage firms.

In 1968 a surprise audit of Dempsey-Tegeler & Co. indicated that the firm had a net capital deficiency of over one million dollars. The New York Stock Exchange imposed certain sanctions against the defendant's business and management in response to this capital deficiency and in response to other violations of the Exchange's record-keeping rules. A 1969 audit revealed that the sanctions were ineffective and the defendant firm's operational and financial condition was deteriorating. This led the Exchange to impose further restrictions on Dempsey-Tegeler & Co., but it still did not suspend the firm from the Exchange. In 1970, after communications between the Exchange, the Securities and Exchange Commission and Dempsey-Tegeler & Co., the Exchange lifted its restrictions in conjunction with an arrangement for an infusion of capital in the form of subordination agreements executed by plaintiff Hughes in favor of the defendant firm.

Shortly after the execution of the subordination agreements, the stock market experienced a severe decline. This decline in securities value had a devastating effect on Dempsey-Tegeler & Co. The firm was forced to sell the securities subordinated by Hughes as provided for in the subordination agreement, which resulted in a loss of more than one million dollars to Hughes.

The Regulatory Duties of the Exchange

Hughes brought an action against the New York Stock Exchange, alleging that it breached its duty under section 6 of the Securities Exchange Act of 1934 for failure to suspend the firm and for encouraging the activities that precipitated the subordination agreement. Initially, the court held that a private right of action against the Exchange did lie even though the Securities Exchange Act does not provide for such an express cause of action.[21] The existence of a private right of action against an ex-

21. *Id.* at 166. The court's position is consistent with two recent Supreme Court decisions. *See* Cort v. Ash, 422 U.S. 66 (1975); Securities Investor Protection Corp. v. Barbour, 421 U.S. 412 (1975).

change for violation of section 6 is supportable, the Ninth Circuit noted, by two well-established legal theories: (1) a tort theory, under which section 6(b) of the Securities Exchange Act supplies the duty element;[22] and (2) a third-party beneficiary theory, under which the rules governing an exchange are construed to be not only for the protection of customers of member firms, but also for the protection of investors who acquire interests in a member brokerage firm.[23]

The Ninth Circuit next considered the enforcement duties of the Exchange imposed by section 6 of the Securities Exchange Act of 1934. The court concluded that an exchange has an obligation to enforce provisions of the Act and the regulations promulgated pursuant to it.[24] This obligation, however, does not impose an inflexible duty; rather, "[f]lexibility in regulatory response is critical if the response is to be appropriate to the situation."[25] The Ninth Circuit concluded that the same policy considerations used by Justice Marshall in examining the actions of the Securities Investor Protection Corporation in *Securities Investor Protection Corp. v. Barbour*[26] should be used in examining the responses of the Exchange in its regulation of the securities market. Thus, the Ninth Circuit looked to (1) whether the Exchange took prompt action to investigate alleged violations; and (2) whether the Exchange took action "reasonably designed to restore compliance with the rules" if a violation did exist.[27] The court noted that all the circumstances of the particular case should be considered and, most importantly, courts should not substitute their retrospective judgment for the judgment of an exchange concerning the appropriate action.

In the instant case, the restrictions imposed by the Exchange were reasonably addressed to the origins of the problems confronting the brokerage firm. There was no breach of duty because the Exchange's response was not unreasonable. However, *Dempsey-Tegeler* concluded that the Exchange's subsequent decision to lift the previously imposed restrictions was not reasonable. The restrictions were imposed to cure two problems of Dempsey-Tegeler & Co.—a capital deficiency and an inadequate

22. *See* Baird v. Franklin, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944).
23. *See* Weinberg v. New York Stock Exch., 335 F. Supp. 139 (S.D.N.Y. 1971).
24. 534 F.2d at 169.
25. *Id.*
26. 421 U.S. 412, 421-23 (1975).
27. 534 F.2d at 170.

record-keeping system. While lifting the restrictions on account of an infusion of capital may be reasonably related to the capital deficiency, it was unreasonable inasmuch as it was not designed to cure the record-keeping problem. Thus the *Dempsey-Tegeler* court concluded that the Exchange invited an aggravation of the record-keeping problems by lifting the restrictions.[28] The restrictions were still necessary to alleviate the record-keeping problems; by lifting the restrictions, the Exchange breached its duty under section 6.[29]

Contrary to the district court's view, the Ninth Circuit found that the extent of plaintiff's information concerning the transaction was irrelevant to the question of whether the Exchange had breached its duty. However, the court stated that plaintiff's knowledge was relevant in determining whether the plaintiff should be permitted to recover. The court held that despite the Exchange's breach of its duty, the doctrine of waiver barred the plaintiff from recovering any losses he might have suffered as a result of the breach.[30]

In this context, the doctrine of waiver raises the issue of whether the plaintiff knowingly waived his right to recover for the Exchange's breach of duty.[31] In analyzing whether the plaintiff Hughes intentionally waived his right, the court focused on the plaintiff's knowledge that the Exchange had imposed restrictions on the operations of Dempsey-Tegeler & Co. for the benefit of the investing public, of which he was a part. The court construed the fact that Hughes knowingly conditioned his subordination agreement on a lifting of the restrictions as encouraging the Exchange to breach its duty. To buttress its holding, the court noted that Hughes was fully aware of the risks accompanying his decision to enter into the subordination agreement and that he was an experienced and sophisticated investor.

Rule 10b-5 Claims

In addition to his suit against the New York Stock Exchange, Hughes alleged that an officer of Dempsey-Tegeler & Co. misrep-

28. *Id.* at 174.

29. *Id.* Thus, "[t]he district court's holding to the contrary was 'clearly erroneous' within the meaning of Section 52(a) of the Federal Rules of Civil Procedure." *Id.*

30. 534 F.2d at 174-75.

31. *Id.* at 175. The doctrine of waiver should bar plaintiff's recovery only in cases where a waiver of rights is intended; thus, "the right in question must be found

resented material facts to him concerning the subordination agreement and, therefore, rule 10b-5 liability should be imposed. In response to this claim, the court analyzed the officer's duty of disclosure under the flexible duty standard established in *White v. Abrams*.[32] After considering the factors suggested in *White*,[33] the court held that the officer did not breach the duty of disclosure that he owed to Hughes and, therefore, no rule 10b-5 liability existed.[34] The fact that all representations made to Hughes were in the context of a fully detailed disclosure conference, and that the officer acted with good faith efforts to fully inform Hughes, influenced this conclusion.

The court's finding that complete disclosure had been made to Hughes also precluded his rule 10b-5 action against the Exchange. The Ninth Circuit reasoned that such a high degree of disclosure was inconsistent with the charge that the Exchange's regulation of Dempsey-Tegeler & Co. operated as a fraudulent "course of business" or "device, scheme, or artifice."[35]

Judge Sneed concurred in the result reached by the majority for different reasons. He concluded that the Exchange's lifting of the restrictions was within the standards established by the majority decision, that is, within the "permissible degree of discretion or flexibility in choosing a response."[36] He reasoned that changed circumstances (*i.e.*, the possibility of acquiring subordinated capital) made the Exchange's response proper.[37] However, Judge Sneed agreed that the plaintiff's "actual knowledge of all the material facts available to a reasonably prudent investor"[38] barred recovery.

Judge Trask dissented from the judgment. He agreed with the

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to be actually known before waiver becomes effective." *Id.*, *quoting* Royal Air Properties, Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1964).

32. 495 F.2d 724 (9th Cir. 1974).

33. According to the *Dempsey-Tegeler* court, a "synthesis must be made of a number of factors . . . some supporting the imposition of a heavy duty and some a light one." 534 F.2d at 176. These factors include "the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access . . . [and] the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions . . . ." White v. Abrams, 495 F.2d 724, 735-36 (9th Cir. 1974) (footnotes omitted).

34. 534 F.2d at 176.

35. *Id.* at 177.

36. *Id.* at 179.

37. *Id.* Judge Sneed did not respond to the back-office crisis created by record-keeping inadequacies that even the infusion of new capital could not remedy.

38. 534 F.2d at 197, *quoting* Hughes v. Dempsey-Tegeler & Co., [1973 Transfer Bin-

district court conclusion that lifting the previously imposed restrictions was a violation of the Exchange's duty. However, he did not agree that the doctrine of waiver barred plaintiff from relief. He stated that Hughes' business expertise should not overshadow his limited understanding of the implications of the hybrid financing transaction involved in this case. Judge Trask also concluded that the defendant firm did not present the full facts to Hughes. This conclusion, combined with Judge Trask's view that the doctrine of waiver should not be available in securities and antitrust suits,[39] led him to his ultimate determination that the Exchange's actions were a proximate cause of the recoverable loss sustained by Hughes.

II. THE RELIANCE REQUIREMENT IN RULE 10b-5 CLASS ACTIONS

A. INTRODUCTION

Congress enacted the Securities Exchange Act of 1934[1] in order to " 'insure the maintenance of fair and honest markets' in transactions conducted on the securities exchanges."[2] Consistent

der] FED. SEC. L. REP. (CCH) ¶ 94,133 (C.D. Cal. 1974).

39. Judge Trask devoted much of his opinion to a discussion of the doctrine of waiver. In his view, the public purpose underlying the securities laws in general and the policies behind the creation of a private right of action—to supplement self-regulation with a private guardian so that self-policing is effective—are not achieved if liability is sidestepped when an investor relies on the superior knowledge of an exchange. Judge Trask disagreed with what he considered to be the practical effect of the court's ruling on the doctrine of waiver. He did not agree that

> when an investor bargains out of self-interest with an Exchange charged with a statutory duty of protecting the investing public, he forfeits his right to rely upon the Exchange's expertise and judgment.

534 F.2d at 183.

1. 15 U.S.C. §§ 78a-78jj (1970).

2. United States v. Charnay, 537 F.2d 341, 347 (9th Cir. May, 1976) (per Jameson, D. J.), *citing* 15 U.S.C. § 78b (1970). In *Charnay*, the court confronted the question of whether an indictment charging a rule 10b-5 violation is fatally defective absent an allegation of a specific intent to defraud. In responding to the question, Judge Jameson engaged in an extensive discussion of the legislative and judicial history of section 10(b) and rule 10b-5. The court concluded that the charge that a market manipulation artificially depressed the market price of a security on a national security exchange is an indictable offense under rule 10b-5, so long as it charges "a knowing participation by all of the defendants," even though the indictment failed to allege a specific intent to defraud. 537 F.2d at 351-52. The precedential value of this holding depends on how expansively the recent Supreme Court's holding in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), is construed. If *Ernst* requires that a claim based on section 10(b) and rule 10b-5 must allege more than mere negligence, then the Ninth Circuit's holding in *Char-*

with this broad mandate to prohibit deceptive devices, the Securities and Exchange Commission adopted rule 10b-5[3] in 1942.[4] Rule 10b-5 proscribes various activities and applies to numerous parties involved in securities transactions. The judiciary has defined and clarified the parameters of rule 10b-5 on a case-by-case basis, and courts have interpreted Securities Exchange Act section 10(b)[5] and rule 10b-5 as providing an implied right of recovery in favor of injured individuals.[6] The creation of this civil remedy has spawned much litigation, permitting abundant opportunities for

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nay that knowing participation of the defendants is clearly actionable is correct. On the other hand, if *Ernst* requires "intentional or willful conduct designed to deceive or defraud investors," *id.* at 199, then the knowing participation criterion in *Charnay* does not satisfy the proper scienter standard for a rule 10b-5 violation. The fact that *Charnay* is a criminal case and *Ernst* is a civil case is of little consequence: "[P]recedents established in civil cases interpreting Rule 10b-5 are applicable in criminal prosecutions . . . ." 537 F.2d at 348.

3. 17 C.F.R. § 240.10b-5 (1975). The rule provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [*sic*] commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (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.

4. The rule was published by the Securities Exchange Act Release No. 3230 (May 21, 1942). The authority of the Securities and Exchange Commission to promulgate rules pursuant to the Securities Exchange Act of 1934 may be found in 15 U.S.C. § 78w (1970).

5. Section 10(b) of the Securities Exchange Act of 1934 is codified at 15 U.S.C. § 78j (1970). The section 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—
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commissioner may prescribe as necessary or appropriate in the public interest or for the protection of investors.

6. *See, e.g.*, Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). For a discussion of the private right of action see Klein, *The Extension of a Private Remedy to Defrauded Securities Investors Under SEC Rule 10b-5*, 20 U. MIAMI L. REV. 81 (1965); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627 (1963).

judicial interpretation of rule 10b-5. In order to effectuate the legislative intent behind the Securities Exchange Act, the courts today generally view rule 10b-5 as a catch-all provision which proscribes all manipulative and deceptive devices in connection with the purchase or sale of securities.[7]

Claims premised on rule 10b-5 no longer parallel the common law tort of deceit. Nevertheless, the principles of the common law tort continue to permeate various facets of the statutory right.[8] At common law, a plaintiff was required to allege and prove the following elements in order to state a cause of action for deceit: (1) a false representation of fact by the defendant; (2) knowledge or belief by the defendant that the representation is false; (3) an intention to induce the plaintiff to rely on the misrepresentation; (4) the plaintiff's justifiable reliance on the misrepresentation; and (5) damage suffered by the plaintiff due to such reliance.[9] The substantive elements necessary to establish a prima facie rule 10b-5 case are quite similar and include: (1) a material misrepresentation, an omission of a material fact or a scheme to defraud; (2) a loss suffered by a buyer or seller as a result thereof; and (3) scienter on the part of the defendant.[10]

B. *Blackie v. Barrack*

The most significant securities issue confronted by the Ninth Circuit during the past term involved rule 10b-5 liability in impersonal open market transactions.[11] *Blackie v. Barrack*[12] presented the court with a fact situation wherein the plaintiffs had purchased Ampex Corporation securities during a twenty-seven month period between the release of the corporation's 1970 and 1972 annual reports. The plaintiffs filed a class action suit against the corporation, its principal officers during the period and the company's independent auditor. They alleged that the financial reports issued by Ampex Corporation failed to either establish

7. United States v. Charnay, 537 F.2d 341, 351 (9th Cir. May, 1976), *quoting* Securities & Exch. Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833, 859 (2d Cir. 1968).

8. Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 584-85 (1975) [hereinafter cited as *Reliance Requirement* Note]. For an extensive analysis of rule 10b-5 liability based on the common law tort theory see Ruder, *supra* note 6, at 631-35.

9. W. PROSSER, LAW OF TORTS § 105, at 685-86 (4th ed. 1971).

10. *See* 2 A. BROMBERG, SECURITIES LAW: FRAUD: SEC RULE 10b-5 §§ 8.1-8.9 (1975).

11. The court's opinion did not discuss rule 10b-5 liability in situations involving face-to-face securities transactions.

12. 524 F.2d 891 (9th Cir. Sept., 1975) (per Koelsch, J.), *cert. denied*, 45 U.S.L.W. 3249 (U.S. Oct. 5, 1976), *noted in* 29 VAND. L. REV. 287 (1976).

adequate reserves for possible losses or recognize and account for inventory obsolescence on a timely basis. The gravamen of the complaint was the defendants' inaccurate reporting procedures—regardless of how the inaccuracies were classified, the plaintiffs claimed that they artificially inflated the market price of Ampex securities[13] and, in so doing, resulted in an economic loss to investors who had bought the securities at the inflated price.[14]

Plaintiffs moved for class certification, and, after extensive briefing and argument, the district judge certified the suit as a class action.[15] The district judge also denied a motion for reconsideration of the class certification,[16] but permitted several of the defendants to seek an interlocutory appeal from the class certification order.[17] Other defendants took a direct appeal from the order under 28 U.S.C. section 1291.[18] The Ninth Circuit refused to hear the direct appeal of the order because it was not a final decision under section 1291.[19] Nevertheless, the court did consider the merits of the certification order as to those defendants who had taken an interlocutory appeal pursuant to 28 U.S.C. section 1292(b).[20]

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13. Quoting from the plaintiffs' complaint, *Blackie* listed the reasons the price of the stock was alleged to be artificially inflated:

> [T]he annual reports of Ampex for fiscal years 1970 and 1971, various interim reports, press releases and other documents (a) overstated earnings, (b) overstated the value of inventories and other assets, (c) buried expense items and other costs incurred for research and development in inventory, (d) misrepresented the companies' current ratio, (e) failed to establish adequate reserves for receivables, (f) failed to write off certain assets, (g) failed to account for the proposed discontinuation of certain product lines, (h) misrepresented Ampex's prospects for future earnings.

524 F.2d at 902.

14. The magnitude of the aggregate economic loss involved is reflected by the disparity between the 1970 Ampex annual report, which reported a profit of $12,000,000, and the 1972 Ampex annual report, which stated that Ampex had suffered losses of $90,000,000. *Id.* at 894.

15. The class was conditionally certified to encompass all purchasers of Ampex securities during the twenty-seven month class period. Conjunctively, the purchasers were involved in about 120,000 transactions involving about 21,000,000 shares. *Id.* at 901.

16. *Id.* at 894.

17. *Id.*

18. 28 U.S.C. § 1291 (1970) grants courts of appeals jurisdiction of appeals from final decisions of the district courts.

19. For a detailed discussion of the court's denial of the direct appeal of the class certification order by the defendants see the Federal Practice & Procedure section of the Survey, *supra* at p. 258 *et seq.*

20. 28 U.S.C. § 1292(b) (1970) provides:

The question presented upon appeal was whether the class was certified in compliance with the requirements of Federal Rule of Civil Procedure (Fed. R. Civ. P.) 23(a) and 23(b)(3).[21] The *Blackie* court answered in the affirmative, holding that: (1) common questions of law and fact united the class;[22] (2) common questions predominated over individual questions of reliance, because direct proof of individual subjective reliance is not required;[23] and (3) potential conflicts among class members concerning the amount of damages did not defeat class action certification.[24]

Common Questions of Law or Fact

In reaching the conclusion that common questions of law or fact united the class, *Blackie* was required to find that the class was

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> When a district judge, in making in a civil action an order not otherwise appealable under this section, shall be of the opinion that such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation, he shall so state in writing in such order. The Court of Appeals may thereupon, in its discretion, permit an appeal to be taken from such order, if application is made to it within ten days after the entry of the order: *Provided, however,* That application for an appeal hereunder shall not stay proceedings in the district court unless the district judge or the Court of Appeals or a judge thereof shall so order.

21. FED R. CIV. P. 23(a) provides:

> One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

FED. R. CIV. P. 23(b)(3) provides:

> An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:
>
> . . . .
>
> (3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy . . . .

22. 524 F.2d at 902.

23. *Id.* at 905.

24. *Id.* at 905, 908. With respect to the issue of damages, the court summarily disposed of the claim, concluding that individual questions concerning the amount of damage do not defeat class status. *Id.* at 905, *citing In re* U.S. Financial Sec. Litigation, 64 F.R.D. 443, 451-52 (S.D. Cal. 1974).

united more by a "mutual interest in the settlement of common questions than it [was] divided by the individual members' interest in the matters peculiar to them."[25] First, the court noted that the class members shared a common interest in establishing the defendants' liability even though the alleged misrepresentations relied on by the different plaintiffs were contained in a number of documents. The Ninth Circuit found that the plaintiffs' common interests could not be defeated by the slight differences in the class members' positions.[26] The court took care to stress the common effect of the "interrelated, interdependent, and cumulative . . ."[27] misrepresentations of the defendants involved in *Blackie*.[28]

The *Blackie* court also found that simply because each class member may need to depend on proof of a different set of accounting facts, in order to establish the inadequacy of the reserves as reported in the annual reports and other documents, class certification is not necessarily improper. The court stated that the class was properly certified because the purchasers were united by a common interest in the application of the pertinent accounting principles.[29] Thus, although there may have been diverse accounting facts upon which each class member must have relied,

25. *See* 3B MOORE'S FEDERAL PRACTICE ¶ 23.45[2], at 23-751 (2d ed. 1976).

26. *See* 524 F.2d at 902.

27. *Id.* at 903, *quoting* Fischer v. Katz, 41 F.R.D. 377, 381 (S.D.N.Y. 1966).

28. The fact that the misrepresentations were written rather than oral is a significant factor in favor of finding common questions of fact which unite the class. *See* 6 L. Loss, SECURITIES REGULATION 3947 (2d ed. Supp. 1969). According to Loss, when a rule 10b-5 claim is based upon oral misrepresentations, common questions of fact may not exist because the misrepresentations vary as to each class member. *See, e.g.*, Gatzke v. Owen, 334 SEC. REG. & L. REP. (BNA) A-20 (N.D. Miss. Dec. 17, 1975). However, if the oral statements are only the means by which written misrepresentations are conveyed to the plaintiff, one court has held that since the source of the misrepresentations is common to all members, a class action is appropriate even though the members may have learned about them in a variety of ways. Sharp v. Coopers & Lybrand, 342 SEC. REG. & L. REP. (BNA) A-22 (E.D. Pa. Feb. 19, 1976). Crasto v. Estate of Kaskel, 63 F.R.D. 18 (S.D.N.Y. 1974), involved both oral and written misrepresentations, which were disseminated in a number of ways at varying times over a three and one-half year period. Contrary to the approach taken by the Ninth Circuit in *Blackie*, the court in *Crasto* looked to the means of dissemination, rather than its overall effect. The court held that when the misrepresentations made by defendants vary materially among the class members, then the issue of misrepresentation is not a common question, but constitutes a series of individual questions. *Id.* at 22. The conflicting results reached in these cases seem to indicate that the courts utilize a "means" or "effect" analysis in resolving class certification questions, depending on whether the circumstances warrant circumventing or satisfying FED. R. CIV. P. 23(a) common question requirement.

29. 524 F.2d at 904. In a footnote, the court distinguished between accounting principles which are common standards of law and accounting estimates which are dependent upon a distinct factual analysis. *Id.* at 904 n.20.

depending upon the time of purchase, the accounting principle was a question of law common to all members. This satisfied Fed. R. Civ. P. 23(a), which requires either a common question of law *or* fact.[30]

The defendants argued that the application of the "flexible duty standard"[31] would defeat a proper class certification because the standard requires an individual balancing of a number of factual considerations[32] in order to determine the appropriate duty that should be imposed on each defendant. Under this standard, each defendant's duty varies depending on his or her relationship to the corporation. The *Blackie* court rejected the defendants' argument, noting that once each defendant's duty is established, it "will be owed identically to all market purchasers, who are for practical purposes identically situated."[33] Therefore, *Blackie* concluded that the necessity of applying the flexible duty standard to each defendant does not defeat class certification.[34] To support its conclusion, the court reasoned that potentially disparate circumstances among the defendants did not render the common interest of the plaintiff class unsuitable for class treatment. The determinative factor in the court's analysis was the fact that the securities market responds to various misrepresentations in a manner which affects each purchaser identically.

Predominance of Common Questions of Law or Fact

After finding that common questions existed, the court addressed the issue of whether the common questions of law or fact predominated over individual issues, as required by Fed. R. Civ. P. 23(b)(3). The Ninth Circuit found that individual questions of reliance would not be an impediment to class certification, since subjective reliance is not a distinct element of proof in rule 10b-5

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30. *Id.* For the text of FED. R. CIV. P. 23(a) see note 21 *supra*.

31. For a discussion of the "flexible duty standard" see Forseter, *Rule 10b-5 Violations in the Ninth Circuit: I Know It When I See It*, 30 BUS. LAW. 773 (1975).

32. Factors that should be considered include, but are not limited to,

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

White v. Abrams, 495 F.2d 724, 735-36 (9th Cir. 1974) (footnotes omitted).

33. 524 F.2d at 905.

34. *Id.*

claims of the type involved in *Blackie*. The court's holding on this issue is particularly significant because it determines the feasibility of a class action in the open market securities fraud situation when the plaintiff's claims are based on a defendant's misrepresentations. The importance of the issue is highlighted by the court's own statement:

> We think it is for the predominance and other requirements of Rule 23(b)(3), rather than the common question requirement, to function to keep the balance between the economies attained and lost by allowing a class action.[35]

The language of rule 10b-5 explicitly requires only that the defendant be guilty of misconduct in connection with a purchase or sale of securities. However, courts have uniformly imposed on a plaintiff the requirements of proving causation and loss because rule 10b-5 claims are compensatory in nature.[36] First, the defendant's conduct must have been the cause of the plaintiff's entering into the transaction (transactional causation), and second, the defendant's conduct must have been the cause of a loss suffered by plaintiff in the transaction (loss causation).[37] Thus, in order to withstand a defendant's demurrer, the plaintiff must adequately allege both transactional and loss causation.

C. The Reliance Requirement

The element of reliance serves the function of proving transactional causation.[38] However, requiring proof of individual subjective reliance in order to establish transactional causation may prevent plaintiffs from proceeding as a class because these individual questions are likely to predominate over the common questions uniting the class. The Supreme Court has recognized the problem, and, in *Affiliated Ute Citizens v. United States*,[39] it ac-

35. *Id.* at 903 n.19.

36. The compensatory nature of rule 10b-5 mandates that the measure of recovery rests on the magnitude of the injury, not on the degree of fault. Without the requirement of causation, rule 10b-5 would be a strict liability provision. No court has gone to this extreme; yet without the requirement of a loss, there would be no need for a private right of action.

37. 524 F.2d at 906. *See* 2 A. Bromberg, *supra* note 10, § 8.7[1], at 215-16.

38. *See* Tucker v. Arthur Andersen & Co., 67 F.R.D. 468 (S.D.N.Y. 1975), which states that the purpose of reliance is "to restrict the potentially limitless thrust of Rule 10b-5 to [those] situations in which there exists a causation in fact between the act and injury." *Id.* at 478, *quoting* Titan Group v. Faggen, 513 F.2d 234, 238-39 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975).

39. 406 U.S. 128 (1972).

knowledged that it is not theoretically sound to require proof of reliance in all rule 10b-5 claims. In *Affiliated Ute*, the Supreme Court held that causation would be sufficiently established, even absent proof of reliance, if the plaintiff proved that the defendant withheld a material fact that he or she had an obligation to disclose.[40] The case involved two employees of a bank who developed a resale market for specific securities. The employees purchased securities from the sellers, but failed to disclose to the sellers either the existence of the secondary market they had created or the prevailing price on that market. The Court summarized its holding as follows:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.[41]

This holding by the Supreme Court has, in effect, resolved all doubts concerning the applicability of the indirect reliance doctrine in rule 10b-5 omission cases.[42] Under the indirect reliance doctrine, once the omission is shown to be material, reliance is presumed. The conceptual rationale underlying the elimination of plaintiffs' burden of pleading and proving direct reliance in nondisclosure cases is based on the fact that the requirement imposes an insurmountable task of proving that the investor would not have acted had the true facts been known.[43] This onerous burden of proof leads to the conclusion that "reliance is virtually impossible to prove in cases involving pure omissions."[44] The *Affiliated Ute* Court did not discuss the difficulties involved in proving reliance in nondisclosure cases. Instead, the Court based its holding on the policy considerations underlying the Securities Exchange Act of 1934: (1) "to substitute a philosophy of full disclosure for the philosophy of caveat emptor;"[45] and (2) to avoid securities frauds by liberally construing securities legislation "to effectuate

40. *Id.* at 153-54.

41. *Id.*

42. *See* 5 A. JACOBS, THE IMPACT OF RULE 10b-5 § 64.01[b], at 3-184 (1st ed. 1974).

43. *See Reliance Requirement* Note, *supra* note 8, at 590.

44. Note, *The Nature and Scope of the Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 24 CASE W. RES. L. REV. 363, 379 (1973).

45. 406 U.S. at 151, *quoting* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

its remedial purposes."[46] In order to carry out these policy considerations, the Court created an alternative means of proving transactional causation.

The Ninth Circuit and the Reliance Requirement

The Ninth Circuit panel in *Blackie* held that in the open market stock exchange context, causation can be established by proof of purchase and by proof of the materiality of the misrepresentations without direct proof of reliance.[47] The impact of this holding is best understood in the light of the court's own analysis which discusses the case from the alternative perspectives of a nondisclosure case and a misrepresentation case.

The *Blackie* court noted that the plaintiffs' claims could be "cast in omission or non-disclosure terms . . . ,"[48] since the defendants "failed to disclose . . . facts necessary to make the reported figures not misleading."[49] By construing the allegations in terms of an omission, the court attempted to bring the defendants' misconduct within the parameters of the *Afiliated Ute* rule.[50] Under this approach, the only distinction between *Affiliated Ute* and *Blackie*, aside from the fact that the former was a pure omission case and the latter was an omission and misrepresentation case, is that in *Affiliated Ute*, the defendants' omissions occurred in a face-to-face transaction, whereas in *Blackie* the conduct construed as omissions occurred in an impersonal open market context. The significance of this distinction is minimal, however, because the practical difficulties involved in proving that an investor would not have acted are equally onerous in both situations. If direct proof of subjective reliance were relied in both situations, the plaintiffs would have to prove that had they known of the omitted facts, they would not have acted.

Alternatively, *Blackie* indicated that the defendants' actions could be characterized as deceptive misrepresentations and that proof of subjective reliance was unnecessary to establish a rule 10b-5 claim where such misrepresentations inflated the price of stock traded in the open market.[51] The Ninth Circuit indicated

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46. 406 U.S. at 151, *quoting* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963).

47. 524 F.2d at 906.

48. *Id.* at 905.

49. *Id.*

50. See text accompanying notes 39-46 *supra* for a discussion of *Affiliated Ute*.

51. *Blackie* eliminated any requirement of direct reliance due to the "unreason-

that causation could adequately be established in rule 10b-5 actions in impersonal, open market situations solely by proving that stock was purchased and that the misrepresentations involved were material.[52] The court reasoned that the materiality requirement indirectly establishes the reliance of some stock purchasers and the subsequent inflation in the market price of the stock. *Blackie* concluded that once a purchase of that stock is made, the causal link between the defendant's conduct and the plaintiff's loss is sufficiently established to fulfill the requirements of a prima facie case.[53] Thus, the burden of proof shifts to the defendant to disprove the prima facie inference of causation.[54]

The defendant has an opportunity to defeat the claims of those plaintiffs whose losses were not in fact caused by the misrepresentation. Once the misrepresentation is shown to be material and a prima facie case of causation is established, the defendant may disprove the prima facie case. The *Blackie* court indicated that the

> [d]efendants may do so in at least 2 ways: 1) by disproving materiality, or by proving that,

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able and irrelevant evidentiary burden" such a requirement would impose on the plaintiffs. 524 F.2d at 907. Rule 10b-5 was designed to foster the expectation that securities transactions are free from fraud. Requiring direct proof from each purchaser that he or she relied on a particular misrepresentation would defeat the recovery of those whose reliance was indirect, "despite the fact that the causational chain is broken only if the purchaser would have purchased the stock even if he had known of the misrepresentation." *Id.* In effect, *Blackie*'s rejection of the direct reliance requirement is a protection of the expectations of the reasonable investor who relies on the fact that the market price of stock is validly set without the influences of fraud or manipulation.

52. "The basic test of 'materiality,' . . . is whether 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question.' " List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965). However, note that the test of materiality has also been formulated as whether a reasonable investor might attach importance, rather than whether he or she would have attached importance to the facts misrepresented. *Reliance Requirement* Note, *supra* note 8, at 602 n.84.

53. Note that the court's analysis here is confined to proof of transactional causation. It does not encompass loss causation, which still must be proved directly with a showing of economic damage. The Ninth Circuit's adoption of the indirect reliance doctrine is consistent with Professor Bromberg's observation that causation is satisfied when the plaintiff's investment decision is affected by the market change initiated by the defendant's misconduct even though the plaintiff was unaware of the misconduct itself. 2 A. BROMBERG, *supra* note 10, § 8.6[2], at 212. Another commentator has stated that in artificially manipulated or deflated market price situations, "recovery seems proper even in the absence of reliance." Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1370 (1965). *See also* Comment, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 672 (1965).

54. 524 F.2d at 906.

> despite materiality, an insufficient number of traders relied to inflate the price; and 2) by proving that an individual plaintiff purchased despite knowledge of the falsity of a representation, or that he would have, had he known of it.[55]

The rationale motivating this shift in the burden of proof to the defendant is similar to the rationale underlying the Supreme Court's holding in *Affiliated Ute*. Large investors who have been defrauded in open market transactions will normally initiate rule 10b-5 suits since the litigation costs of such a suit will normally not exceed the amounts recovered in damages.[56] Consequently, rule 10b-5 suits involving large-claim investors will not be easily blocked by a direct proof of reliance requirement, even though they would benefit from its elimination. However, maintaining a proof of direct reliance requirement in open market transactions, involving defrauded small-claim investors, would make it difficult for them to recover damages in rule 10b-5 suits. Ordinarily, the high cost of litigation will preclude the practical feasibility of pursuing an individual small claim.[57] Elimination of the direct reliance requirement makes it possible for small-claim investors to be certified as a class under rule 23(b)(3). Thus, class certification in this area of the law makes it possible for small-claim investors to obtain redress of their legal rights where no such redress would normally be available.[58]

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55. *Id.*

56. In Little v. First Cal. Co., 532 F.2d 1302 (9th Cir. Mar., 1976) (per Sneed, J.), the Ninth Circuit indicated that requiring individual proof of reliance by plaintiffs whose claims are not large enough to support the costs of such proof would prevent these plaintiffs from being compensated for their open market losses. *Id.* at 1304 n.4. Thus, the court implicitly recognized that large-claim plaintiffs could afford to bear the costs of such proof.

57. *See* Escott v. Barchris Constr. Corp., 340 F.2d 731 (2d Cir.), *cert. denied*, 382 U.S. 816 (1965). The *Escott* court stated:

> In our complex modern economic system where a single harmful act may result in damages to a great many people there is a particular need for the representative action as a device for vindicating claims which, taken individually, are too small to justify legal action but which are of significant size if taken as a group . . . . The usefulness of the representative action . . . is "persuasive of the necessity of a liberal construction of . . . Rule 23."

340 F.2d at 733 (citations omitted).

58. The Second Circuit has also dispensed with any requirement of proof of reliance as a prerequisite to recovery in securities cases. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Herbst v. International Tel. & Tel., 495 F.2d 1308 (2d Cir. 1974); Chris-Craft Indus. Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). In *Chris-Craft*, the Second Circuit ex-

D. CONCLUSION

The Ninth Circuit decision in *Blackie* implicitly recognized that the distinction commonly drawn in rule 10b-5 cases between nondisclosures and misrepresentations is often meaningless. Consequently, it is inferable that the distinction is an unsound criterion upon which to base the method by which a plaintiff must

tended *Affiliated Ute* to a deception affecting market conditions. The plaintiffs in *Chris-Craft* had claimed that the defendant had withheld material information in tender offers made to shareholders in a corporation which the plaintiff and the defendant sought to control. The Second Circuit, reasoning that it would be difficult for the plaintiff to prove that numerous shareholders with varying degrees of knowledge and expertise had relied on the defendant's misrepresentations, found that a presumption of reliance could be established "where it is logical to presume that reliance in fact existed." 480 F.2d at 375. Similarly, *Shapiro* explicitly indicated that the *Affiliated Ute* rule, which arose in a face-to-face securities transaction, could be extended to transactions carried out in national securities exchanges. 495 F.2d at 240. The *Shapiro* court stated the *Affiliated Ute* rule was not dependent upon the character of the securities transaction, but simply "upon whether the defendant [was] obligated to disclose the inside information." *Id. Contra*, Titan Group, Inc. v. Faggen, 513 F.2d 234 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975) (direct proof of reliance is required in rule 10b-5 cases involving face-to-face misrepresentations and material nondisclosures); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975) (in a misrepresentation case, the plaintiff must demonstrate that he relied on misrepresentations in question when he entered into the transaction which caused him harm). Only the Ninth and the Second Circuits have contributed significantly to the development of the indirect proof of reliance doctrine. Other courts are still uncertain as to whether proof of individual reliance is required in rule 10b-5 suits. *See* B & B Inv. Club v. Kleinert's, Inc., 62 F.R.D. 140, 144 (E.D. Pa. 1974).

Some federal district courts have allowed plaintiffs to maintain rule 10b-5 class actions without requiring proof of individual reliance. *See, e.g.*, Tucker v. Arthur Andersen & Co., 67 F.R.D. 468 (S.D.N.Y. 1975) (presumption of reliance is raised in rule 10b-5 action involving an open market transaction by a showing of materiality); Werfel v. Kramarsky, 61 F.R.D. 674 (S.D.N.Y. 1974) (proof of actual reliance is not necessary in a rule 10b-5 action involving misrepresentations; plaintiffs need only show that the defendant's action caused price of stock to be artificially inflated, thereby inducing a purchase). Other district courts have continued to impose the reliance requirement. *See* REA Express, Inc. v. Interway Corp., 410 F. Supp. 192 (S.D.N.Y.), *rev'd on other grounds*, 538 F.2d 953 (2d Cir. 1976) (proof of actual reliance is required to recover on a rule 10b-5 claim involving misrepresentations); Lorber v. Beebe, 407 F. Supp. 279 (S.D.N.Y. 1976) (presumption of reliance is appropriate only in rule 10b-5 nondisclosure cases and not in misrepresentation cases); Friedlander v. City of New York, [Current] FED. SEC. L. REP. (CCH) ¶ 95,624 (S.D.N.Y. June 21, 1976) (presumption of reliance is inappropriate in rule 10b-5 class action cases involving misrepresentations not contained in a common document); Mascolo v. Merrill Lynch, Pierce, Fenner & Smith, [Current] FED. SEC. L. REP. (CCH) ¶ 95,470 (S.D.N.Y. March 17, 1976) (presumption of reliance is limited to nondisclosure cases or deception cases affecting the integrity of the market, but is inappropriate in misrepresentation cases).

Much confusion exists over the question of whether the elimination of the direct reliance requirement is appropriate solely in rule 10b-5 class actions or should be applied to *all* private actions brought under the rule. *Compare* Davis v. Avco Corp., 371 F. Supp. 782, 792 (N.D. Ohio 1974) (no proof of individual reliance required in any action brought under rule 10b-5), *with* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 374 (2d Cir. 1973), *cert. denied*, 414 U.S. 910 (1973) (indicating that indirect

prove transactional causation.[59] All misrepresentations are, to some extent, nondisclosures because there is a failure to disclose which facts in the representation are not true. Allowing plaintiffs to forego positive proof of reliance only in *Affiliated Ute*-type situations (involving a failure to disclose) makes the plaintiff's ultimate chances of recovery dependent on judicial characterization of actions by a defendant which never admit of precise definition. The *Blackie* court recognized the fact that requiring proof of actual subjective reliance in rule 10b-5 actions involving large-claim plaintiffs would thwart the congressional interest in providing a means by which investors may recover for stock market manipulations in the federal courts. Consequently, the court extended the rationale of *Affiliated Ute* to situations involving misrepresentations made in the open market, where such misrepresentations have artificially inflated the price of stock.[60]

Blackie's shift of the burden of disproving a prima facie case of causation to the defendant will make it difficult for defendants to avoid rule 10b-5 liability.[61] A defendant's best hope for avoiding

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proof of reliance is "particularly appropriate" in class actions). In light of the fact that the Supreme Court's recognition of the indirect reliance in *Affiliated Ute* did not arise in a class action case, there seems to be little justification for the elimination of proof of direct reliance only in class action suits. Further support for this view may be found in the Rules Enabling Act, 28 U.S.C. § 2072 (1970) (giving the Supreme Court authority to promulgate rules of practice and procedure in the federal courts), which provides in pertinent part that rules promulgated under the Act "shall not abridge, enlarge or modify any substantive right . . . ." Thus, it can be persuasively argued that any substantive rules adopted by the courts in rule 10b-5 suits must be equally applicable to all types of litigation.

It should be noted that pre-*Affiliated Ute* cases involving rule 10b-5 class actions found that plaintiffs' class could be certified notwithstanding individual questions of reliance. *See* Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968). The *Wolf* court noted that when individual questions of reliance were involved in a class action, the trial court could order separate trials on that particular issue, as is often done on the question of damages. *Id.* at 301.

59. *See* Little v. First Cal. Co., 532 F.2d 1302, 1304 n.4 (9th Cir. Mar., 1976) (observing that the categories of "omission" and "misrepresentation" are not mutually exclusive).

60. Ninth Circuit decisions subsequent to *Blackie* have been inconsistent in their statement of the precise holding of the decision. *Compare* Little v. First Cal. Co., 532 F.2d 496 (9th Cir. Aug., 1976) (per Sneed, J.), wherein the Ninth Circuit refused to Cir. Mar., 1976) (per Voorhees, D.J.) (apparently limiting *Blackie* to rule 10b-5 cases involving nondisclosures), *with* Cameron v. E.M. Adams & Co., No. 74-2911, slip op. at 5-7 (9th Cir. Dec. 8, 1976) (per Choy, J.) (noting that *Blackie* was applicable to rule 10b-5 cases involving misrepresentations or nondisclosures). *See also* Harmsen v. Smith, 542 F.2d 496 (9th Cir. Aug., 1976) (per Sneed, J.), wherein the Ninth Circuit refused to eliminate the necessity of showing reliance in actions brought under section 93 of the National Banking Act, 12 U.S.C. § 93 (1970).

61. *See* Little v. First Cal. Co., 532 F.2d 1302 (9th Cir. Mar., 1976), where the court stated:

liability is to disprove the materiality of its representations, since the other alternative means of disproving causation appear to present impossible burdens of proof.[62] However, in light of the Supreme Court's recent holding in Ernst & Ernst v. Hochfelder[63] that defendant's liability for damages under rule 10b-5 requires a form of "scienter," defendants will have to meet the burden of disproving the prima facie case only when they have engaged in intentional misconduct. Viewed in light of *Ernst*, *Blackie* appears to place the most severe evidentiary burden of proof equitably on the proper party in a rule 10b-5 case. Once plaintiffs in an open market securities fraud case have established both that a defendant intentionally misrepresented or failed to disclose facts and that such actions were material, requiring the defendant to prove nonmateriality or nonreliance comports with the liberal construction that should be given rule 10b-5 to effectuate its remedial purposes.[64]

Daniel V. Burke

> Even though *Blackie* nominally allows defendants to rebut causation by a showing of no reliance, it seems to us that such a concession is virtually meaningless, and perhaps nonsensical, in an open market situation.

Id. at 1304 n.4.

62. *See Reliance Requirement* Note, *supra* note 8, at 599.

63. 425 U.S. 185, 201 (1976).

64. The Court has shifted the burden of proof to defendants in at least one other case involving a remedial statute designed to protect private litigants. *See* McDonnell Douglas Corp. v. Green, 411 U.S. 792, 802 (1973) (in Title VII cases, once an employee establishes a prima facie case of racial discrimination, the burden of proof shifts to the employer to articulate a nondiscriminatory purpose for his action).