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Janus Capital Group, Inc v. First Derivative Traders: The Culmination of the Supreme Court's Evolution from Liberal to Reactionary in Rule 10B-5 Actions

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Janus Capital Group, Inc v. First Derivative Traders: The Culmination of the Supreme Court's Evolution from Liberal to Reactionary in Rule 10B-5 Actions

JANUS CAPITAL GROUP, INC. V. FIRST DERIVATIVE TRADERS:
THE CULMINATION OF THE SUPREME COURT'S EVOLUTION
FROM LIBERAL TO REACTIONARY IN RULE 10B-5 ACTIONS

CHARLES W. MURDOCK[†]

ABSTRACT

“Political” decisions such as *Citizens United* and *National Federation of Independent Business* (Obamacare) reflect the reactionary bent of several Supreme Court Justices. But this reactionary trend is discernible in other areas as well. With regard to Rule 10b-5, the Court has handed down a series of decisions that could be grouped into four trilogies. The Article examines the trend over the past forty years which has become increasingly conservative and, finally, reactionary.

The first trilogy was a liberal one, arguably overextending the scope of Rule 10b-5. This was followed by a conservative trilogy that put a brake on such extension, but did so in a jurisprudentially sound manner. The next trilogy, dealing with insider trading, regressed Rule 10b-5 analysis back to a common law perspective. This was ironic since the securities laws were enacted because of the inadequacy of the common law.

The final trilogy is unquestionably reactionary. Precedent is disregarded and the Court, in constraining the scope of Rule 10b-5, fails to hold accountable clearly wrongful conduct such as conspiring to inflate a corporation's earnings or making false representations in prospectuses. In so doing, the Court characterizes a conspiracy to inflate the earnings of a corporation as an “ordinary course transaction” taking place in the “marketplace for goods and services” and adopts a definition of “making” a statement that exculpates the person who drafted the statement and was the only person who knew the statement was false.

Consequently, the conclusion asserts that the Court is less interested in protecting investors and more interested in constraining the scope of Rule 10b-5, and asserts the need for Congress to reinstate aiding and abetting liability in private securities fraud litigation. Such action by Congress will reverse not just *Central Bank* but also *Stoneridge* and *Ja-*

† Professor of Law, Loyola University Chicago. I would like to express my appreciation for their helpful comments to Patricia O'Hara, Professor of Law at Notre Dame, and David Ruder, Professor of Law at Northwestern University and Former Chairman, Securities and Exchange Commission. Professor Ruder pointed out that, with class actions, an expansive approach to Rule 10 b-5 could potentially impose ruinous liability on an issuer. I concur. But *Central Bank* and its progeny can create a “what, me worry” attitude. The best way to avoid liability is to tell the truth. Unfortunately, in business, as in politics, truthfulness is sometimes a forgotten virtue.

nus Capital, which supposedly were mandated by the Supreme Court's decision in *Central Bank*.

TABLE OF CONTENTS

INTRODUCTION.....	372
I. A BRIEF HISTORY OF THE EVOLUTION OF RULE 10B-5.....	376
A. <i>The Growth of a Little Acorn into a Massive Oak Tree</i>	376
B. <i>The First Trilogy: The Supreme Court’s Belated Role in Expanding the Scope of Rule 10b-5</i>	378
1. <i>National Securities: The Supreme Court’s Initial Foray into Rule 10b-5</i>	378
2. <i>Bankers Life: The Apogee of Supreme Court Expansion of Rule 10b-5</i>	380
3. <i>Affiliated Ute Citizens: Engendering Unnecessary Confusion</i>	383
II. THE SECOND, “CONSERVATIVE” TRILOGY: REACTION TO THE “OVER” EXPANSION OF RULE 10B-5	386
A. <i>Blue Chip Stamps: Adoption of the Birnbaum Standing Rule</i>	387
B. <i>Ernst & Ernst: Scieniter Mandated by Statute—A Lesson in Administrative Law</i>	390
C. <i>Santa Fe: Harmonizing State and Federal Law and Putting Closure on a Federal Law of Corporations</i>	394
III. THE INSIDER TRADING TRILOGY	397
A. <i>Chiarella: The Start of Retrenchment</i>	397
B. <i>Dirks: A Clear Policy Choice Favoring Greed over Investors</i> ...	402
1. <i>The Basic Facts</i>	402
2. <i>The Divergent Views of the Majority and Minority</i>	403
3. <i>The Failed Policy Chosen by the Majority in Dirks</i>	407
4. <i>The Problem of Tone, the Explosion of Insider Trading, and the Congressional Response</i>	410
C. <i>Carpenter: The Uncertain Status of the Misappropriation Theory</i>	412
IV. THE FOURTH TRILOGY: INSULATING COLLATERAL PARTICIPANTS FROM LIABILITY	415
A. <i>Central Bank: The Demise of Aiding and Abetting</i>	415
1. <i>Reactionary Judicial Decision Making</i>	416
2. <i>The Flawed Analysis</i>	418
3. <i>Distinction Between Express Negligence Causes of Action and an Implied Cause of Action Requiring Recklessness</i>	419
B. <i>Stoneridge: Direct Participant Liability</i>	422
1. <i>The Contrast Between Central Bank and Stoneridge</i>	422
2. <i>The Arguments for and Against Direct Liability</i>	423
3. <i>Contorting Fact to Fit Bias</i>	424
C. <i>Janus Capital: Who “Makes” a Misrepresentation</i>	426
1. <i>The Facts</i>	427
2. <i>The Flawed Analysis of the Majority</i>	428
3. <i>The Consequences of the Court’s Decision</i>	431
CONCLUSION	437
EXHIBIT A	440

INTRODUCTION

It is surprising that the United States Supreme Court would occupy center stage in the midst of a presidential campaign. Yet, as the end of its 2012 term approached, the anticipated decision in *National Federation of Independent Business v. Sebelius*¹ preoccupied the media.² To the surprise of many, Chief Justice Roberts switched from the “conservative” block to join the four “liberals” in upholding the Affordable Care Act.³ Although the mandate in the Act requiring those who could afford insurance to do so or pay a penalty was upheld as a tax, Justice Roberts determined that the federal government could not support the mandate under the Commerce Clause,⁴ nor could the federal government require the states to expand Medicare coverage or else lose their existing Medicare funding.⁵ Thus, his decision hardly reflected a conversion to the liberal wing of the Court.

At the same time, *Citizens United v. Federal Election Commission*⁶ again became topical as millions of dollars of political advertisements flooded the media.⁷ *Citizens United* curtailed the power of the federal government to limit political donations⁸ and, in the current term, the Court also limited the power of the states to do so.⁹ While the Roberts

1. 132 S. Ct. 2566 (2012).

2. See Linda P. Campbell, Editorial, *Decision Day for Health Care Law*, PITTSBURGH POST-GAZETTE, June 22, 2012, at A7 (discussing the media’s repeated attempts to gain access for TV cameras to record the Court’s opinion announcements); Ann Gerhart, *Nothing to Do but Wait for Court Decision*, WASH. POST, June 25, 2012, at C1 (discussing the strong interest in the court’s ruling in *National Federation of Independent Business v. Sebelius*, 132 S. Ct. 2566, including members of the media); Michael Grillo & Kristin Stoller, *13K Tweets a Minute After Law Upheld Health Care Ruling*, HARTFORD COURANT, June 29, 2012, at A4 (noting that all news organizations were anxiously waiting the Court’s decision, leading to several releasing incorrect information before they understood the actual result).

3. *Sebelius*, 132 S. Ct. at 2601 (“[The mandate] is therefore constitutional, because it can reasonably be read as a tax.”); see also Richard A. Epstein, Op-Ed., *A Confused Opinion*, N.Y. TIMES, June 29, 2012, at A25 (noting “[t]he stunner yesterday was that Chief Justice John G. Roberts Jr., [was] joined by the Supreme Court’s four most liberal justices”); Martine Powers, *Morning of Tension Is Broken by Cheers*, BOS. GLOBE, June 29, 2012, at A, available at http://www.boston.com/news/nation/articles/2012/06/29/harvard_law_professors_students_cheer_su_preme_court_decision_on_health_care_act/ (discussing the surprise felt by all when learning that Justice Roberts upheld the Affordable Care Act).

4. *Sebelius*, 132 S. Ct. at 2591.

5. *Id.* at 2607.

6. 558 U.S. 310 (2010).

7. See Matt Bai, *How Did Political Money Get This Loud?*, N.Y. TIMES MAG., July 22, 2012, at MM14 (discussing the impact of *Citizens United* on political fundraising); Richard L. Hasen, *The Numbers Don’t Lie*, SLATE (Mar. 12, 2012), http://www.slate.com/articles/news_and_politics/politics/2012/03/the_supreme_court_s_citizens_united_decision_has_led_to_an_explosion_of_campaign_spending.html (noting that in the 2012 election season through March 8, total spending was 234 percent higher than 2008’s numbers and 628 percent higher than 2004’s numbers).

8. See *Citizens United*, 558 U.S. at 365–66.

9. See *Am. Tradition P’ship, Inc. v. Bullock*, 132 S. Ct. 2490, 2491 (2012) (per curiam) (stating that the holding from *Citizens United* clearly applies to state law).

Court is often referred to as conservative, arguably it might be more accurately described as reactionary or libertarian. “Libertarian” is the term George Will, a conservative pundit, has applied to Justice Kennedy, the so-called swing vote.¹⁰

These decisions, though highly significant, arguably involved “political” issues, rather than moral and ethical issues, that is, those that involve whether or not certain conduct is wrongful. However, the reactionary shift of the court is visible in these areas as well.

Consider Securities and Exchange Commission Rule 10b-5, which embraces the ethic of the securities laws that it is “sinful” not just to lie, but to tell half-truths as well.¹¹ The private cause of action under Rule 10b-5 was judicially adopted in the 1946 case of *Kardon v. National Gypsum Co.*¹² Over twenty years passed before the Supreme Court opined upon Rule 10b-5 and, during that period, lower courts took an expansive view of its scope to remedy a broad range of wrongdoing. The initial approach of the Supreme Court to Rule 10b-5 was a “liberal” one, but over time the approach became more conservative.

A little over a year ago, the Supreme Court, in *Janus Capital Group, Inc. v. First Derivative Traders*,¹³ decided the third case in a trilogy of decisions that are unique both in their dubious jurisprudence and the willingness of the Court to adopt an interpretation of the law that permitted clearly wrongful conduct to go unpunished. Accountability for wrongful conduct is no longer a serious jurisprudential consideration for the Roberts Court. Since the Supreme Court ventured into the Rule 10b-5 domain in 1969, it has handed down several decisions that can be grouped into a series of trilogies.

The first trilogy was a liberal one that expanded the scope of Rule 10b-5,¹⁴ while the second trilogy was a conservative one that put the brakes on such expansion.¹⁵ This latter trilogy embodied sound policy and thoughtful jurisprudence, although *Blue Chip Stamps v. Manor Drug Stores*¹⁶ did not reflect judicial restraint—at this point a bellwether of conservative judicial philosophy. But then came two trilogies, supposedly conservative, that were characterized by sloppy reasoning and an out-

10. See Lucas Grindley, *George Will Predicts Win for Marriage Equality in Supreme Court*, ADVOCATE.COM (July 2, 2012, 12:48 AM ET), <http://www.advocate.com/politics/marriage-equality/2012/07/02/george-will-predicts-win-marriage-equality-supreme-court> (quoting George Will as saying, “I think [Justice Kennedy is] . . . driven in both directions by a constant compass and that is he’s a libertarian” (internal quotation mark omitted)).

11. See SEC Rule 10b-5, 17 C.F.R. § 240.10b-5(b) (2013) (making it a violation 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”).

12. 69 F. Supp. 512, 513–14 (E.D. Pa. 1946).

13. 131 S. Ct. 2296 (2011).

14. See *infra* Part I.A.

15. See *infra* Part I.B.

16. 421 U.S. 723 (1975).

come-determinative approach to judicial decision making. The third trilogy dealt with insider trading¹⁷ and the fourth, and current, trilogy with the potential liability of those who might be characterized as “collateral participants” in fraud.¹⁸ Sadly, these latter two trilogies had the effect of insulating corporate corruption from liability and undermining the investor protection that was the goal of the securities acts.

The first decision in the fourth trilogy, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,¹⁹ eliminated secondary liability for aiding and abetting under the securities laws.²⁰ Congress responded by reinstating aiding and abetting liability in enforcement actions brought by the Securities Exchange Commission (SEC).²¹ The second decision, *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*,²² though it arguably involved primary liability, rejected a cause of action against those who conspired with their customer to inflate the customer’s earnings.²³ Supposedly the Supreme Court was constrained by the *Central Bank* decision. The third and current decision, *Janus Capital*, insulated an asset management firm and its investment advisor subsidiary from liability for misrepresentations made by a mutual fund it sponsored.²⁴ The Court’s ill-reasoned analysis as to who “makes” a misrepresentation has far-reaching implications, and the logic of its decision could insulate corporate management, other than directors, from liability for fraudulent representations the corporation makes affecting securities markets.

Part I of this Article traces the evolution of Rule 10b-5 from its origin and development in the lower courts until the Supreme Court’s initial venture into the Rule 10b-5 thicket, in which the court facilitated the expansion of Rule 10b-5 litigation, arguably beyond reasonable boundaries. Part II then reviews the second trilogy in which the Court, moving in a conservative direction after appointments by President Nixon, placed a series of constraints upon the ability to bring a Rule 10b-5 action, employing a well-reasoned perspective that took into account the other provisions of the securities laws. Part III analyzes the third trilogy which, rather than putting a brake upon unwarranted expansion of Rule 10b-5, involved undercutting the essential purposes of the securities laws to provide a fair playing field for investors—and regressed the analysis of securities litigation to a common-law perspective, even though the securities laws were enacted because the common law was inadequate to

17. See *infra* Part III.

18. See *infra* Part IV.

19. 511 U.S. 164 (1994).

20. *Id.* at 184–85.

21. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 1995 U.S.C.C.A.N. (109 Stat.) 737.

22. 552 U.S. 148 (2008).

23. *Id.* at 159.

24. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011).

deal with securities fraud. Part IV of the Article then focuses upon the liability of what are arguably collateral participants, that is, persons who are not the primary wrongdoer but rather assist or conspire with the primary wrongdoer. This is a critical area since the primary wrongdoer, by the time the fraud is uncovered, is often insolvent or otherwise unable to make whole the investors injured by the fraud. In addition, collateral participants are often “gatekeepers” upon whom the public relies to ensure that issuers are responsible and accountable.

The tragedy of the decisions comprising the fourth trilogy is that, even though the existence of wrongdoing is unquestioned, the Supreme Court opted to let the wrongdoers go unpunished and extended similar protection to subsequent generations of wrongdoers. Part IV first examines the unparalleled judicial activism reflected in the *Central Bank* decision. It then examines how the Court twisted well-settled principles of law in an outcome-determinative mode of judicial decision making. *Central Bank* appeared to leave the door ajar when, arguably, those assisting the primary wrongdoer were so directly involved in the fraud that they could be considered primary wrongdoers themselves. But, in *Stoneridge Investment Partners*, an unnecessary extension of *Central Bank*, the Court again twisted logic in holding that a conspiracy with suppliers to inflate earnings did not impact investors.

Finally, Part IV analyzes the impact of *Janus Capital*. Superficially, the decision involves a limited issue: the responsibility of an asset manager for misrepresentations made by its captive mutual fund. However, by markedly narrowing the concept of who “makes” a misrepresentation, the decision could have far-reaching, untoward consequences. For example, the district court in the Enron litigation found that the attorneys for Enron, who knowingly drafted false disclosure documents, could be liable for “making” a misrepresentation. This analysis would now be foreclosed by the *Janus Capital* decision.

The Conclusion asserts that the Supreme Court was fully aware of the wrongdoing involved in *Stoneridge Investment Partners* and *Janus Capital*, and the impact of its decisions. Thus, the conclusion is inescapable that the Supreme Court is more concerned with constraining the scope of the securities laws than curtailing corporate fraud. The result is diminished protection for the investing public. It is also clear that the Court is not acting as an umpire,²⁵ dispassionately applying well-settled law in the cases that come before it, but rather unsettling established law

25. See *Confirmation Hearing on the Nomination of John G. Roberts, Jr. to Be Chief Justice of the United States*, 109th Cong. 55 (2005) (statement of John G. Roberts, Chief Justice nominee), available at <http://www.washingtonpost.com/wp-dyn/content/article/2005/09/13/AR2005091300693.html> (“Judges and Justices are servants of the law, not the other way around. Judges are like umpires. Umpires don’t make the rules, they apply them.”).

in a reactionary fashion to undermine the basic principles undergirding the securities laws.

I. A BRIEF HISTORY OF THE EVOLUTION OF RULE 10B-5

A. *The Growth of a Little Acorn into a Massive Oak Tree*

Rule 10b-5 was promulgated in 1942²⁶ pursuant to Section 10 of the 1934 Securities Exchange Act.²⁷ By its terms, it defines certain manipulative or deceptive conduct as illegal and, thus, could be the basis for a SEC enforcement action²⁸ or criminal prosecution by U.S. Attorneys.²⁹ It was not until 1946, in *Kardon v. National Gypsum Co.*,³⁰ that a federal court implied a private course of action based upon Rule 10b-5. What is striking about the opinion is its brevity and curt analysis. Based upon the analogy to a statutory tort, the *Kardon* court accepted as basically self-evident the judicial principle that a rule defining illegality could establish a duty, the breach of which could give rise to a civil cause of action.³¹

After the *Kardon* decision, litigation premised upon Rule 10b-5 figuratively exploded. While courts frequently struggled to find deception,³² many of these cases involved conduct that could be characterized as a breach of fiduciary duty.³³ Thus, some commentators questioned whether a federal law of corporations was developing.³⁴

The apogee of the development of Rule 10b-5 occurred in 1968 in the Texas Gulf Sulphur litigation. In an enforcement action, *SEC v. Tex-*

26. Securities and Exchange Commission, 13 Fed. Reg. 8177 (Dec. 22, 1948) (codified at 17 C.F.R. § 240.10b-5(b) (2013)).

27. See 15 U.S.C. § 78j (2012).

28. See *id.*

29. See *id.*

30. 69 F. Supp. 512 (E.D. Pa. 1946).

31. *Id.* at 513-14.

32. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 463 (1977) (holding that deception is required for a violation of Rule 10b-5); *Kademian v. Ladish Co.*, 792 F.2d 614, 622 (7th Cir. 1986) (dismissing, after extensive analysis of whether defendants deceived the plaintiffs, the 10b-5 claims for lack of manipulation or deception); *Madison Consultants v. Fed. Deposit Ins. Corp.*, 710 F.2d 57, 61-62 (2d Cir. 1983) (providing that alleged wrongful removal of a restrictive legend on a stock issuance was not a cause of action under Rule 10b-5 because plaintiffs alleged no manipulation or deception).

33. See, e.g., *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971), (holding that an investment advisor corporation that realized profits in connection with the appointment of a new advisor upon its recommendation violated its fiduciary duty, thereby violating the Investment Company Act), *superseded by statute*, Investment Company Act of 1940, 15 U.S.C. § 80a-15(f) (1975), as recognized in *Meyer v. Oppenheimer Mgmt. Corp.*, 895 F.2d 861, 865 (2d Cir. 1990); *Schein v. Chasen*, 478 F.2d 817, 823 (2d Cir. 1973) (stating that while a breach of fiduciary duty usually leads to recourse through state laws, such a breach can also lead to a federal cause of action under Rule 10b-5), *vacated*, *Lehman Bros. v. Schein*, 416 U.S. 386 (1974); *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799, 814 (3d Cir. 1949) (stating that the court need not find a breach of a fiduciary duty to find liability under federal securities laws, but such a breach can be sufficient in showing a violation).

34. See, e.g., Arthur Fleischer, Jr., "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146, 1146-47 (1965); Stanley A. Kaplan, *Corporation Law and Securities Regulation*, 18 BUS. LAW. 868, 868 (1963); Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1794 (2006).

as *Gulf Sulphur Co.*,³⁵ the Second Circuit examined the conduct surrounding the discovery by Texas Gulf Sulphur of a rich ore deposit in Timmins, Canada.³⁶ “Act I” encompassed the period from the drilling of a core in November 1963 until April 1964.³⁷ During this period, corporate employees and directors purchased Texas Gulf Sulphur stock on the open market.³⁸ “Act II” began in early April 1964, when rumors that the ore strike was extraordinary began circulating; in response, the company issued what has been characterized either as a “gloomy” or a “misleading” press release on April 12, 1964 and four days later, announced the extraordinary nature of the find.³⁹

With regard to Act I, the Second Circuit determined that employees, even low-level employees, who purchased stock, were “insider[s]” who could not trade on “inside information,” namely material non-public information,⁴⁰ but rather had a duty to “disclose . . . or . . . abstain.”⁴¹ In Act II, in determining that the company was liable for the misleading press release, the court essentially employed a negligence standard.⁴² And, in defining materiality, the court vacillated between information that a reasonable investor *might*⁴³ consider important versus *would*⁴⁴ consider important. While the case was an enforcement action, it spawned a series of private damages actions.⁴⁵

Texas Gulf Sulphur was foreshadowed by an SEC decision authored by former Columbia Law Professor William Cary, and then-SEC Chairman, *In re Cady, Roberts & Co.*⁴⁶ That case was a “bad news” situation: Curtiss–Wright’s Board of Directors had decided to cut the dividend. In such a situation, someone with foreknowledge might seek to sell Curtiss–Wright stock. A board member, thinking that the corporate secretary had earlier disseminated the information to the public,⁴⁷ telephoned a fellow partner at Cady Roberts who then sold the stock.

35. 401 F.2d 833 (2d Cir. 1968).

36. *Id.* at 839–40.

37. *Id.* at 843–45.

38. *Id.* at 844.

39. *Id.* at 845–47 (internal quotation marks omitted).

40. *Id.* at 848 (internal quotation marks omitted).

41. *Id.*

42. *Id.* at 862–63. This position was reversed in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), discussed *infra* Part II.B.

43. *Tex. Gulf*, 401 F.2d at 860.

44. *Id.* at 863. The Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), adopted the would/probability standard.

45. *See, e.g.,* *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 241 (2d Cir. 1974) (holding insiders liable directly to plaintiffs that purchased stock on the open market without knowledge of the material inside information); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 562 (E.D.N.Y. 1971) (allowing civil liability in a class action based on material misstatements and omissions contained in a registration statement).

46. *Cady, Roberts & Co.*, Exchange Act Release No. 6668, 1961 WL 60638 (Nov. 8, 1961). *See* discussion *infra* note 201.

47. *Cady, Roberts & Co.*, 1961 WL 60638, at *2.

The Commission disciplined the partner who sold and its opinion is significant in several respects. First, the partner back at the office who sold stock (the "tippee") had no connection to Curtiss-Wright.⁴⁸ Second, the "tipper," the director, did not know that dissemination of the information had been delayed and thus did not "sin," a fact that the Supreme Court, in the *Dirks v. SEC*⁴⁹ case, did not appreciate.⁵⁰ Most importantly, because this was a bad news situation, the insider would be selling to a buyer who very likely was not a shareholder.⁵¹ Contrast this with a "good news" situation in which the insider would seek to buy stock: the only person from whom the insider could buy stock would be a shareholder to whom a corporate insider arguably would owe a fiduciary duty.⁵² The defendant argued that no duty was owed to a non-shareholder to whom the stock was sold, but the Commission made short shrift of this argument by asserting that the securities laws were enacted because the common law was inadequate to protect investors.⁵³ Thus, the absence of a common law duty was irrelevant to whether there was a violation of the securities laws—a proposition that the Supreme Court, in *Chiarella v. United States*,⁵⁴ declined to follow.⁵⁵

B. The First Trilogy: The Supreme Court's Belated Role in Expanding the Scope of Rule 10b-5

1. *National Securities*: The Supreme Court's Initial Foray into Rule 10b-5

Over twenty years passed between the judicial recognition of a private cause of action under Rule 10b-5 in *Kardon* and the Supreme Court's initial consideration of this cause of action in *SEC v. National Securities, Inc.*⁵⁶ As the Court noted, "[a]lthough § 10(b) and Rule 10b-5 may well be the most litigated provisions in the federal securities laws, this is the first time this Court has found it necessary to interpret them."⁵⁷ The *National Securities* Court then asserted a caution that the Court, as

48. *Id.*

49. 463 U.S. 646 (1983).

50. *See id.* at 665-67 (holding that the "tippee" only sins if the "tipper" sinned, meaning the defendant who received inside information from an insider who did not personally benefit from the disclosure was not liable under Rule 10b-5).

51. In "bad news" cases, the insider knows about some impending harm to the company, meaning the stock price will fall in the future. Here, the insider sells stock, and the buyer of that stock generally did not already own stock in that company. While a current stockholder can always buy more stock, it will often be someone without any current ownership of the company.

52. *See Goodwin v. Agassiz*, 186 N.E. 659, 661 (Mass. 1933) (holding, in a "good news" case, that directors had no duty to disclose their identity, or the good news, when buying shares from a current stockholder).

53. *Cady, Roberts & Co.*, 1961 WL 60638, at *5.

54. 445 U.S. 222 (1980).

55. *See id.* at 236 (holding that the defendant, who was not a corporate insider, could not be liable for trading on material, nonpublic information because the "outsider" owed no duty to the shareholders, meaning no duty was owed to the plaintiffs).

56. 393 U.S. 453 (1969).

57. *Id.* at 465.

constituted subsequent to 1980, should have heeded: “The questions presented are narrow ones. They arise in an area where glib generalizations and unthinking abstractions are major occupational hazards.”⁵⁸

The primary issue in the *National Securities* case was whether the approval of a merger by the Arizona Director of Insurance precluded an action by the SEC to set aside the merger on the ground that its approval had been procured by a misleading proxy statement.⁵⁹ The defendants argued that such action by the SEC would supersede state law regulating the business of insurance in violation of the McCarran–Ferguson Act.⁶⁰ The Court concluded that “[t]he paramount federal interest in protecting shareholders is in this situation perfectly compatible with the paramount state interest in protecting policy holders.”⁶¹

The Ninth Circuit had affirmed judgment on the pleadings in favor of defendants on the basis that McCarran–Ferguson Act barred the SEC action.⁶² However, defendants had also argued below that a merger did not constitute a “purchase or sale” under Rule 10b-5, and that Rule 10b-5 would not apply to misrepresentations in connection with a proxy notification.⁶³ While these issues were not directly before the Court, it “reached” to provide guidance to the trial court on remand.

The Court made short shrift of both arguments. With respect to the purchase or sale issue, the Court rejected the “no sale” argument premised upon the former Rule 133⁶⁴ and determined that a merger did constitute a sale for purpose of Rule 10b-5. The Court stated:

Whatever the terms “purchase” and “sale” may mean in other contexts, here an alleged deception has affected individual shareholders’ decisions in a way not at all unlike that involved in a typical cash sale

58. *Id.*

59. *Id.* at 455–56.

60. *Id.* at 456; see 15 U.S.C. § 1012(b) (2012) (stating that “[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance . . .”).

61. *Nat’l Sec., Inc.*, 393 U.S. at 463. The Court also stated:

The gravamen of the complaint was the misrepresentation, not the merger. The merger became relevant only insofar as it was necessary to attack it in order to undo the harm caused by the alleged deception. Presumably, full disclosure would have avoided the particular Rule 10b-5 violations alleged in the complaint. Nevertheless, respondents contend that any attempt to interfere with a merger approved by state insurance officials would “invalidate, impair, or supersede” the state insurance laws made paramount by the McCarran-Ferguson Act. We cannot accept this overly broad restriction on federal power.

Id. at 462–63.

62. *Id.* at 456.

63. *Id.* at 464–65 (internal quotation marks omitted).

64. Former Rule 133 provided that certain transactions, such as mergers, did not involve a “sale” under the 1933 Act, and thus the stock issued in the transaction did not need to be registered with the SEC prior to sale. *Registration of Certain Transactions Involving Merges, Consolidations and Acquisitions of Assets*, 37 Fed. Reg. 23631 (Nov. 7, 1972) (rescinding 17 C.F.R. § 230.133 (1968)).

or share exchange. The broad antifraud purposes of the statute and the rule would clearly be furthered by their application to this type of situation. Therefore we conclude that Producers' shareholders "purchased" shares in the new company by exchanging them for their old stock.⁶⁵

The Court also determined to dismiss rather quickly the argument that Rule 10b-5 did not cover misrepresentations in proxy material.⁶⁶ Even though an insurance company might be exempt from federal proxy regulation, "Congress may well have concluded that the Commission's general antifraud powers over purchases and sales of securities should continue to apply to insurance securities."⁶⁷ The approach of the Court suggests a presumption in favor of expanding the coverage of Rule 10b-5 to prevent fraud, rather than restricting the scope of Rule 10b-5 to facilitate fraud.

At this stage, the Supreme Court was not only comfortable with the development of Rule 10b-5 by the lower courts but also focused upon an expansive interpretation of Rule 10b-5 to further the anti-fraud purposes of the securities acts.

2. *Bankers Life*: The Apogee of Supreme Court Expansion of Rule 10b-5

*Superintendent of Insurance of the State of New York v. Bankers Life & Casualty Co.*⁶⁸ was a very short and superficial opinion dealing with a very complicated set of facts.⁶⁹ In effect, a crook, Begole, purchased all the stock of Manhattan Casualty Co. for \$5 million.⁷⁰ Begole and other conspirators then caused Manhattan Casualty to sell U.S. Treasury bonds for approximately \$5 million and appropriated the proceeds to pay Bankers Life the \$5 million purchase price.⁷¹ Plaintiff brought suit as liquidator of the assets of Manhattan Casualty.

The Second Circuit, in affirming the dismissal, stated that "no investor [was] injured" and that "[t]he purity of the security transaction and the purity of the trading process were unsullied."⁷² The facts would seem to support the Second Circuit's reasoning. Bankers Life sold the shares of its subsidiary for \$5 million. In fact, Bankers Life received \$5 million, apparently what the shares were worth. Therefore, there was no fraud in the purchase of the Manhattan stock. With respect to the sale of bonds by

65. *Nat'l Sec., Inc.*, 393 U.S. at 467.

66. *Id.* at 468.

67. *Id.* at 468-69.

68. 404 U.S. 6 (1971).

69. *Id.* at 7-9.

70. *Id.* at 7-8.

71. *Id.* at 8.

72. *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 430 F.2d 355, 361 (2d Cir. 1970), *rev'd*, 404 U.S. 6 (1971).

Manhattan, apparently the bonds were worth what the buyer of the bonds paid. Thus the buyer of the bonds was not defrauded. Moreover, since the bonds were worth what Manhattan sold them for, Manhattan was not defrauded in the bond transaction *itself*. What happened was that the proceeds of the sale, instead of being deposited in Manhattan Casualty's bank account, were misappropriated by the crooks.

The factor that enabled the Supreme Court to treat this as a securities case was that the asset that was sold was a financial asset, namely, Treasury bonds. If, instead of being a Treasury bond, the circumstances were the same except that the company whose stock was purchased was a construction company and the asset sold was a large crane, this is no way could be conjured to be a securities case.

In the case at bar, as the Second Circuit Court observed, no investor was injured. This was a situation in which crooks embezzled from a company they owned. The company became bankrupt and the state agency sought to recover the embezzled funds. No one was deceived about the value of any security. Each party to both of the securities transactions received the price that each sought. It was a real stretch to treat this as a securities case.

The Supreme Court acknowledged that, “[t]o be sure, the full market price was paid for those bonds.”⁷³ However, the Court added: “but the seller was duped into believing that it, the seller, would receive the proceeds.”⁷⁴ The Court, understandably, was concerned that there was an act “which operated as ‘a fraud or deceit’ on Manhattan.”⁷⁵ But, embezzling the proceeds of the sale of a crane would also be a fraud or deceit. However, it is not a securities fraud. This was a suit on behalf of creditors of a corporation to recover funds embezzled by the owner of a corporation. Cases such as this engendered concern about the development of a federal law of corporations and about whether the fraud was “in connection with” a securities transaction, as discussed below.

The Court stated that “Manhattan was injured as an investor through a deceptive device which deprived it of any compensation for the sale of its valuable block of securities”⁷⁶ and that “[t]he Act protects corporations as well as individuals who are sellers of a security.”⁷⁷ But the injury here was not the typical injury that a defrauded investor would suffer. Both the buyer and the seller were happy with the price. Manhattan Casualty's injury occurred when the proceeds were misappropriated.⁷⁸

73. *Bankers Life*, 404 U.S. at 9.

74. *Id.*

75. *Id.*

76. *Id.* at 10.

77. *Id.*

78. The Court later recognized a related theory on which to find violations of federal securities laws, which it termed the “misappropriation theory.” See *United States v. O’Hagan*, 521 U.S.

Moreover, Manhattan Casualty was a unique corporate investor. It was not injured in a transaction involving its own equity securities, as in *Pappas v. Moss*.⁷⁹ Rather, it was, in effect, selling part of its "inventory," since the "inventory" of a financial institution in part consists of securities. As stated above, if Manhattan Casualty were a construction company and sold its crane, this would not have been a Rule 10b-5 case. As also stated above, the "investor," Manhattan Casualty, was not complaining about the price received in the transaction.

The opinion contained other expansive language. The fact that the fraud was committed by an officer, therefore breaching his fiduciary duty to Manhattan, was "irrelevant" since § 10(b) bars fraud by "any person."⁸⁰ Also irrelevant was the fact that this was a private transaction, i.e., one not conducted over an exchange or in the formal over-the-counter market and that the proceeds were "misappropriated."⁸¹

The Court did realize that there must be some connection between the fraud and a securities transaction, since the Court acknowledged "that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement."⁸² But the Court provided little guidance as to when fraud is "in connection with" a securities transaction when it held that Manhattan's injury was the result of "deceptive practices touching its sale of securities as an investor."⁸³ "Touching" is not a very precise legal standard.

Looking ahead to the next trilogy,⁸⁴ the opinion would have been sounder if it would have held that Manhattan Casualty was not deceived since its sole shareholder, who controlled the board of directors, was the perpetrator of the misappropriation of the proceeds of sale. Instead, it created a tenuous connection between the fraud and the securities transaction, a connection even more tenuous than that which exists in insider

642, 652-53 (1997) (internal quotation marks omitted). In a case dealing with insider trading, the Court found that a lawyer who traded on secret information he obtained while working for the corporation could be liable under Rule 10b-5. *Id.* at 653. Even though no harm was caused to those selling to the insider, the Court found that the lawyer misappropriated information from his employer, making him liable under Rule 10b-5. *Id.* at 653-54.

79. 393 F.2d 865 (3d Cir. 1968). In *Pappas*, the board of directors voted to sell shares of the corporation to themselves at a price far below market value. *Id.* at 867. The Third Circuit found that this sale violated Rule 10b-5 because the board of directors deceived the independent shareholders by selling stock cheaply to themselves. *Id.* at 869. The corporation itself was harmed because the board of directors acted against the interest of the corporation by improperly selling securities, which is different from misappropriating the assets of the corporation.

80. *Bankers Life*, 404 U.S. at 10 (internal quotation marks omitted).

81. *Id.*

82. *Id.* at 12.

83. *Id.* at 12-13 (emphasis added).

84. See *infra* Part II (discussing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), as one of the trilogy's conservative decisions limiting the scope of Rule 10b-5 in Part II.C).

trading under the misappropriation theory, which will be explored in connection with the third trilogy.⁸⁵

The result reached by the *Bankers Life* Court was not necessarily dictated by the language of the statute, by existing case law, or by the facts of the case, and could be criticized as being overly expansive in its view of Rule 10b-5. However, in contrast to the latest trilogy, the *Bankers Life* Court caused little disruption to existing statutory interpretation and was not diametrically inconsistent with existing case law.⁸⁶

3. *Affiliated Ute Citizens*: Engendering Unnecessary Confusion

*Affiliated Ute Citizens of Utah v. United States*⁸⁷ once again dealt with a complicated set of facts but unfortunately did so, not in a short opinion, but rather in an unnecessarily long one. In *Affiliated Ute Citizens*, a bank was appointed transfer agent for mixed-blood Indians with regard to stock they owned in a corporation formed to hold assets for which distribution would otherwise be impracticable.⁸⁸ These assets included transferred oil, gas and mineral rights, and unliquidated claims against the U.S. government, pursuant to the Ute Indian Supervision Termination Act.⁸⁹ Each mixed-blood Ute was to receive ten shares of Ute Distribution Corp. (UDC) stock; however, instead of distributing the shares directly to the mixed-bloods, UDC deposited the shares with the bank and the bank issued receipts to the shareholders.⁹⁰

The primary focus of the litigation was the sale by eighty-five mixed-bloods to two assistant managers at one of the defendant-bank's branch offices and to thirty-two other white men.⁹¹ Sales by the mixed-bloods ranged from \$300 to \$700 per share.⁹² The district court determined that the value of the stock was \$1,500 and found that the bank and employees were liable to the mixed-bloods for damages.⁹³

Considering the state of the law respecting Rule 10b-5 at this time, this should have been a rather routine securities case. The basic ethic of Rule 10b-5 is that it is a sin not only to lie but also to tell half-truths. This is embodied in paragraph (b) of the Rule, which makes it unlawful: "To make any untrue statement of a material fact [(a lie)] or to omit to state a material fact necessary in order to make the statements made, in the light

85. See *infra* Part III.C (discussing the uncertain status of misappropriation as discussed in *Carpenter v. United States*, 484 U.S. 19 (1987), and *United States v. O'Hagan*, 521 U.S. 642 (1997)).

86. See *infra* Part IV.

87. 406 U.S. 128 (1972).

88. *Id.* at 136.

89. 25 U.S.C. § 677a(f) (2012).

90. *Affiliated Ute Citizens*, 406 U.S. at 136-37.

91. *Id.* at 146-47.

92. *Id.* at 147.

93. *Id.* at 156-57.

of the circumstances under which they were made, not misleading [(a half-truth)]⁹⁴

Since the employees represented that their offers were at the market price, but did not disclose that there was a two-tiered market, this was a typical “half-truth” case. On the other hand, the Supreme Court treated this as a “silence” case, in which materiality substituted for reliance.

The Tenth Circuit, even though taking a constricted view of defendants’ liability, recounted that, as to the purchases personally made by the bank employees, “the record shows that the individual defendants [represented] that the prevailing price or market price was the figure at which their own purchase was made.”⁹⁵ According to the Tenth Circuit, this sufficed for liability on the personal purchases by the employees. However, the Tenth Circuit rejected liability for purchases by other white men on the basis that, in the other purchases, the employees performed only “ministerial” acts, such as preparing an affidavit that the mixed-bloods had offered the shares to UDC.⁹⁶

With respect to the purchases by the other white men, the Tenth Circuit acknowledged that one employee stated “I contacted a number of people [mixed-bloods] telling them that if they were interested in selling, I was interested in offering the highest price.”⁹⁷ The Tenth Circuit also stated that the employees actively encouraged a market for the UDC stock.⁹⁸

Even under the Supreme Court’s later, more restrictive definition of who is a seller under the 1933 Act, the activity of the bank and its employees could constitute them as purchasers with regard to the mixed-blood sales to other white men, because they solicited the purchases from the mixed-bloods.⁹⁹ Furthermore, since the employees, besides purchas-

94. 17 C.F.R. § 240.10b-5(b) (2013).

95. *Reynos v. United States*, 431 F.2d 1337, 1347 (10th Cir. 1970), *aff’d in part, rev’d in part sub nom. Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

96. *Reynos*, 431 F.2d at 1346.

97. *Id.* at 1347 (internal quotation marks omitted).

98. The court stated:

The record shows that the bank officials at the Roosevelt office of the defendant bank were active in encouraging a market for the UDC stock among non-Indians. This was probably not contemplated by the UDC-bank relationship. This gave rise to some indirect benefits to the bank by way of increased deposits, but it did not constitute a violation of any duty the bank may have had to the plaintiffs by contract or otherwise.

....

... The bank and the individual defendant employees had developed a market at the Roosevelt Agency of the bank for UDC stock, received inquiries from time to time for stock, and had customers of the bank who were prepared to make purchases from time to time. The defendant bank and the individual defendants were thus entirely familiar with the prevailing market for the shares at all material times.

Id. at 1345, 1347.

99. *Cf. Pinter v. Dahl*, 486 U.S. 622, 654–55 (1988) (rejecting the “substantial factor” test in determining who is a seller under the 1933 Act, however, determining that someone who actually

ing for their own account, were soliciting the mixed-bloods to sell and were soliciting or receiving orders from other white men to buy, the situation could certainly fall within clause (c) of Rule 10b-5: “[engaging] 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.”¹⁰⁰ Thus the defendants could be liable for fraud in their selling activity, both with respect to their own sales and those that they facilitated.

Consequently, the Court found a course of business embodying a scheme to defraud on the following basis: “This is so because the defendants devised a plan and induced the mixed-blood holders of UDC stock to dispose of their shares without disclosing to them material facts that reasonably could have been expected to influence their decisions to sell.”¹⁰¹ So far so good. But the Court then went on to categorize the defendants as “market makers,” an unnecessary characterization: “The individual defendants, in a distinct sense, were market makers, not only for their personal purchases constituting 8 1/3% of the sales, but for the other sales their activities produced. This being so, they possessed the affirmative duty under the Rule to disclose this fact to the mixed-blood sellers.”¹⁰²

Not only did the Court refer to the defendants as market makers, but it also cited *Chasins v. Smith, Barney & Co.*,¹⁰³ a case involving professional market makers, which had imposed a duty of disclosure upon market makers, thus touching off a firestorm of concern.¹⁰⁴ While the bank and its employees were “making a market,” they were not professional market makers.¹⁰⁵ Securities professionals who may make a mar-

solicited a sale could be a seller even though such person did not take title (internal quotation marks omitted)).

100. 17 C.F.R. § 240.10b-5(c) (2013).

101. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153 (1972).

102. *Id.* The Court also stated:

It is no answer to urge that, as to some of the petitioners, these defendants may have made no positive representation or recommendation. The defendants may not stand mute while they facilitate the mixed-bloods’ sales to those seeking to profit in the non-Indian market the defendants had developed and encouraged and with which they were fully familiar. The sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in that market.

Id.

103. 438 F.2d 1167 (2d Cir. 1970).

104. See Note, *Affiliated Ute Citizens v. United States—The Supreme Court Speaks on Rule 10b-5*, 1973 UTAH L. REV. 119, 126–130 (1973) (explaining that while the Second Circuit in *Chasins* noted that identification as a market maker was material, it never found a duty to disclose such status—the Court’s holding that market maker status must be disclosed should be limited to the facts of this case); see also Arthur Fleischer, Jr. et al., *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 846, 856–57 (1973) (discussing the problems created by *Affiliated Ute Citizens* for market traders engaged in continuous trading activity due to unresolved questions relating to the scope of this decision).

105. *Market maker* is defined by the SEC as an organization, association, or group of persons that “(1) [b]rings together the orders for securities of multiple buyers and sellers; and (2) [u]ses

ket in several stocks and engage in hundreds of transactions a day were concerned with what disclosure obligations could be imposed upon them as a result of the *Affiliated Ute Citizens* decision.

This first trilogy clearly represented an expansive, possibly overly expansive, approach to the scope of Rule 10b-5. The cases in the trilogy could easily be characterized as “liberal.” The analysis by the Court at this point was not particularly rigorous and the Court appeared primarily motivated to curb wrongdoing. Policy—protecting investors—was more important than rigorous analysis.

II. THE SECOND, “CONSERVATIVE” TRILOGY: REACTION TO THE “OVER” EXPANSION OF RULE 10B-5

The 1960s were a time of social and political upheaval, sparked in large part by the civil rights movement and the Vietnam War,¹⁰⁶ and to some extent by reaction to the liberal decisions of the Warren Court.¹⁰⁷ In 1968, one issue upon which President Nixon campaigned was that he would appoint a strict constructionist to be Chief Justice of the Supreme Court.¹⁰⁸ After his election, he made good on his promise, appointing Warren Burger as Chief Justice in 1969.¹⁰⁹ He also had three other ap-

established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.” 17 C.F.R. § 240.3b-16(a) (2013).

106. See, e.g., STEPHEN FEINSTEIN, *THE 1960S FROM THE VIETNAM WAR TO FLOWER POWER* 60–61 (2006) (noting the significant events of the 1960s); ROBERT BUZZANCO, *VIETNAM AND THE TRANSFORMATION OF AMERICAN LIFE* 1–9 (1999) (explaining the social and political movements of the 1960s). The Vietnam War, along with the assassinations of President John F. Kennedy, Martin Luther King, Jr., and Robert Kennedy; the riots after the King assassination; the Peace Movement of the 1960s; the Women’s Liberation movement of the 1960s; and the 1968 Chicago Democratic Convention all had significant impact on politics of the 1960s. *Id.*

107. While *Brown v. Board of Education*, 347 U.S. 483 (1954), was a 1954 case, its progeny carried over to the 1960s and later. Howard A. Glickstein, Remarks, *The Impact of Brown v. Board of Education and Its Progeny*, 23 HOW. L.J. 51, 51 (1980). In addition, there were many other liberal decisions. See, e.g., *Miranda v. Arizona*, 384 U.S. 436, 498–99 (1966) (holding that statements obtained from defendants without full warning of constitutional rights were inadmissible as a violation of the Fifth Amendment); *Reynolds v. Sims*, 377 U.S. 533, 586–87 (1964) (holding existing and proposed plans for apportionment of seats in the Alabama Legislature invalid under the Equal Protection Clause); *Gideon v. Wainwright*, 372 U.S. 335, 343 (1963) (holding that defendants in a state court criminal prosecution have the right to have counsel appointed); *Mapp v. Ohio*, 367 U.S. 643, 655 (1961) (holding evidence obtained by an unconstitutional search was inadmissible at trial, thereby nullifying the conviction).

108. DONALD GRIER STEPHENSON JR., *CAMPAIGNS AND THE COURT: THE U.S. SUPREME COURT IN PRESIDENTIAL ELECTIONS* 181 (1999) (noting Nixon’s promise to nominate Supreme Court Justices who “would be strict constructionists who saw their duty as interpreting law and not making law” and who “would see themselves as caretakers of the Constitution and servants of the people, not super-legislators with a free hand to impose their social forces and political viewpoints on the American people” (quoting ALPHEUS THOMAS MASON & DONALD GRIER STEPHENSON, JR., *AMERICAN CONSTITUTIONAL LAW* 513 (11th ed. 1996)) (internal quotation marks omitted)).

109. *Warren E. Burger, 1969-1986*, SUP. CT. HIST. SOC’Y, <http://www.supremecourthistory.org/history-of-the-court/chief-justices/warren-burger-1969-1986/> (last visited Apr. 21, 2014).

pointments: Justice Blackmun in 1970,¹¹⁰ and Justices Powell and Rehnquist in 1972.¹¹¹ Three of the four turned out to be moderate to strong conservatives, but Justice Blackmun, to the chagrin of the conservatives, turned out to be a strong liberal, authoring the Court's opinion in *Roe v. Wade*,¹¹² which has had political repercussions up to the present.

Speaking of his appointments, President Nixon stated:

I consider my four appointments to the Supreme Court to have been among the most constructive and far-reaching actions of my presidency. . . . It is true that the men I appointed shared my conservative judicial philosophy and significantly affected the balance of power that had developed on the Warren Court. But as individuals they were each dedicated and able constitutional lawyers who often disagreed on major cases.¹¹³

The conservative shift that Nixon accomplished is reflected in the next trilogy of cases. While the cases reflected movement away from the prior expansionist approach of the federal courts to Rule 10b-5, they also reflected, as President Nixon suggested, able constitutional lawyering.

A. Blue Chip Stamps: *Adoption of the Birnbaum Standing Rule*

The first case in this trilogy, *Blue Chip Stamps v. Manor Drug Stores*,¹¹⁴ involved a very unique set of facts. Normally, the concern in a public offering is that the issuer, in preparing the registration statement or other offering documents, will be unduly "optimistic" in order that the investing public may be induced by misleading statements to buy and thus to be euchred into a bad investment. The converse occurred in *Blue Chip Stamps*.

Pursuant to a federal antitrust consent decree, "Old" Blue Chip and its controlling shareholders were required to offer stock in the "New" Blue Chip to retailers who had used the stamp service but were not shareholders, in proportion to their past stamp usage.¹¹⁵ The offering to the retailers would reduce the holdings of the nine retailers who previ-

110. *Harry A. Blackmun, 1970-1994*, SUP. CT. HIST. SOC'Y, <http://www.supremecourthistory.org/history-of-the-court/associate-justices/harry-blackmun-1970-1994/> (last visited Apr. 21, 2014).

111. *Lewis F. Powell, Jr., 1972-1987*, SUP. CT. HIST. SOC'Y, <http://www.supremecourthistory.org/history-of-the-court/associate-justices/lewis-powell-jr-1972-1987/> (last visited Apr. 21, 2014); *William H. Rehnquist, 1986-2005*, SUP. CT. HIST. SOC'Y, <http://www.supremecourthistory.org/history-of-the-court/chief-justices/william-rehnquist-1986-2005/> (last visited Apr. 21, 2014).

112. 410 U.S. 113 (1973).

113. Jonathan Movroydis, *Nixon Era Legal Experts Revisit High Court Nominations*, NEW NIXON (Nov. 21, 2011), <http://blog.nixonfoundation.org/2011/11/nixon-era-officials-re-visit-the-rehnquist-and-powell-nominations/>.

114. 421 U.S. 723 (1975).

115. *Id.* at 725-26.

ously owned 90% of “Old” Blue Chip.¹¹⁶ Thus, it was to the advantage of those who controlled “Old” Blue Chip that the retailers—to whom shares in “New” Blue Chip were offered—not purchase such shares. Consequently, according to plaintiff-retailers, defendants prepared a prospectus that was fraudulently “pessimistic” in order to induce them not to buy.¹¹⁷

The so-called *Birnbaum* rule required that a plaintiff, in order to have standing to bring an action under Rule 10b-5 (which required that the fraud be “in connection with” a securities transaction), must have been a purchaser or seller of securities.¹¹⁸ This rule was generally followed in the lower courts, although certain exceptions were recognized.¹¹⁹ Because plaintiffs had neither bought nor sold securities, the district court in *Blue Chip* dismissed the complaint,¹²⁰ but a divided panel of the Ninth Circuit reversed the district court on the basis that the instant facts fell within an exception to the *Birnbaum* rule.¹²¹

In the instant case, the Supreme Court declined to recognize an exception to the *Birnbaum* rule and made the rule an absolute standing requirement, subject to no exceptions. The majority opinion concluded:

Were we to agree with the Court of Appeals in this case, we would leave the *Birnbaum* rule open to endless case-by-case erosion depending on whether a particular group of plaintiffs was thought by the court in which the issue was being litigated to be sufficiently more discrete than the world of potential purchasers at large to justify an exception. We do not believe that such a shifting and highly fact-orientated disposition of the issue of who may bring a damages claim for violation of Rule 10b-5 is a satisfactory basis for a rule of liability imposed on the conduct of business transactions.¹²²

There is no question that permitting persons who are not purchasers or sellers to sue carries with it possibilities of abuse. Consider the *Texas*

116. *Id.*

117. *Id.* at 726–27.

118. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir. 1952). *Birnbaum* was short and to the point; in contrast to the *Blue Chip* decision, which was almost fifty page long, *Birnbaum* was only four pages.

119. See, e.g., *Landy v. Fed. Deposit Ins. Corp.*, 486 F.2d 139, 156 (3d Cir. 1973) (holding that a plaintiff seeking injunctive relief has standing after establishing a causal connection between the alleged violations and alleged injury, even without showing a purchase or sale of the security); *Mut. Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 547 (2d Cir. 1967) (providing an exception to the *Birnbaum* rule where the plaintiffs are seeking injunctive relief, whereby no sale or purchase of the security is necessary where the plaintiff is seeking an injunction to prevent the wrongdoing); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 637 (2d Cir. 1967) (granting standing because shareholder was forced to sell his shares at a later time); see also 5B ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 9:5 (2013) (explaining the several exceptions to the *Birnbaum* rule).

120. *Manor Drug Stores v. Blue Chip Stamps*, 339 F. Supp. 35, 40 (C.D. Cal. 1971), *rev'd*, 492 F.2d 136 (9th Cir. 1973), *rev'd*, 421 U.S. 723 (1975).

121. *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136, 141–42 (9th Cir. 1973), *rev'd*, 421 U.S. 723 (1975).

122. *Blue Chip Stamps*, 421 U.S. at 755.

Gulf Sulfur case previously discussed.¹²³ The corporation published a misleading press release; subsequent to the SEC action, private plaintiffs who had sold their shares after that press release initiated suits and prevailed.¹²⁴ Professor Ruder, later chairman of the SEC, opined that these lawsuits worked to the disadvantage of the continuing shareholders who did not sell on the basis of the press release.¹²⁵

Consider a pejorative spin on the foregoing. Assume the shareholders, prior to the press release, were composed of two groups: short-term speculators and long-term investors. Upon the issuance of the press release, the speculators would sell and the investors would hold. The recovery of the speculators could devastate the capital of the corporation, since corporations frequently trade at significant multiples of book value, and thus the burden would fall upon those long-term investors who did not sell.¹²⁶

But what if those who neither purchased nor sold could sue? Then everybody in the world could potentially claim that they would have bought “but for” the misleading press release. Such a situation would wipe out the corporation.

At trial, probably only a few potential investors would succeed. Discovery and cross-examination could demonstrate—as in the case of *Texas Gulf Sulfur*¹²⁷—that the investor had never invested in mining stocks, or that he had sought no research on the corporation, or that he did not have the requisite liquidity to buy. But the litigation process itself can be costly, time consuming, and disruptive to the corporation and its management. Moreover, there is always the risk of success by the plaintiff. Accordingly, an unfounded lawsuit still may have settlement or strike-suit value. As the concurring opinion pointed out:

Proving, after the fact, what ‘one would have done’ encompasses a number of conjectural as well as subjective issues: would the offeree have bought at all; how many shares would he have bought; how long would he have held the shares; were there other ‘buys’ on the market at the time that may have been more attractive even had the

123. See *supra* notes 36–45 and accompanying text.

124. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 840–42 (2d Cir. 1968).

125. David S. Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U. L. REV. 423, 426 (1968).

126. Assume a corporation trades at four times book value. If the book value is 100, then the pre-press release market value would be 400. If the market value were to lose 10% (to 360) upon the issuance of the press release but then increase 50% (to 540) after a corrective press release, the measure of damages would be \$180 per share. If 20% of the shares traded between the two press releases, the corporation would lose 36% of its capital base. This could have a devastating impact upon the corporation and its patient investors. Judge Friendly, concurring in *Texas Gulf Sulphur*, warned that this type of litigation could “lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.” 401 F.2d at 867 (Friendly, J., concurring).

127. *Id.* at 851 (majority opinion).

offeree known the facts; did he in fact use his available funds (if any) more advantageously by purchasing something else?¹²⁸

Judge Hufstедler, dissenting in the Ninth Circuit below, put the issue into a concise perspective: “although [strike suits] are difficult to prove at trial, they are even more difficult to dispose of before trial.”¹²⁹ By framing *Birnbaum* as an absolute standing requirement, the majority insured that meritless litigation brought by a person who neither purchased nor sold could be disposed very simply and inexpensively, merely by filing a motion to dismiss for lack of standing.

In *Blue Chip Stamps*, the statutory analysis was sound: the statute and Rule 10b-5 both spoke of “purchase or sale”; Rule 10b-5 was derived from § 17 of the 1933 Act, which covered offerees—a phrase deleted from the Rule;¹³⁰ and the SEC had unsuccessfully sought to have Congress expand § 10(b) to cover “any attempt to purchase or sell, any security.”¹³¹ Accordingly, the judicial craftsmanship was well done. Moreover, the policy concern was legitimate: “If § 10b were extended to embrace offers to sell, the number of persons claiming to have been offerees could be legion.”¹³²

The only criticism that could be levied against *Blue Chip Stamps* is that the Supreme Court chose to bar a potentially meritorious case on the basis that there might be subsequent meretricious ones, thus raising the question whether this was the proper vehicle to adopt the current policy. Because the defendants were required to offer shares only to a particular group of plaintiffs, the potential liability was not to the world at large, but only to a discrete group.

B. Ernst & Ernst: *Scienter Mandated by Statute—A Lesson in Administrative Law*

The conservative trend continued with *Ernst & Ernst v. Hochfelder*,¹³³ where the Supreme Court rejected negligence as a basis for a Rule 10b-5 action and required a state of mind for the defendant that embraced “scienter.” In a footnote, the Court defined scienter as a “mental state embracing intent to deceive, manipulate, or defraud.”¹³⁴ However, the

128. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 758 n.2 (1975) (Powell, J., concurring).

129. *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136, 147 n.9 (9th Cir. 1973) (Hufstедler, J., dissenting), *rev'd*, 421 U.S. 723 (1975).

130. Compare 15 U.S.C. § 77q(a) (2012) (“It shall be unlawful for any person in the *offer or sale* of any securities . . . or any security-based swap agreement . . .”) (emphasis added), with 15 U.S.C. § 78j(b) (2012) (“[It is unlawful to] use or employ, in connection with the purchase or sale of any security . . .”).

131. 103 CONG. REC. 11636 (1957) (internal quotation mark omitted).

132. *Blue Chip Stamps*, 421 U.S. at 758–59 (Powell, J., concurring).

133. 425 U.S. 185 (1976).

134. *Id.* at 193 n.12.

Court left the door open for private suits to be based upon a standard less than subjective intent to defraud by adding:

In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10b and Rule 10b-5.¹³⁵

While President Nixon had succeeded in changing the liberal inclination of the Supreme Court, the circuit courts retained their “liberal” perspective into the 1980s, when President Reagan in effect imposed a litmus test upon all judicial nominees.¹³⁶ Consequently, in short order, all circuits adopted recklessness as the standard under Rule 10b-5.¹³⁷

Interestingly, the opinion dealt with a lawsuit against an aider and abettor.¹³⁸ Leston Nay was the president and controlling shareholder of First Securities;¹³⁹ however, on the side, he ran a Ponzi scheme analogous to that of Bernie Madoff,¹⁴⁰ in which he induced investors to invest in escrow accounts that he personally managed and which he represented would yield a high rate of return. To avoid detection, he had a policy that no one could open his mail while he was gone from the office (the “mail

135. *Id.*

136. I can speak from personal experience. When I was interviewed by the Justice Department in connection with a judicial appointment, concern was raised about an article I had written, Charles W. Murdock, *Civil Rights of the Mentally Retarded: Some Critical Issues*, 48 NOTRE DAME LAW. 133 (1972). While the title just as easily could have been “A Cost/Benefit Approach to the Care and Education of the Retarded,” it was difficult for those interviewing me to get past any expanded notion of civil rights. See also Stuart Taylor Jr., *The One-Pronged Test for Federal Judges*, N.Y. TIMES, Apr. 22, 1984, at 45 (stating that Reagan put ideology first in filling judicial vacancies).

137. *Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 620 (4th Cir. 1999); *SEC v. Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992); *Harris v. Union Elec. Co.*, 787 F.2d 355, 369 n.12 (8th Cir. 1986); *White v. Sanders*, 689 F.2d 1366, 1367 n.4 (11th Cir. 1982) (per curiam); *McLean v. Alexander*, 599 F.2d 1190, 1197–98 (3d Cir. 1979); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023 (6th Cir. 1979); *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 596 (10th Cir. 1979); *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir. 1978) (per curiam); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44 (2d Cir. 1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir. 1977); *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir. 1977).

138. The Court reviewed judgment on whether civil liability exists for aiding and abetting. *Ernst*, 425 U.S. at 191 n.7, 191–93. Eighteen years later, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Court struck down aiding and abetting liability under Rule 10b-5, without recognizing how *Ernst & Ernst* undercut its analysis. 511 U.S. 164, 177 (1994). See *infra* Part IV.A.

139. *Ernst*, 425 U.S. at 189.

140. Bernard Madoff was seen by most on Wall Street as a top trader who consistently achieved high returns for his clients while charging very low fees, who was able to maintain his success in both bull and bear markets. In December 2008, he was arrested for what he described as “a giant Ponzi scheme.” Diana B. Henriques & Zachery Kouwe, *U.S. Arrests a Top Trader in Vast Fraud*, N.Y. TIMES, Dec. 12, 2008, at A1 (internal quotation mark omitted). Mr. Madoff had for years been paying returns to certain investors using money he received from other investors. When a few clients sought to make a large withdrawal from their accounts, the scheme collapsed. Losses were estimated to be as high as \$50 billion. *Id.*; see also Diana B. Henriques, *U.S. Proposes 150 Years for Madoff*, N.Y. TIMES, June 27, 2009, at B3.

rule”).¹⁴¹ After he committed suicide, First Securities became bankrupt, and Ernst & Ernst was charged by plaintiff for aiding and abetting Nay’s fraud by not uncovering the mail rule.¹⁴² Ernst & Ernst was not charged with intentional misconduct but rather “inexcusable negligence.”¹⁴³

Once again, the opinion exemplified sound judicial reasoning. The Court first turned to the language of the statute. Section 10 of the 1934 Act makes it illegal “[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance” in contravention of SEC rules.¹⁴⁴ In analyzing this language, the Court concluded that “[t]he words ‘manipulative or deceptive’ used in conjunction with ‘device or contrivance’ strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct.”¹⁴⁵ The Court then looked at the legislative history of the 1934 Act and found little bearing upon the interpretation of § 10.¹⁴⁶ However, what little history existed clearly was not inconsistent with the approach taken by the Court.¹⁴⁷

Much of the opinion addressed and rebutted arguments by the SEC that Rule 10b-5 encompassed negligent conduct. The Court extensively addressed the SEC’s argument that the structure of the securities acts supported § 10 sounding in negligence. The SEC pointed out that § 9(e) requires “willful[] participat[ion]”¹⁴⁸ while § 10(b) is “not by its terms explicitly restricted to will[ing], knowing, or purposeful conduct.”¹⁴⁹ In response, the Court embarked upon its own analysis of the structure of the securities acts.

Looking first to the 1933 Act, the Court noted that the express liability provisions all sounded in negligence,¹⁵⁰ but also contained procedural protections, such as requiring plaintiff to post a bond¹⁵¹ or imposing

141. *Ernst*, 425 U.S. at 190 (internal quotation mark omitted).

142. *Id.* at 189–90.

143. *Id.* at 190 n.5 (internal quotation marks omitted).

144. 15 U.S.C. § 78j(b) (2012).

145. *Ernst*, 425 U.S. at 197.

146. *Id.* at 201–07.

147. In the concluding portion of its opinion, the Court stated: “When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct.” *Id.* at 214.

148. 15 U.S.C. § 78i(f) (2012).

149. *Ernst*, 425 U.S. at 207.

150. Section 11(b), 15 U.S.C. § 77k(b) (2012), imposes almost absolute liability on the issuer, but directors, underwriters, experts and officers who sign the registration statement are not liable if they can establish a due diligence defense. *Ernst*, 425 U.S. at 208 n.26. A similar defense exists under § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2012), and controlling person liability under § 15, 15 U.S.C. § 77o (2012), may be avoided if the control person had no “reasonable ground(s) to believe” in the facts rendering the control person liable. *Ernst*, 425 U.S. at 208 (alteration in original) (internal quotation marks omitted). Basically, a person who can establish that he or she was not negligent will not be liable.

151. *Id.* at 208–10.

a shortened statute of limitation.¹⁵² Because Rule 10b-5 protects buyers as well as sellers, plaintiff-buyers could choose to bring suit under Rule 10b-5, instead of the aforesaid express liability provisions, and thereby short circuit these statutory protections for defendants in the case of negligent wrongdoing. The Court stated:

We think these procedural limitations indicate that the judicially created private damages remedy under §10(b) which has no comparable restrictions—cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by §§ 11, 12(2), and 15 to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.¹⁵³

The Court addressed the 1934 Act provisions in a footnote.¹⁵⁴ Other than § 16(b), which was directed at officers, directors, and ten percent shareholders, and which essentially created absolute liability for “insider” trading encompassed within a six-month period,¹⁵⁵ the Court opined that all other express liability provisions had state of mind conditions. Section 9(e), as stated above, requires willful participation; § 18, dealing with filing misleading statements with the SEC, requires knowledge; and § 20, dealing with controlling person liability, requires that the controlling person “induce” the controlled person’s act.¹⁵⁶ These latter two provisions are actually phrased as affirmative defenses.

In effect, the Supreme Court recognized that, if Rule 10b-5 sounded in negligence, Rule 10b-5, like Sherwin Williams’s paint, could “cover the earth”¹⁵⁷ and make the express liability provisions superfluous.

The SEC also argued that the language of subsections (b) and (c) of Rule 10b-5, standing alone, support a negligence standard.¹⁵⁸ This argument, in part, was also the rationale for the dissent.¹⁵⁹ The majority easily disposed of an argument based upon the language of Rule 10b-5, rather than on the statute, by recounting well-settled administrative law principles. The authority of the SEC to promulgate rules is limited by the rule

152. 15 U.S.C. § 77m (2012).

153. *Ernst*, 425 U.S. at 210 (footnote omitted).

154. *Id.* at 209 n.28.

155. *Id.*; 15 U.S.C. § 78p(b) (2012). The Court apparently saw Congress holding “insiders” to a higher standard than that applicable to persons generally.

156. 15 U.S.C. §§ 78(i)(f), 78(r)(a), 78(t)(a) (2012).

157. SHERWIN-WILLIAMS, <http://www.sherwin-williams.com/> (last visited Apr. 22, 2014) (depicting the company logo containing the slogan “cover the earth”).

158. *Ernst*, 425 U.S. at 212. In *Aaron v. SEC*, 446 U.S. 680, 690 (1980), the Court held that similar language in a statute, § 17 of the 1933 Act, 15 U.S.C. § 77q (2012), sounded in negligence, but the same language in Rule 10b-5 could not because the interpretation of the rule was controlled by the statute, § 10(b).

159. *Ernst*, 425 U.S. at 216–17 (Blackmun, J., dissenting).

making authority conferred by the statute.¹⁶⁰ The rule must implement the statute, not override it. Thus, if the statute gives the SEC power to proscribe fraud, the SEC does not have the power to proscribe negligence. The rule cannot be broader than the authority conferred by the statute. This probably accounts for the half-hearted dissent.

C. Santa Fe: Harmonizing State and Federal Law and Putting Closure on a Federal Law of Corporations

*Santa Fe Industries, Inc. v. Green*¹⁶¹ is the last case in the trilogy of thoughtful and well-crafted conservative decisions limiting the scope of Rule 10b-5. As will be discussed, the policy perspective envisioned in the opinion actually played out in the controversy that gave rise not just to the *Santa Fe* opinion but to two other cases as well.¹⁶²

Santa Fe involved the short form merger of a subsidiary of Santa Fe, Kirby Lumber Corp.,¹⁶³ with another subsidiary of Santa Fe. No vote of the shareholders of Kirby was necessary, but the shareholders were entitled to ten days' notice of the effectiveness of the merger and had the right to dissent and receive the judicially appraised value of their shares.¹⁶⁴ Santa Fe furnished Kirby minority shareholders with an information statement containing an appraisal of the Kirby assets. While the physical assets were appraised at \$640 per share, Morgan Stanley valued the shares at \$125 per share and Santa Fe offered the minority shareholders \$150 per share.¹⁶⁵

Rather than following through on their appraisal rights,¹⁶⁶ plaintiffs in the *Santa Fe* case filed suit under Rule 10b-5, alleging a scheme to defraud the minority shareholders out of the difference between the value of the physical assets and the \$150 per share offered by Santa Fe. Both the district court¹⁶⁷ and the Second Circuit¹⁶⁸ viewed plaintiffs' complaint as presenting two grounds for liability: (1) gross undervaluation, and (2)

160. See *Manhattan Gen. Equip. Co. v. Comm'r*, 297 U.S. 129, 134 (1936) ("A regulation which . . . operates to create a rule out of harmony with the statute, is a mere nullity."); see also *Miller v. United States*, 294 U.S. 435, 439 (1935) (noting an administrative agency cannot create a rule that regulates anything beyond the what Congress enabled it to regulate through the plain meaning of the statute).

161. 430 U.S. 462 (1977).

162. See *infra* text accompanying notes 182-84.

163. Kirby was actually a subsidiary of a subsidiary and another subsidiary was formed which merged into Kirby, such that Kirby was the surviving corporation. The net effect of the corporate machinations was that the majority shareholders of Kirby were cashed out, and Santa Fe now had a wholly owned subsidiary. *Santa Fe*, 430 U.S. at 465.

164. *Id.* at 465-66.

165. *Id.* at 466.

166. Initially, plaintiffs petitioned for appraisal, but then withdrew the petition and filed the federal lawsuit. *Green v. Santa Fe Indus., Inc.*, 391 F. Supp. 849, 855 (S.D.N.Y. 1975), *aff'd in part, rev'd in part*, 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977).

167. *Id.* at 852.

168. *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1285 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977).

squeezing out the minority without a business purpose. Both courts agreed that gross undervaluation without any accompanying misrepresentation or lack of disclosure would not be actionable under Rule 10b-5.¹⁶⁹ Although the district court held that Delaware law did not require a business purpose for a squeeze-out merger,¹⁷⁰ the Second Circuit held that neither misrepresentation nor nondisclosure was necessary for a Rule 10b-5 action:

We hold that a complaint alleges a claim under Rule 10b-5 when it charges, in connection with a Delaware short-form merger, that the majority has committed a breach of its fiduciary duty to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose. The minority shareholders are given no prior notice of the merger, thus having no opportunity to apply for injunctive relief, and the proposed price to be paid is substantially lower than the appraised value reflected in the Information Statement.¹⁷¹

The Supreme Court, in reversing the Second Circuit, took essentially the same tack it took in *Ernst & Ernst*. It first looked to the language of the statute, focusing upon the words “manipulative or deceptive” in conjunction with “device or contrivance,”¹⁷² and then reasserted that a rule cannot exceed the power conferred by Congress pursuant to the statute.¹⁷³ Consequently, the Court concluded that “the claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as ‘manipulative or deceptive.’”¹⁷⁴ Since the district court found that there was no omission or misstatement of a material fact, plaintiffs had no cause of action.¹⁷⁵

The opinion could have concluded at this point but the Court also undertook a *Cort v. Ash*¹⁷⁶ analysis to drive home the point that breaches of fiduciary duty, unaccompanied by deception, are not within a private cause of action under Rule 10b-5. The Court asserted that the “fundamental purpose” of the securities laws was to implement a policy of “full and fair disclosure.”¹⁷⁷ If there is full disclosure, then “the fairness of the

169. 533 F.2d at 1291; 391 F. Supp. at 854.

170. *Compare* Weinberger v. UOP, Inc., 457 A.2d 701, 715 (Del. 1983) (explaining that corporations need not have a valid business purpose when effectuating a merger), *with* Coggins v. New Eng. Patriots Football Club, Inc., 492 N.E.2d 1112, 1119 (Mass. 1986) (holding that under Massachusetts law, defendants must prove (1) the merger was for a legitimate business purpose, and (2) it was fair to the minority), *and* Bryan v. Brock & Blevins Co., 490 F.2d 563, 570 (5th Cir. 1974) (stating that the Georgia Corporation Merger Statute requires corporations to show a valid business purpose for a merger in order to avoid the statute’s anti-fraud provisions).

171. *Green*, 533 F.2d at 1291.

172. *Santa Fe*, 430 U.S. at 472 (internal quotation marks omitted).

173. *Id.* at 472–73.

174. *Id.* at 473–74.

175. *Id.* at 474.

176. *See* 422 U.S. 66, 78 (1975).

177. *Santa Fe*, 430 U.S. at 477–78.

terms of the transaction is at most a tangential concern."¹⁷⁸ Consequently, recognizing a cause of action merely for breach of fiduciary duty is not necessary to fulfill the purposes of the securities laws. Moreover, breach of fiduciary duty is an area traditionally relegated to state law. Accordingly, the Court rejected the possibility that Rule 10b-5 could be used to create a federal law of corporations:

Federal courts applying a "federal fiduciary principle" under Rule 10b-5 could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system. Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.¹⁷⁹

In effect, the Court was harmonizing federal and state law. The purpose of federal law is to promote disclosure.¹⁸⁰ Where, as here, full disclosure is made, there is no federal cause of action. However, if the fully disclosed facts reveal a basis for breach of fiduciary duty or other state remedy, the plaintiff has access to state law for a substantive remedy.

This is exactly what occurred in the *Santa Fe* situation. While plaintiffs in the case before the Supreme Court failed in their federal action because *Santa Fe* made full disclosure, including the fact that the physical assets were worth \$640 per share,¹⁸¹ substantially more than the \$150 per share offered by *Santa Fe*, plaintiffs in two other lawsuits took advantage of this disclosure to initiate appraisal and breach of fiduciary duty actions. In a case filed in Delaware under the appraisal statute, plaintiffs recovered \$254.40 per share;¹⁸² on the other hand, in New York, plaintiffs filed a breach of fiduciary duty case, but were not successful because, as required by Delaware law, there was no fraud, misrepresentation, or blatant overreaching.¹⁸³ Thus, the factual situation demonstrates the workability of *Santa Fe* limiting Rule 10b-5 actions to those involving deception because the disclosure provided by federal law would enable a plaintiff to take advantage of common law remedies.¹⁸⁴

178. *Id.* at 478.

179. *Id.* at 479 (footnote omitted).

180. *Id.* at 477-78.

181. *Id.* at 466.

182. *Bell v. Kirby Lumber Corp.*, 413 A.2d 137, 140 (Del. 1980).

183. *Green v. Santa Fe Indus., Inc.*, 514 N.E.2d 105, 113 (N.Y. 1987) (holding that the plaintiff's acceptance of the offer by *Santa Fe* was not made in reliance on any deception or omission on the part of defendants but was, on the contrary, the result of an informed judgment that resorting to an appraisal proceeding would be too costly and time-consuming).

184. *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1108 (1991), undercut this schema somewhat by not finding maldisclosure actionable when the minority shareholders did not have sufficient votes to defeat the merger proposal. As Justice Kennedy pointed out in his dissent, in this situation there is all the more need for full disclosure. *Id.* at 1118 (Kennedy, J., dissenting). He asserted that the majority had engaged in "a sort of guerilla warfare to restrict a well-established implied right of action." *Id.* at 1115.

The second trilogy, while “curbing” the expansion of Rule 10b-5 litigation, did so in a responsible manner that was consistent with both the policy and the language of the securities laws. The securities laws were designed to protect investors; *Blue Chip Stamps* precluded a “non-investor” from claiming he or she would have bought “but for” some alleged misstatement, while using the benefit of hindsight. *Ernst & Ernst* focused on the language of the statute, asserting that an administrative rule cannot be broader than its statutory authorization. It also harmonized the scope of an implied action with the express civil actions created by Congress. Finally, *Santa Fe* recognized that the focus of the securities laws is upon disclosure, and that a federal action should not lie where the issuer has made full and complete disclosure, even if it has disclosed a breach of fiduciary duty. State and federal law were harmonized since the federal disclosure could provide the information necessary to assert state remedies.

III. THE INSIDER TRADING TRILOGY

The next trilogy of cases, *Chiarella v. United States*,¹⁸⁵ *Dirks v. SEC*,¹⁸⁶ and *Carpenter v. United States*,¹⁸⁷ all dealt with insider trading and represent a significant departure from the sound reasoning reflected in the previous trilogy. They also represent a move toward constraining the scope of Rule 10b-5 in circumstances where its broad application would have furthered the policy of the securities laws. While the previous trilogy put a brake upon the unwarranted expansion of Rule 10b-5, it did so by focusing on the language of the statute, which limits the scope of the rule; moreover, it did so in a manner that was not aimed at permitting fraudulent activity to escape accountability.

On the other hand, as will be demonstrated, the insider trading trilogy and the final trilogy dealing with collateral participants have encouraged illicit activity and undermined the purpose of the securities laws “to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate,”¹⁸⁸ or, as Congress has stated, “to assure that dealing in securities is fair and without undue preferences or advantages among investors.”¹⁸⁹

A. *Chiarella*: *The Start of Retrenchment*

Chiarella dealt with an employee of Pandick Press, a financial printer.¹⁹⁰ He worked on five documents dealing with corporate takeover

185. 445 U.S. 222 (1980).

186. 463 U.S. 646 (1983).

187. 484 U.S. 19 (1987). The Court, in *United States v. O'Hagan*, later accepted the misappropriation theory. 521 U.S. 642, 650 (1997); see *infra* text accompanying note 302.

188. *Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting).

189. H.R. REP. NO. 94-229, at 91 (1975) (Conf. Rep.); S. REP. NO. 94-75, at 3 (1975).

190. 445 U.S. at 224 (majority opinion).

bids and, while the names of the bidder and the target were not disclosed to the printer until the night before the bids were made public, Chiarella was able to discern their identity and make pre-bid purchases at what was then the market price.¹⁹¹ After the takeover bids were made public and the stock price rose, he sold the shares and realized a substantial gain.¹⁹² Chiarella was first investigated by the SEC, and subsequently entered into a consent decree in which he disgorged his profits.¹⁹³ He was then indicted by the U.S. Attorney and convicted on seventeen counts of violating Rule 10b-5.¹⁹⁴ The majority and the dissent viewed the scope of the indictment and the jury instructions from very different perspectives.

According to the Court, the jury, pursuant to the district court's charge, could convict Chiarella if it "found that he willfully failed to inform sellers of target company securities that he knew of a forthcoming takeover bid that would make their shares more valuable."¹⁹⁵ The Court opined that it could not affirm Chiarella's conviction "without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information,"¹⁹⁶ or, in other words, a broad duty to the market as a whole. This the Court refused to do. Instead, it asserted that silence¹⁹⁷ is actionable only where there is a duty to disclose and such a duty arises only from a common law relationship of trust and confidence between the parties to the transaction.¹⁹⁸

The Court's decision is problematic in several respects. First of all, the Court applied what it describes as the "catchall" provision of the 1934 Securities Exchange Act.¹⁹⁹ The reason why the securities laws were enacted was because the common law was inadequate. Yet, the Court used the common law to constrict the scope of the securities laws. This is catch-22 reasoning. The Court opined that, although Rule 10b-5 is a catchall provision, "what it catches must be fraud."²⁰⁰ But there is no question that Chiarella engaged in fraudulent activity. As Chief Justice Burger eloquently stated in his dissent: "Chiarella, working literally in the shadows of the warning signs in the printshop, misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence."²⁰¹

191. *Id.*

192. Over the course of 14 months, Chiarella made a profit of more than \$30,000. *Id.* An attorney who worked on the case told me that the SEC was tipped to Chiarella's activity by a jilted boyfriend who thought his romance was undercut by his rival's new found wealth.

193. *Id.*

194. *Id.* at 225.

195. *Id.* at 226.

196. *Id.* at 233.

197. The court treated this case as a "silence" case since Chiarella made no disclosure before he traded. *Id.* at 226.

198. *Id.* at 230.

199. *Id.* at 226.

200. *Id.* at 234-35.

201. *Id.* at 245 (Burger, C.J., dissenting). Chief Justice Burger also pointed out that:

In this connection, the Court positively cited *Cady, Roberts & Co.*²⁰² to support its position, without appreciating that *Cady, Roberts* in fact undermined its opinion. As discussed earlier, *Cady, Roberts* dealt with a bad news situation in which an insider would sell, very likely, to someone who was not a shareholder.²⁰³ The defendant in *Cady, Roberts* argued that there was not a common law fiduciary duty by a corporate insider to someone who was not a shareholder. On the other hand, the SEC took the position that the securities laws were not constrained by common law concepts.

Cady, Roberts involved a “traditional insider” as tipper and “company-specific” information. Tender offers present a different paradigm. The diagram set forth in Exhibit A illustrates the situation.²⁰⁴ Below the bidder is what is sometimes referred to as “temporary insiders,” such as attorneys and investment bankers. And the relevant information is not company-specific, but rather “market information.”

The majority focused upon the fact that Chiarella had no relationship, and thus no common law duty to the shareholders of the target corporation.²⁰⁵ Chief Justice Burger, with a conservative “tough on crime” perspective, focused upon the fact that Chiarella stole confidential information from his employer to obtain an illicit gain.²⁰⁶ This was the essential difference between the majority and minority positions.

While the Court’s majority, in applying “disclose or abstain,” found an obligation to disclose only when the defendant owed a duty to the person on the other side of the transaction,²⁰⁷ Justice Burger found the duty to disclose became operative because of the illicit manner in which the defendant obtained the information.²⁰⁸ He found support from Professor Keeton:

[The] way in which the buyer acquires the information which he conceals from the vendor should be a material circumstance. The information might have been acquired as the result of his bringing to

Chiarella, himself, testified that he obtained his informational advantage by decoding confidential material entrusted to his employer by its customers [and that Chiarella’s counsel conceded that] . . .

. . . “Mr. Chiarella got on the stand and he conceded, he said candidly, ‘I used clues I got while I was at work. I looked at these various documents and I deciphered them and I decoded them and I used that information as a basis for purchasing stock.’ There is no question about that. We don’t have to go through a hullabaloo about that. It is something he concedes. There is no mystery about that.”

Id. at 244–45.

202. *Id.* at 241–42 (discussing *Cady, Roberts & Co.*, Exchange Act Release No. 34-6668, 1961 WL 60638 (Nov. 8, 1961)).

203. *See supra* text accompanying notes 46–55.

204. *See infra* Exhibit A.

205. *Chiarella*, 445 U.S. at 231 (majority opinion).

206. *Id.* at 244–45 (Burger, C.J., dissenting).

207. *Id.* at 227 (majority opinion).

208. *Id.* at 240 (Burger, C.J., dissenting).

bear a superior knowledge, intelligence, skill or technical judgment; it might have been acquired by mere chance; or it might have been acquired by means of some tortious action on his part. . . . *Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information.*²⁰⁹

Justice Burger also found support in the repeated use of “any” in the statute: section (b) made illegal actions by “any person engaged in any fraudulent scheme,”²¹⁰ and concluded that “congressional concern was [not] limited to trading by ‘corporate insiders’ . . . [and that] Congress cannot have intended one standard of fair dealing for ‘white collar’ insiders and another for the ‘blue collar’ level.”²¹¹

Finally, Justice Burger looked at legislative history which indicated that the purpose of the securities laws was to prohibit “manipulative and deceptive practices which have been demonstrated to fulfill no useful function,”²¹² and to “assure that dealing in securities is fair and without undue preferences or advantages among investors.”²¹³ He then concluded that: “An investor who purchases securities on the basis of misappropriated nonpublic information possesses just such an ‘undue’ trading advantage; his conduct quite clearly serves no useful function except his own enrichment at the expense of others.”²¹⁴

Justice Burger’s approach makes more sense than that of the majority, which is predicated upon the existence, or lack thereof, of a common law fiduciary duty. Since the securities laws were enacted because of the shortcomings of the common law in dealing with securities fraud, why then look to the common law to interpret the securities laws? On the other hand, Justice Burger was guided by the policy behind the securities laws. As the SEC stated in *Cady, Roberts*, in view of the “broad language of the anti-fraud provisions[,] we are not to be circumscribed by fine distinctions and rigid classifications.”²¹⁵ Accordingly, the SEC concluded:

Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to intro-

209. *Id.* (alteration in original) (quoting W. Page Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 25–26 (1936)).

210. *Id.*

211. *Id.* at 240–41.

212. *Id.* at 241 (quoting S. REP. NO. 73-792, at 6 (1934)) (internal quotation mark omitted).

213. *Id.* (quoting H.R. REP. NO. 94-229, at 91 (1975) (Conf. Rep.)) (internal quotation mark omitted).

214. *Id.*

215. *Cady, Roberts & Co.*, Exchange Act Release No. 34-6668, 1961 WL 60638, at *4 (Nov. 8, 1961).

duce these into the broader anti-fraud concepts embodied in the securities acts.²¹⁶

Justice Burger's position is not quite a "possession" standard. But it is not burdensome to expect that corporate insiders and securities professionals should know that it is illegal for them to trade on material, non-public information. The doctrine of scienter would limit the persons subject to liability. This, of course, would make it easier to surmount a motion to dismiss, whereas Justice Burger sought to encourage disposing of litigation on a motion to dismiss in *Blue Chip Stamps*.

The majority may have been led astray by the inept phrase "disclose or abstain," which originated in the *Texas Gulf Sulphur* case.²¹⁷ The fallacy with phrasing the duty as disclose or abstain is that, invariably, the person subject to this adage has a duty not to disclose. For example, in *Texas Gulf Sulphur*, the employees had a duty to their employer not to disclose while the corporation assessed the scope of the discovery and obtained additional mineral rights. Thus, the employee did not have the option of disclosing or abstaining.²¹⁸

The Second Circuit should have articulated the employees' obligation as "abstain until disclosable." If that were the jargon with which the federal courts were grappling, the Supreme Court might have upheld Chiarella's conviction since this latter standard does not implicate any duty to the shareholders of the target company. Holding a person like Chiarella accountable for stealing his employer's information in order to obtain an informational advantage is certainly consistent with the securities law policies recounted by Justice Burger.

In the long run, Justice Burger's position prevailed. His closing comment that Chiarella stole valuable nonpublic information that was entrusted to him²¹⁹ became the basis for the misappropriation theory.²²⁰ A year later, the misappropriation theory was the basis of a conviction in *United States v. Newman*,²²¹ and four years later, in a case involving facts that were a clone of those in *Chiarella*, the conviction of an employee of a financial printing firm was upheld on the basis that he "misappropriated—stole to put it bluntly—valuable nonpublic information" entrusted to him by his employer.²²²

216. *Id.* at *5.

217. See *supra* text accompanying notes 35–45.

218. The *Dirks v. SEC*, 463 U.S. 646 (1983), discussion, *infra* note 243, is one of the rare instances where "disclose or abstain" might actually work.

219. *Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting).

220. See *id.* (Blackmun, J., dissenting).

221. 664 F.2d 12, 17 (2d Cir. 1981).

222. *SEC v. Materia*, 745 F.2d 197, 201 (2d Cir. 1984) (internal quotation marks omitted).

B. Dirks: A Clear Policy Choice Favoring Greed over Investors

1. The Basic Facts

*Dirks v. SEC*²²³ involved a very strange and convoluted set of facts, which may, in part, account for the divergence between the majority and minority opinions.²²⁴ It is as if the members of the Supreme Court were watching two different movies: the majority seeing a hero and the dissent seeing a villain.

The underlying facts were close to unbelievable. Equity Funding was an insurance company that sought to increase its earnings.²²⁵ Unfortunately, not enough real people were buying its policies. So, it began creating people, who then bought policies so as to increase revenue.²²⁶ Management understood that, in the insurance business, there are both inflows and outflows, as people die and the beneficiaries collect on the policies. Consequently, Equity Funding also killed some people—fortunately, these persons were only fictitious to begin with.²²⁷

In early 1973, a disgruntled former executive, Ronald Secrist, tipped Raymond Dirks, an officer of a broker-dealer firm who specialized in insurance company securities, about the scam and asked him to publicize it.²²⁸ Secrist estimated that, by 1972, Equity Funding had 40,000 fictitious policies, about one-third of its business.²²⁹ Dirks interviewed Equity Funding employees and, although management denied the charges, some employees corroborated Secrist's story.²³⁰

Dirks then took two divergent courses of action. He disclosed what he had learned to a number of clients and investors, including five institutional investors that subsequently liquidated more than \$16 million in

223. 463 U.S. 646 (1983).

224. *See id.* at 648–52.

225. *See id.* at 649.

226. *Dirks v. SEC*, 681 F.2d 824, 829 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983).

227. The SEC found:

Since 1970, EFCA had been creating fictitious life insurance policies, known to insiders as "Y business." These policies were sold to reinsurers for an amount equal to 80% of first-year premiums. By this method, management hoped to generate cash flow, maintain an impressive growth rate and boost the value of EFCA stock. In some cases, legitimate policies were reinsured for more than their face amount, while at other times totally fictitious policies were created. To carry out this scheme, EFCA created supporting files, medical records and death certificates for non-existent policy holders, bribed and intimidated some of its auditors and state examiners, and falsified its financial records to show the receipt and disposition of non-existent premiums. Secrist claimed that he had actually witnessed the creation of fictitious files which were used to deceive EFCA's auditors. He asserted that, as a result of such activities, many EFCA employees had left the company. He estimated that, by 1972, EFCA carried at least 40,000 fictitious policies on its books, representing at least one-third of EFCA's outstanding life insurance business.

Raymond L. Dirks, Exchange Act Release No. 34-17480, 1981 WL 36329, at *2 (Jan. 22, 1981) (footnotes omitted).

228. *Id.* at *1–2.

229. *Id.* at *2.

230. *Dirks*, 463 U.S. at 649.

Equity Funding investments.²³¹ As the SEC opinion chronicles, Dirks had numerous conversations with these investors and even arranged contacts between them and former employees of Equity Funding. Dirks also opined that Equity Funding stock would soon stop trading and that the stock should be sold.²³² In return, Dirks received additional business; the majority and minority took differing views as to the effect of this upon Dirks's motivation.²³³

However, Dirks also contacted Equity Funding's auditors and the Wall Street Journal, which, after following up on Dirks's information, contacted the SEC and the SEC then called Dirks in.²³⁴ The majority asserts then the Wall Street Journal declined to write the story,²³⁵ while the dissent asserts that the Wall Street Journal investigated and informed the SEC.²³⁶ The same day Dirks met with the SEC, March 27, 1973, the New York Stock Exchange suspended trading because of the increased trading volume and the precipitous drop in price from \$26 per share to \$15.²³⁷ Also at this time, the California and Illinois Departments of Insurance were investigating Equity Funding and were preparing to shut down its operations.²³⁸

2. The Divergent Views of the Majority and Minority

In view of the foregoing facts, consider the differing approaches of the majority and minority. According to the majority, the SEC had "concluded" in disciplining Dirks that: "Where 'tippees'—regardless of their motivation or occupation—come into possession of material . . . 'information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading."²³⁹

While the foregoing quotation is found in the SEC's opinion, it is not the conclusion or holding of the SEC. Rather the SEC concluded:

231. *Id.*

232. *Dirks*, 1981 WL 36329, at *5.

233. The majority focused upon the SEC finding that Dirks "played an important role in bringing [Equity Funding's] massive fraud to light," *Dirks*, 463 U.S. at 651–52 (alteration in original) (internal quotation marks omitted), while the dissent focused upon the fact that Dirks and his firm "gained both monetary rewards and enhanced reputations for 'looking after' their clients," *id.* at 669 n.4 (Blackmun, J., dissenting), by enabling them to "dump[] stock on unknowing purchasers." *Id.* at 671.

234. *Id.* at 670.

235. *Id.* at 649–50 (majority opinion).

236. *Id.* at 670 (Blackmun, J., dissenting).

237. *See id.*

238. In 1983, I was Deputy Attorney General for Illinois, and Illinois insurance officials informed me that they and the California officials were preparing a "raid" on the offices of Equity Funding at the time the story broke.

239. *Dirks*, 463 U.S. at 651 (majority opinion) (quoting Raymond L. Dirks, Exchange Act Release No. 34-17480, 1981 WL 36329, at *6 (Jan. 22, 1981)).

In sum, Dirks [an analyst] came into possession of material, non-public corporate information, from persons who he knew were insiders, at a time when he knew that the information was confidential and not then publicly available. He communicated that information to those likely to trade before the information became generally available. In committing these acts, Dirks acted with scienter. Accordingly, we conclude that Dirks willfully aided and abetted violations by Boston, Dreyfus, TZP, M&N and Bristol of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10-5b thereunder.²⁴⁰

There are two fundamental differences between the two “conclusions.” The SEC did not rely on “disclose or abstain,” but rather found Dirks liable as an aider and abettor because he disclosed confidential information to persons who would sell before the information would be publicly available. In this regard, the SEC opinion was a forerunner of Rule 10b5-2(b)(2).²⁴¹

Second, the SEC clearly focused upon scienter. This is a key element in insider trading—one that provides the proper bounds to limit the scope of persons who are subject to the insider trading proscriptions. Dirks was a securities professional who knew the information was material,²⁴² knew the information was non-public, knew that it was given to him in confidence to publicly disclose, and knew that his tippees would sell before public disclosure.²⁴³

The Court began its analysis of the issues raised by the SEC sanctioning of Dirks by again referencing *Cady, Roberts* as a seminal case, once again without realizing that the *Cady, Roberts* decision sanctioned a securities professional who was tipped by an insider who did not “sin”;

240. *Dirks*, 1981 WL 36329, at *9.

241. See 17 C.F.R. § 240.10b5-2(b)(2) (2013) (promulgated in Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, Securities Exchange Act Release No. 34-43154, Investment Company Act Release No. 24599, 73 SEC Docket 3 (proposed Aug. 15, 2000)).

242. As the SEC stated:

The inside information to which Dirks had become privy demonstrated, in the words of one commentary, that “one of the darlings of Wall Street, a company that had managed to produce continued high earnings growth for a decade, was, instead, a gigantic fraud.” Under the circumstances, it took little insight into the operations of the market—and Dirks was, of course, a highly experienced and highly sophisticated analyst—to recognize that anyone who held EFCA shares and became aware of the information in Dirks’ possession would have a strong incentive to sell before that knowledge became widespread. Indeed, Dirks expressly advised at least one of those whom he tipped to sell, and he observed that others did so, even without an explicit recommendation, based on his revelations. Accordingly, we find that Dirks knew or should have known that his selective disclosure of the information he had gleaned from EFCA insiders would result in trading.

Dirks, 1981 WL 36329, at *9 (footnotes omitted).

243. Parenthetically, this is one of the rare times that “disclose or abstain” made sense: Dirks did have the option (if not the obligation) to disclose publicly the confidential information he had received. Absent such a disclosure, he had the obligation to abstain.

in other words, *Cady, Roberts* was in direct opposition to the approach ultimately taken by the Court in *Dirks*.²⁴⁴

The Court, in Part II of the *Dirks* opinion, accepted the concept set forth in *Cady, Roberts* that, for there to be a violation of Rule 10b-5 in an insider trading context, two elements must be met: “(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.”²⁴⁵

But, relying on *Chiarella*, the Court asserted that “‘a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.’ Such a duty arises rather from the existence of a fiduciary relationship.”²⁴⁶

Again, *Cady, Roberts* rejected the argument that a duty under the securities laws derived from common law fiduciary concepts.²⁴⁷

The Court concluded Part II of its opinion by affirming the *Cady, Roberts* principle that “an insider will be liable under Rule 10b-5 for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes ‘secret profits.’”²⁴⁸

At this point it is not clear where the Court is going. But the Court then runs amuck in Part III, beginning its analysis by recognizing that a “typical tippee” generally has no common law fiduciary relationship with the corporation.²⁴⁹ The SEC had taken the position that a tippee who receives confidential non-public material information from an insider is subject to the same constraints as the insider.²⁵⁰ Following *Chiarella*, the Court *rejected* the proposition that “[*anyone*]—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose.”²⁵¹ However, it did acknowledge: “[t]he conclusion that recipients of inside information do not invariably acquire a duty to dis-

244. *Cady, Roberts & Co.*, Exchange Act Release No. 34-6668, 1961 WL 60638, at *2 (Nov. 8, 1961).

245. *Dirks v. SEC*, 463 U.S. 646, 653–54 (1983) (quoting *Chiarella v. United States*, 445 U.S. 222, 227 (1980)) (internal quotation marks omitted).

246. *Id.* at 654 (citation omitted).

247. As the SEC stated:

Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.

Cady, Roberts, 1961 WL 60638, at *5.

248. *Dirks*, 463 U.S. at 654 (quoting *Cady, Roberts*, 1961 WL 60638, at *6 n.31).

249. *Id.* at 655.

250. *Id.* at 655–56.

251. *Id.* at 656 (alteration in original) (quoting *United States v. Chiarella*, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980)) (internal quotation marks omitted).

close or abstain does not mean that such tippees always are free to trade on the information. The need for a ban on some tippee trading is clear.”²⁵²

What is the “some tippee trading” that is forbidden? According to the Court:

Thus, some tippees must assume an insider’s duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*. And for Rule 10b-5 purposes, the insider’s disclosure is improper only where it would violate his *Cady, Roberts* duty. Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.²⁵³

Besides inferring that insider trading liability is the exception rather than the rule by repeated use of “some,” the Court then waffled on when an insider breaches his fiduciary duty of non-disclosure: “All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders.”²⁵⁴ Consequently, “the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.”²⁵⁵ Consequently, the tippee sins only if the tipper sins, and the tipper sins only when he or she receives a benefit from the tippee.

As indicated above, the dissent had an entirely different view of both the law and the facts. With respect to the facts, the dissent observed, “In disclosing . . . [inside] information to Dirks, Secrist intended that Dirks would disseminate the information to his clients, those clients would unload their Equity Funding securities on the market, and the price would fall precipitously, thereby triggering a reaction from the authorities.”²⁵⁶

The dissent also focused upon the fact that Dirks was compensated for “looking after” his clients²⁵⁷ and that his efforts to bring the fraud to

252. *Id.* at 659.

253. *Id.* at 660 (footnote omitted).

254. *Id.* at 661–62.

255. *Id.* at 662.

256. *Id.* at 669 (Blackmun, J., dissenting). The dissent also opined:

But this is precisely what Secrist did. Secrist used Dirks to disseminate information to Dirks’ clients, who in turn dumped stock on unknowing purchasers. Secrist thus intended Dirks to injure the purchasers of Equity Funding securities to whom Secrist had a duty to disclose. Accepting the Court’s view of tippee liability, it appears that Dirks’ knowledge of this breach makes him liable as a participant in the breach after the fact.

Id. at 671 (footnote omitted).

257. *Id.* at 669 n.4 (internal quotation marks omitted).

light were “feeble.”²⁵⁸ Dirks informed his clients before making any attempt to contact the SEC. To the minority, Dirks was no hero who brought to light a fraud, which otherwise might have gone undiscovered,²⁵⁹ but, rather, a market professional who knew his actions would injure most of the shareholders²⁶⁰ while enabling his clients to avoid a major loss.²⁶¹

With respect to the law, the dissent, responding to the majority’s holding that Dirks was not liable because Secrist did not obtain any personal benefit and thus did not violate his duty to Equity Funding, stated that “the Court imposes a new, subjective limitation on the scope of the duty owed by insiders to shareholders. The novelty of this limitation is reflected in the Court’s lack of support for it.”²⁶² The dissent asserted that “[t]he fact that the insider himself does not benefit from the breach does not eradicate the shareholder’s injury.”²⁶³ According to the dissent, “[t]he duty is addressed not to the insider’s motives, but to his actions and their consequences on the shareholder. Personal gain is not an element of the breach of this duty.”²⁶⁴ The scope of the duty is circumscribed by the requirement of scienter.

3. The Failed Policy Chosen by the Majority in *Dirks*

Consider now the differing opinions from a policy standpoint. In this case, there were two interests in conflict: those of the shareholders and the investing public that bought from Dirks’s tippees, on the one hand, and those of analysts and others who wished to take advantage of non-public information they had obtained, on the other hand. The purpose of the securities laws in general is to insure “the maintenance of fair and honest markets,”²⁶⁵ and of § 10 in particular to support “the public interest” and insure “the protection of investors.”²⁶⁶ Consequently, whose interests should the Supreme Court consider paramount: (a) those of Dirks and his tippees who saved millions of dollars by bailing out early on the basis of material non-public information, or (b) those of (i) the shareholders, who were unaware of Dirks’s information and suffered the precipitous drop in price, and (ii) the investors, who bought from the

258. *Id.* at 670.

259. As stated earlier, state officials were in the process of shutting down Equity Funding’s scam. See *supra* note 238; *Dirks*, 463 U.S. at 668–69 (Blackmun, J., dissenting).

260. Once disclosure is publicly made, all shareholders have a comparable opportunity to sell as the price declines. As a result of Dirks’s actions, the uninformed shareholders were not informed until after the stocks had plummeted. *Id.* at 669–70.

261. *Id.* at 670.

262. *Id.* at 671.

263. *Id.* at 673. The dissent added: “It makes no difference to the shareholder whether the corporate insider gained or intended to gain personally from the transaction; the shareholder still has lost because of the insider’s misuse of nonpublic information.” *Id.* at 674.

264. *Id.* at 674 (footnote omitted).

265. 15 U.S.C. § 78b (2012).

266. 15 U.S.C. § 78j (2012).

tippee institutions only to find that they owned stock in a defunct company?

While the majority favored the analysts and institutions that wanted to make a fast buck, the dissent championed the uninformed shareholders and investors. For the majority, opportunists are favored over the investing public. This is a pattern that continued through the fourth trilogy in *Central Bank*, *Stoneridge Investment Partners*, and *Janus Capital*.²⁶⁷

The majority in *Dirks*, as it continued its pattern of cutting back on the scope of Rule 10b-5, was overly enamored of the importance of analysts to the functioning of the securities markets. The majority rejected the SEC position that those receiving material, non-public information from a corporate insider had a duty to disclose or abstain (more properly, abstain until disclosed) on that basis that such an approach “could have an inhibiting influence on the role of market analysts.”²⁶⁸ According to the majority:

It is commonplace for analysts to ‘ferret out and analyze information,’ and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation’s securities. The analyst’s judgment in this respect is made available in market letters or otherwise to clients of the firm.²⁶⁹

The Court opined—erroneously as we will see²⁷⁰—that “[i]t is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation’s stockholders or the public generally.”²⁷¹ While the majority recognized that *Dirks*’s startling information “required no analysis,”²⁷² it opined that “the principle at issue here extends beyond these facts.”²⁷³

In taking this position, the Court was not embodying a conservative approach because the majority focused not upon the facts of the case before it, but rather “legislated,” as it did in *Blue Chip Stamps*,²⁷⁴ to solve a problem not then presented to the Court. Moreover, the majority opinion reflects a lack of understanding of the corporation’s role in disclosing material information and the analyst’s role in uncovering information.

267. See *infra* Part IV.

268. *Dirks*, 463 U.S. at 658 (majority opinion).

269. *Id.* at 658–59 (footnote omitted) (citation omitted).

270. See *infra* text at notes 275–76.

271. *Dirks*, 463 U.S. at 659.

272. *Id.* at 658 n.18.

273. *Id.*

274. See *supra* text accompanying note 128–32.

Contrary to the opinion, it is possible to disclose material information in a public fashion. The SEC has adopted Regulation F-D,²⁷⁵ which requires that when a corporation or a person acting on its behalf discloses material, non-public information, it shall simultaneously disclose such information to the public or, in the case of inadvertent disclosure, as promptly as possible.²⁷⁶

With respect to the proper role of analysts, the SEC opinion in *Dirks* should have provided insight to the Supreme Court as to what a legitimate analyst actually does:

In this connection, it is important to recognize that this is not a case in which a skilled analyst weaves together a series of publicly available facts and non-material inside disclosures to form a “mosaic” which is only material after the bits and pieces are assembled into one picture. We have long recognized that an analyst may utilize non-public, inside information which in itself is immaterial in order to fill in “interstices in analysis.” That process is legitimate even though such “tidbits” of inside information “may assume heightened significance when woven by the skilled analyst into the matrix of knowledge obtained elsewhere,” thereby creating material information.²⁷⁷

The SEC opinion, while recognizing the importance of an analyst’s work and the legitimacy of tracking down rumors, concluded that “the analyst’s role, like that of any other person, is constrained by the well-established proscriptions of the antifraud provisions of the federal securities laws, and we cannot condone the unfairness inherent in the selective dissemination of material, inside information prior to its public disclosure.”²⁷⁸

Clearly the position of the SEC and the dissent is true to the purposes of the securities laws, while the position of the majority undercuts the protection of investors.

Subsequent events in the 2000s have brought into question the integrity of the analyst community and the quality of its analysis. Enron was a highly-touted stock that also was the darling of the analysts until Bethany McLean questioned its business model and earnings.²⁷⁹ Thereafter, Enron’s scam was revealed and its stock became worthless.²⁸⁰ Later, after the dot-com bubble burst, New York Attorney General Eliot Spitzer uncovered a flood of recommendations by analysts touting stocks for the

275. 17 C.F.R. § 243.100 (2013).

276. 17 C.F.R. § 243.100(a) (2013).

277. Raymond L. Dirks, Exchange Act Release No. 34-17480, 1981 WL 36329, at *7 (Jan. 22, 1981) (footnote omitted).

278. *Id.* at *10.

279. Bethany McLean, *Is Enron Overpriced?*, FORTUNE, Mar. 5, 2001, available at http://money.cnn.com/2006/01/13/news/companies/enronoriginal_fortune/.

280. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002).

public to buy that they were at the same time disparaging as “crap” to their colleagues.²⁸¹ Their motivation frequently was to obtain underwriting commitments for the investment banking side of their firm.²⁸² Sometimes the motivation was merely to get a daughter into nursery school.²⁸³ The Court should no longer be overly solicitous about holding analysts to account.

4. The Problem of Tone, the Explosion of Insider Trading, and the Congressional Response

In the course of the *Dirks* opinion, the Court asserted:

1. “[O]nly some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information.”²⁸⁴
2. “Judge Wright correctly read our opinion in *Chiarella* as repudiating any notion that all traders must enjoy equal information before trading.”²⁸⁵
3. “[T]he disclose-or-refrain duty is extraordinary.”²⁸⁶
4. “[A] duty [to disclose] arises . . . not merely from one’s ability to acquire information because of his position in the market.”²⁸⁷
5. “All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders.”²⁸⁸
6. “Absent some personal gain, there has been no breach of duty to stockholders.”²⁸⁹

281. See Christopher Lucas, Note, *The Triangle Shirtwaist Fire and the Merrill Lynch Analyst Ratings Scandal: Legislative and Prosectorial Responses to Corporate Malfeasance*, 1 BROOK. J. CORP. FIN. & COM. L. 449, 463–64 (2007) (Spitzer found emails describing stock as “a POS [piece of shit]” from an analyst that publicly described that same stock as “an attractive investment” (alteration in original) (internal quotation marks omitted)); Joseph Nocera & Abraham Lustgarten, *Wall Street on the Run*, FORTUNE, June 14, 2004, available at http://money.cnn.com/magazines/fortune/fortune_archive/2004/06/14/372633/ (explaining the settlements reached between the New York attorney general and Wall Street investment banks after Spitzer learned of analysts’ routine betrayal of investors); Complaint ¶ 86, SEC v. Blodget, No. 03 Civ.2947(WHP), 2004 WL 435059 (S.D.N.Y. Mar. 10, 2004), available at <http://www.sec.gov/litigation/complaints/comp18115b.htm> (explaining that the public research reports by analysts were inconsistent with the analysts’ privately expressed negative views).

282. See Pat Huddleston II et al., *Protect Investors from Brokers’ Stock Scams*, TRIAL, Apr. 2003, at 38 (explaining that analysts recommended stocks in order to secure investment-banking business, with no regard for the true financial conditions of the corporations).

283. Gretchen Morgenson & Patrick McGeehan, *Wall St. and the Nursery School: A New York Story*, N.Y. TIMES, Nov. 14, 2002, at A1.

284. *Dirks v. SEC*, 463 U.S. 646, 657 (1983).

285. *Id.*

286. *Id.*

287. *Id.* at 657–58 (second alteration in original).

288. *Id.* at 661–62.

289. *Id.* at 662.

7. “*Chiarella* made it explicitly clear there is no general duty to forgo market transactions ‘based on material, nonpublic information.’”²⁹⁰

8. “In one sense, as market values fluctuate and investors act on inevitably incomplete or incorrect information, there always are winners and losers; but those who have ‘lost’ have not necessarily been defrauded.”²⁹¹

These observations created a tone that arguably contributed to a rash of insider trading that followed the *Chiarella* and *Dirks* decisions in the 1980s. A Wall Street Journal reporter in *Den of Thieves* extensively chronicled the upsurge in insider trading.²⁹² Correlation does not mean causation but pronouncements such as those made by the Supreme Court could well have led to disdain by many in the investment banking community toward any proscription against insider trading. There is no question that insider trading increased markedly in the 1980s. In 1984, a Congressional Report opined that “[i]nsider trading has become a more widespread problem in recent years,” and the SEC “has brought more such cases during the past four years than in all previous years combined.”²⁹³ The Report also opined that “if the *Dirks* decision is properly and narrowly construed by the courts, the Commission’s insider trading program will not be adversely affected.”²⁹⁴

In response to the surge of insider trading, Congress twice took action in an attempt to curtail this activity: in 1984, with the Insider Trading Sanctions Act,²⁹⁵ and in 1988, with the Insider Trading and Securities Fraud Enforcement Act.²⁹⁶ The 1984 Act incorporated a potential treble damage liability for those who engaged in insider trading.²⁹⁷ Decisions by the circuit courts first had looked askance at the “draconian” liability when damages were measured, not by the benefit to the guilty party but by the loss suffered by all investors who traded contemporaneously,²⁹⁸ and then limited recovery to the benefits obtained by a defendant who illegally traded.²⁹⁹ The problem with merely requiring the defendant to

290. *Id.* at 666 n.27 (quoting *Chiarella v. United States*, 445 U.S. 222, 233 (1980)).

291. *Id.*

292. *See generally* JAMES B. STEWART, *DEN OF THIEVES* (1991).

293. H.R. REP. NO. 98-355, at 5 (1983).

294. *Id.* at 15.

295. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264.

296. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677.

297. Insider Trading Sanctions Act of 1984 § 2(A).

298. In *Fridrich v. Bradford*, one insider’s profit was \$13,000 but was subjected by the district court to a judgment of \$361,186.75. 542 F.2d 307, 308 (6th Cir. 1976). In reversing the lower court, the Sixth Circuit characterized this as “Draconian liability.” *Id.* at 309 (internal quotation marks omitted). The concurring opinion suggested that liability only attach to those plaintiffs who traded “contemporaneously” with the insider. *Id.* at 327 (Celebrezze, J., concurring). The 1988 Act adopted this approach. Insider Trading and Securities Fraud Enforcement Act of 1988 § 3(b). *Fridrich* also questions whether an insider who did not abstain “caused” the party on the other side of the transaction to trade. *Fridrich*, 542 F.2d at 323.

299. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 173 (2d Cir. 1980).

disgorge his or her profits is that there is no downside (other than a potential criminal sanction) to engaging in insider trading. If you do not get caught, you win; if you do get caught, you merely return your ill-gotten gain. To put additional teeth into insider trading enforcement, the SEC requested, and Congress conferred, the treble damage penalty provision.

Notwithstanding this new enforcement tool, in 1988 another Congressional Report asserted that "the last few years have seen a dramatic increase in insider trading cases, including cases against some of the most prominent officials in Wall Street investment banking firms."³⁰⁰ Accordingly, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988. This act expanded the civil penalty provision to include broker-dealers, investment advisors and others who failed to take appropriate steps to prevent insider trading by incorporating the prior penalty provisions into a new § 21A of the 1934 Act.³⁰¹ Because the logic of the *Fridrich v. Bardford* decision³⁰² had effectively undercut the causation aspect of private insider trading litigation, Congress resuscitated this cause of action by providing for insider liability to contemporaneous traders.³⁰³ But as damages were limited by the insiders benefit, there has been little incentive to utilize this provision unless the insider's gain was very substantial.

C. Carpenter: *The Uncertain Status of the Misappropriation Theory*

*Carpenter v. United States*³⁰⁴ was another case involving unusual facts. David Carpenter, a roommate of R. Foster Winans, was a bit player in a fraud concocted by Winans and Peter Brandt, a distinguished broker with Kidder Peabody.³⁰⁵ Winans wrote an influential column, "Heard on the Street," for the Wall Street Journal. In his column, Winans applauded certain stocks and downplayed others. Stocks frequently rose after a positive column and fell after a negative one. Winans tipped Brandt as to the publication date and nature of the column and Brandt would buy before a positive column and go short before a negative one.³⁰⁶ After the column was published and the stock moved, Brandt would close out the transaction. Over a four-month period, the scheme netted almost \$700,000.³⁰⁷

300. H.R. REP. NO. 100-910, at 11 (1988).

301. Insider Trading and Securities Fraud Enforcement Act of 1988 § 21A.

302. *Fridrich*, 542 F.2d at 318-20, 323.

303. Insider Trading and Securities Fraud Enforcement Act of 1988 § 20A.

304. 484 U.S. 19 (1987).

305. Kenneth Felis, another participant in scheme, was also a broker at Kidder Peabody. *Id.* at 20-22.

306. The story of the scheme is detailed in Winans's book. R. FOSTER WINANS, *TRADING SECRETS: AN INSIDER'S ACCOUNT OF THE SCANDAL AT THE WALL STREET JOURNAL* (1986). From reading the book, one could glean that the purpose was to punish Peter Brandt, an unscrupulous social climber, who was the chief prosecution witness against Winans and the other defendants. *See Broker in Winans Case Is Sentenced*, N.Y. TIMES, Feb. 27, 1988, at 137.

307. *Carpenter*, 484 U.S. at 23.

In 1987, the decision of the Supreme Court in the pending case of *Carpenter* was eagerly awaited.³⁰⁸ There were some who argued that insider trading was a “victimless crime,” that it moved the stock market in the “correct” direction, that prohibiting it was bad policy,³⁰⁹ and that it was an appropriate way to compensate entrepreneurs and corporate management.³¹⁰ On the other hand, there was hope that the Supreme Court would affirm the misappropriation theory that Justice Burger had articulated in his dissent in *Chiarella*.³¹¹ The decision turned out to be anticlimactic, however, since the Court affirmed the convictions under Rule 10b-5 due to the Court splitting 4:4 on this issue.³¹² The 4:4 split was occasioned by the difficulty some Justices had in accepting that the fraud against the *Wall Street Journal*, namely misappropriating its printing schedule to “time” the trading, was “in connection with” a securities transaction.

It was not until ten years later that the Court upheld the misappropriation theory under Rule 10b-5 and affirmed the conviction of an attorney in a law firm that represented the bidder in a potential takeover.³¹³ The attorney had purchased stock and call options of the target company based upon his knowledge of the pending transaction. When the stock rose dramatically after the tender offer was announced, the attorney made more than \$4.3 million.³¹⁴

In *United States v. O’Hagan*, Justice Scalia dissented on the basis that § 10(b) requires the “manipulation or deception of a party to a securities transaction,”³¹⁵ while Justice Thomas, joined by Chief Justice Rehnquist, dissented on the basis that the majority opinion and the SEC

308. See, e.g., Stuart Taylor, Jr., *Winans Case Taken by Justices*, N.Y. TIMES, Dec. 16, 1986, at D1; James B. Stewart, *Death of a Theory? Supreme Court May Revamp Insider-Trading Law*, WALL ST. J., Sept. 30, 1987.

309. Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 935–37 (1985) (internal quotation marks omitted). For a later view of this thinking, see Donald J. Boudreaux, *Learning to Love Insider Trading*, WALL ST. J., Oct. 24, 2009, at W1.

310. I offered to debate Professor Manne on this point at his Law and Economics program at Dartmouth College. He declined. To rebut his position, consider *Diamond v. Oreamuno*, where two entrepreneurs, knowing that earnings would drop sharply because of a sharp increase in costs, sold 56,000 shares at \$28; the market dropped to \$11 when the adverse earnings were announced. 248 N.E.2d 910, 911 (1969). Is this appropriate compensation?

Nor is insider trading victimless. The conceptual problem is that the injury is to the same side of the market. The person on the other side of the transaction actually benefits because, if buying, the sale by the insider drops the price, whereas, if selling, the purchase by the insider raises the price. But the person on the same side as the insider is always “late to the party.” In *Oreamuno*, the insider got out at \$28, whereas the public could only sell at \$11. If disclosure were first made, the insider would need to compete with other sellers to get out as the market began to plunge. It is likely that an exchange would stop trading until the market digested the news and all would then have equal opportunity at the new price.

311. See *supra* Part III.A.

312. The Court unanimously affirmed the convictions under the mail and wire fraud statute. *Carpenter*, 484 U.S. at 24.

313. *United States v. O’Hagan*, 521 U.S. 642, 642–44 (1997).

314. *Id.*

315. *Id.* at 679 (Scalia, J., dissenting).

failed "to provide a coherent and consistent interpretation" of the "in connection with" requirement.³¹⁶ In particular, they found inconsistent the position that a misappropriation of information would give rise to a Rule 10b-5 action, but a misappropriation of money would not.³¹⁷ The distinction drawn by the majority was that the fraud regarding information occurs when the information is wrongfully used, whereas the fraud in misappropriating money occurs at the time of embezzlement, irrespective of whether the money is later used to purchase securities.³¹⁸

There is another weakness in the misappropriation theory that was recognized by the Second Circuit in *Carpenter*. Because Winans's fraud was converting the information of his employer as to printing schedules, the court observed that "the *Wall Street Journal* or its parent, Dow Jones Company, might perhaps lawfully disregard its own confidentiality policy by trading in the stock of companies to be discussed in forthcoming articles."³¹⁹ But the court felt assured that "a reputable newspaper, even if it could lawfully do so, would be unlikely to undermine its own valued asset, its reputation, which it surely would do by trading on the basis of its knowledge of forthcoming publications."³²⁰

That this would even be an issue illustrates the absurdity of relying upon a common law duty to a person or entity that is not a party to a securities transaction to bring a lawsuit based upon, or "in connection with," a securities transaction. This in turn illustrates the absurdity in *Chiarella* of requiring a common law duty to the person on the other side of the transaction in order to establish deceit. How much more sensible would the law have been if *Chiarella* had truly followed *Cady, Roberts* and rejected reliance on common law principles, reframed "disclose or abstain" to "abstain until disclosable," and recognized that market professionals have such a duty when they knowingly [scienter] trade on material, non-public information?

The cases in this third trilogy reflect a reactionary approach by the Supreme Court. The policy of the securities laws was given lip-service, but basically ignored. A well-reasoned decision, such as *Cady, Roberts*, was cited to support the Court's decision when, in fact, it was diametrically opposed to the rationale in both *Chiarella* and *Dirks*. The Court took the inept phrasing in *Texas Gulf Sulfur*—"disclose or abstain"—and constrained its application by appending to it a common law duty requirement. A flood of insider trading ensued. As stated above, while correlation is not necessarily causation, the tone of the Court's decision, and

316. *Id.* at 680 (Thomas, J., dissenting).

317. *Id.* at 683-84 (quoting the Government's argument at oral hearing).

318. *Id.* at 655-57 (majority opinion).

319. *United States v. Carpenter*, 791 F.2d 1024, 1026, 1033 (2d Cir. 1986).

320. *Id.* at 1033.

the roadblocks to insider trading enforcement that it created, certainly did nothing to inhibit the explosion of insider trading.

IV. THE FOURTH TRILOGY: INSULATING COLLATERAL PARTICIPANTS FROM LIABILITY

The last trilogy of Supreme Court cases dealing with the liability of collateral participants is unique in that fourteen years passed between the first and second decision; however, the second and third quickly followed each other. The Supreme Court saw its most recent decision, *Janus Capital Group, Inc.*, as a necessary outcome if its decision in *Central Bank of Denver, N.A.*³²¹ was not to be undermined.³²² The Court in *Stoneridge Investment Partners* took essentially the same tack.³²³ Because *Central Bank* is both significant in its own right, as well as essentially determinative of the subsequent two cases, it is important to understand the shaky foundation upon which it sits.

A. Central Bank: *The Demise of Aiding and Abetting*

The primary violator in *Central Bank* was a real estate development company that issued bonds in 1986 and planned a new issue in 1988.³²⁴ The bond indenture required that the bonds be secured by real estate valued at 160% of the debentures.³²⁵ Central Bank was the indenture trustee under both the existing and proposed bond offerings.³²⁶ Early in 1988, Central Bank secured a supposedly updated appraisal from the development's appraiser.³²⁷ The values were essentially unchanged from two years earlier, notwithstanding a drop in real estate prices in the Colorado Springs area and a number of foreclosures.³²⁸ The underwriter under the 1986 offering wrote to Central Bank, informed the Bank that the underwriter believed that the appraisal was inflated and that the indenture covenants were violated, and requested that Central Bank commission a new appraisal by an independent appraiser, as it had the authority to do under

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

322. *Janus Capital Grp., Inc. v. First Derivatives Traders*, 131 S. Ct. 2296, 2302 (2011). The Court in *Janus Capital* was unaware of the fact that after its decision in *Central Bank*, the Enron disaster and other massive corporate corruption cases ensued, followed by a major financial collapse, triggered in substantial part by the fraudulent creation and marketing of innovative financial securities. See Charles W. Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Prevent Future Crises?*, 64 SMU L. REV. 1243 (2011). While correlation is not necessarily causation, *Central Bank*, by eliminating aiding and abetting liability, arguably turned professionals, such as attorneys, who should be gatekeepers into hired guns. See *infra* notes 432–44 and accompanying text.

323. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 162–63 (2008).

324. *Cent. Bank*, 511 U.S. at 167.

325. *Id.*

326. *Id.*

327. *Id.*

328. *Id.*

the indenture.³²⁹ The Bank asked its own appraiser to examine the appraisal, and he also thought the appraisal was inflated. The Bank then met with the developer and agreed to postpone the new appraisal until after the 1988 offering. The new offering went forward and shortly thereafter the development company defaulted.³³⁰

The primary violation was the misrepresentations about the value of the real estate by the development company. Central Bank was charged with aiding and abetting³³¹ and the litigation revolved around the second element of aiding and abetting: Central Bank argued that it had no duty under the indenture to get a new appraisal and that, absent such a duty, recklessness was insufficient; without a duty, actual knowledge of the primary fraud was necessary.³³² The Supreme Court went beyond this argument, however, and determined that aiding and abetting liability did not exist in a Rule 10b-5 action.³³³

1. Reactionary Judicial Decision Making

At the outset, it is paradoxical, as well as disingenuous, for a supposedly conservative court to engage in reactionary judicial activism. But that is exactly what the Court in *Central Bank* did. First, the issue decided by the Court was not the one litigated in the courts below, nor was it the issue raised by the parties on appeal. The issue below, and which the parties raised on appeal, dealt with the defendant's knowledge of, or recklessness in not knowing, the primary violation.³³⁴ The parties never questioned the existence of a cause of action for aiding and abetting. Nevertheless, on its own motion, the Court directed the parties to brief this issue.

The next aspect of reactionary judicial activism was that all eleven circuits had accepted aiding and abetting liability.³³⁵ When there is a split

329. *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 894 (10th Cir. 1992), *rev'd sub nom. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

330. *Id.* at 895.

331. Justice Stevens, in his dissent, set forth the elements of aiding and abetting liability:

The Courts of Appeals have usually applied a familiar three-part test for aider and abettor liability, patterned on the Restatement of Torts formulation, that requires (i) the existence of a primary violation of § 10(b) or Rule 10b-5, (ii) the defendant's knowledge of (or recklessness as to) that primary violation, and (iii) "substantial assistance" of the violation by the defendant.

Cent. Bank, 511 U.S. at 194 (Stevens, J., dissenting).

332. *Cent. Bank*, 511 U.S. at 175-76 (majority opinion).

333. *Id.* at 177.

334. *Id.* at 190. The Grant of Certiorari limited review to Question 2 presented by the petition and directed the parties to brief and argue the following additional question: "[W]hether there is an implied private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5." Scott M. Murray, Comment, *Central Bank of Denver v. First Interstate Bank of Denver: The Supreme Court Chops a Bough from the Judicial Oak: There Is No Implied Private Remedy to Sue for Aiding and Abetting Under Section 10(b) and SEC Rule 10b-5*, 30 NEW ENG. L. REV. 475, 505 (1996) (internal quotation marks omitted).

335. See, e.g., *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 986 (10th Cir. 1992); *K & S P'ship v. Cont'l Bank, N.A.*, 952 F.2d 971, 977 (8th Cir. 1991); *Levine v. Diamantheset, Inc.*,

among the circuits, the Supreme Court often resolves it. But aiding and abetting liability was well-settled law. As Justice Stevens pointed out in his dissent:

In *hundreds* of judicial and administrative proceedings in every Circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under § 10(b) and Rule 10b-5. . . . While we have reserved decision on the legitimacy of the theory in two cases that did not present it, all 11 Courts of Appeals to have considered the question have recognized a private cause of action against aiders and abettors under § 10(b) and Rule 10b-5.³³⁶

Central Bank did not resolve unsettled law but rather unsettled very resolved law. While the majority stated that it “granted certiorari to resolve the continuing confusion over the existence . . . of the § 10(b) aiding and abetting action[.]” the only confusion as to its existence was in the mind of the majority.³³⁷

The Court in the *Stoneridge Investment Partners* decision sought to justify its decision by asserting “[t]his is not a case in which Congress has enacted a regulatory statute and then has accepted, over a long period of time, broad judicial authority to define substantive standards of conduct and liability.”³³⁸ But that was exactly what had occurred prior to *Central Bank* with respect to aiding and abetting liability. Section 10(b) was enacted in 1934, Rule 10b-5 was promulgated in 1942, and a private cause of action recognized in 1946, shortly after World War II ended.³³⁹ Aiding and abetting liability in Rule 10b-5 actions was recognized at least as early as 1963,³⁴⁰ and the Supreme Court first considered Rule 10b-5 in 1969.³⁴¹ Congress substantially revised the 1934 Act in 1964³⁴²

950 F.2d 1478, 1483 (9th Cir. 1991); *Schatz v. Rosenberg*, 943 F.2d 485, 496–97 (4th Cir. 1991); *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990); *Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir. 1987), *cert. denied sub nom. Moore v. Frost*, 483 U.S. 1006, 107 S. Ct. 3231 (1987); *Cleary v. Perfecttune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *IIT, An Int’l Inv. Trust v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 799 (3d Cir. 1978). The only court not to have squarely recognized aiding and abetting in private § 10(b) actions has done so in an action brought by the SEC, *see Dirks v. SEC*, 681 F.2d 824, 844–45 (D.C. Cir. 1982), *rev’d on other grounds*, 463 U.S. 646 (1983), and has suggested that such a claim was available in private actions. *See Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35–36 (D.C. Cir. 1987). The Seventh Circuit’s test differs markedly from the other circuits’ in that it requires that the aider and abettor “commit one of the ‘manipulative or deceptive’ acts prohibited under section 10(b) and rule 10b-5.” *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123 (7th Cir. 1990).

336. *Cent. Bank*, 511 U.S. at 192 (Stevens, J., dissenting).

337. *Id.* at 170 (majority opinion).

338. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 163 (2008).

339. *See supra* Part I.A.

340. *See, e.g., Burley & Co.*, Exchange Act Release No. 34-3838, 23 SEC Docket 461 (Aug. 5, 1946).

341. *See SEC v. Nat’l Sec., Inc.*, 393 U.S. 453, 455 (1969).

342. Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565. These amendments expanded the reach of disclosure requirements under the 1934 Act, by making the registration, periodic reporting, proxy, and insider trading provisions applicable to large over-the-counter companies in addition to listed companies which were previously covered by the Act. The amendments

and again in 1975,³⁴³ well aware of aiding and abetting liability in Rule 10b-5 actions. The doctrine itself has been recognized for a century,³⁴⁴ and was formulated in the Restatement of Torts in 1939.³⁴⁵

2. The Flawed Analysis

Judicial activism could be accepted if it made sense from a policy standpoint or if it were supported by sound judicial reasoning. *Central Bank* met neither criterion. From a policy standpoint, the law should discourage wrongdoing, not insulate it from accountability. From a jurisprudential perspective, the *Central Bank* opinion was so outcome determinative that it discredited the Court's objectivity.

The Court began its analysis by recognizing that "Congress did not create a private § 10(b) cause of action and had no occasion to provide guidance about the elements of a private liability scheme."³⁴⁶ However, with respect to the type of conduct prohibited, the statutory language controls. According to the Supreme Court, because the statutory language controls, this "bodes ill" for the existence of aiding and abetting liability as "Section 10(b) does not in terms mention aiding and abetting."³⁴⁷ This is absurd reasoning. The Court acknowledged that the private cause of action was judicially created and thus Congress provided no guidance about its elements. Why then would any rational person expect Congress to deal with whether a remedy it did not create would be complemented by aiding and abetting liability for those who assist a primary violator?

Viewed from a different perspective, the argument can be made that Congress did anticipate aiding and abetting liability under § 10. This section, by its terms, defines "unlawful" activity, and unlawful activity can be prosecuted criminally by the U.S. Attorney. The Crimes and Criminal Procedure section of the U.S. Code specifically provides: "Whoever commits an offense against the United States or aids, abets,

also imposed increased standards and disciplinary controls for broker-dealers in securities. For a thorough analysis of the 1964 Amendments, see Richard M. Phillips & Morgan Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706 (1964).

343. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97. These amendments further expanded the reach of the SEC to oversee self-regulatory organizations and develop a national system for clearance and settlement of securities transactions. They also expanded the reporting requirements of large financial institutions and generally sought to eliminate obstacles to competition within the securities industry. For a thorough analysis of the 1975 Amendments, see John G. Gillis, *Securities Law and Regulation: Securities Acts Amendments of 1975*, 31 FIN. ANALYSTS J. 12 (1975).

344. THOMAS MCINTYRE COOLEY, A TREATISE ON THE LAW OF TORTS: OR THE WRONGS WHICH ARISE INDEPENDENTLY OF CONTRACT 244 (3d ed. 1906).

345. 4 RESTATEMENT OF THE LAW OF TORTS: PERSONS ACTING IN CONCERT § 876(b) (1939).

346. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994).

347. *Id.* at 175 (internal quotation mark omitted).

counsels, commands, induces or procures its commission, is punishable as a principal.”³⁴⁸

There is also further statutory language that suggests that aiding and abetting liability does not affront the statutory scheme: Section 10(b) forbids conduct that “directly or indirectly” is “manipulative or deceptive.”³⁴⁹ The Court rebuts this argument by asserting that “federal courts have not relied on [this language] when imposing aiding and abetting liability.”³⁵⁰ This is because all federal courts prior to *Central Bank* did not find it necessary to construe the statute with regard to aiding and abetting liability as they were dealing with a judicially created cause of action. But, if the statute is viewed with an open mind, rather than an outcome-determinative mindset, there is little basis for rejecting the cause of action.

The Court then asserts that Congress knew how to create aiding and abetting liability. Congress also knows how to pass a budget—or at least it did.³⁵¹ But Congress’s knowledge of neither is relevant to a judicially created cause of action. The Court then concluded its analysis of the statute by asserting that the Court could not amend the statute by “creat[ing] liability for acts that are not themselves manipulative or deceptive.”³⁵² In so doing, the Court fails to understand the difference between primary and secondary liability. It is the primary violator who engages in manipulative or deceptive conduct. The aider and abettor is secondarily liable because the person assists the primary violator. An essential element of aiding and abetting liability is that there must be a primary violation that would encompass manipulative or deceptive conduct.

3. Distinction Between Express Negligence Causes of Action and an Implied Cause of Action Requiring Recklessness

After it completed its nonsensical examination of the statute to determine whether Congress provided for aiding and abetting liability with regard to a judicially created cause of action, the Court then fantasized whether, had Congress created a private cause of action, it would have provided for aiding and abetting. The Court examined the private causes of action that Congress expressly created and noted that none of them provided for aiding and abetting liability. The Court accordingly concluded that “[t]here is no reason to think that Congress would have at-

348. 18 U.S.C. § 2(a) (2012).

349. See 15 U.S.C. § 78j (2012).

350. *Cent. Bank*, 511 U.S. at 176.

351. See Len Burman, *Budget Brinkmanship in Congress Must End*, CHRISTIAN SCI. MONITOR (Dec. 18, 2011), <http://www.csmonitor.com/Business/Tax-VOX/2011/1218/Budget-brinkmanship-in-Congress-must-end> (explaining that Congress consistently followed a successful budget process beginning in 1974, but that in five of the past twelve years, Congress has not passed a budget resolution at all, instead relying on emergency measures and last-minute stop-gaps).

352. *Cent. Bank*, 511 U.S. at 177–78.

tached aiding and abetting liability only to § 10(b) and not to any of the express private rights of action in the Act.”³⁵³

Unfortunately for the Court, there is a very significant reason to distinguish between § 10(b) and the express private rights in the 1933 and 1934 securities acts—a reason the Court itself created almost twenty years earlier. In *Ernst & Ernst*, the Court determined that the language of § 10(b) precluded a private action under Rule 10b-5 from sounding in negligence, thereby requiring scienter³⁵⁴—today recklessness.³⁵⁵ As the Court itself recognized, aiding and abetting liability originated in criminal law,³⁵⁶ and its extension to negligence cases is of relatively recent origin.³⁵⁷ Since the express private causes of action sound in negligence, it is not surprising that Congress did not attach aiding and abetting liability. But, in the express private causes of action, Congress did cast a broad net in terms of liability. For example, § 11 of the 1933 Act imposes liability, not only upon the issuer, but also upon officers, directors, investment bankers, and experts named in the registration statement.³⁵⁸ In other circumstances, some of these named defendants could be considered aiders and abettors.

One of the private actions listed by the Court was § 9 of the 1934 Act.³⁵⁹ Because liability is imposed on those who “willfully participate” in the proscribed manipulation, this is not a negligence provision. But it also does not negate a policy accepting aiding and abetting liability. While § 10 imposes liability upon those who “use or employ” manipulative or deceptive acts, § 9 imposes liability upon one who “willfully participates” in manipulation. The conduct of the suppliers in *Stoneridge Investment Partners*, who conspired with the issuer to inflate its earnings, was challenged on the basis that they directly and willfully participated in the fraud.³⁶⁰ Section 9, by its terms, covers “willful” participants. Yet, on the basis of *Central Bank*, such liability was rejected even though the 1934 Act clearly does not reflect a policy against liability for willful participants.

The Supreme Court, in *Central Bank*, also made short shrift of the argument that the 1984 and 1988 legislative reports approved of aiding and abetting liability under Rule 10b-5.³⁶¹ While the Court characterizes

353. *Id.* at 180.

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

355. *Id.* at 193 n.12 (“In this opinion the term ‘scienter’ refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act.”).

356. *Cent. Bank*, 511 U.S. at 181.

357. *See id.* at 181–82.

358. 15 U.S.C. § 77k(a) (2012).

359. *Cent. Bank*, 511 U.S. at 178.

360. *Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc.*, 552 U.S. 148, 148 (2008).

361. *Cent. Bank*, 511 U.S. at 185 (citing H.R. REP. NO. 100-910, at 27 n.23 (1988)) (noting that a certain provision did “not affect the availability of any other theories of liability, such as aiding and

the Committee reports as making “oblique references” to aiding and abetting,³⁶² the references are hardly oblique. For example, the 1984 Report stated: “The committee endorses the judicial application of the concept of aiding and abetting liability to achieve the remedial purposes of the securities laws.”³⁶³

The Court also states that “the interpretation given by one Congress (or a committee . . . thereof) to an earlier statute is of little assistance in discerning the meaning of that statute.”³⁶⁴ But, paradoxically, this is in effect what the Supreme Court itself has been doing. In the late 1970s, the Court began restricting the circumstances in which a private cause of action would be implied.³⁶⁵ It then uses its recent antipathy toward private courses of action to restrict causes of action developed under an earlier Supreme Court regime in which the law at that time favored the implication of a remedy.

In *Central Bank*, the Court downplayed the fact that Congress had amended the securities laws many times without rejecting the judicial doctrine of aiding and abetting. But, previously with respect to Rule 10b-5, the Supreme Court had stated that “[t]he longstanding acceptance by the courts, coupled with Congress’ failure to reject *Birnbaum*’s reasonable interpretation . . . argues significantly in favor of acceptance of the *Birnbaum* rule by this Court.”³⁶⁶ Now, let us rewrite the prior sentence, substituting “aiding and abetting” for “*Birnbaum*”: “The longstanding acceptance by the courts, coupled with Congress’ failure to reject [*aiding and abetting*], argues significantly in favor of [*aiding and abetting* liability].” Or let us take the same tack to the Court’s language in *Herman & MacLean*, substituting aiding and abetting for “Section 10(b)”:

In 1975[,] Congress enacted the “most substantial and significant revision of this country’s Federal securities laws since the passage of the Securities Exchange Act in 1934.” When Congress acted, federal courts had consistently and routinely permitted a plaintiff to proceed [*under aiding and abetting*]. In light of this well-established judicial interpretation, Congress’ decision to leave [*aiding and abetting*] intact suggests that Congress ratified [*aiding and abetting liability*].³⁶⁷

abetting”). “Current law generally imposed secondary liability on persons who aid and abet the inside trader.” H.R. REP. NO. 98-355, at 10 (1983).

362. *Cent. Bank*, 511 U.S. at 185.

363. H.R. REP. NO. 98-355 (1983), reprinted in 1984 U.S.C.C.A.N. 2274, 2283.

364. *Cent. Bank*, 511 U.S. at 185 (internal quotation mark omitted).

365. See *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216 (6th Cir. 1980), *aff’d*, 456 U.S. 353 (1982); *Cannon v. Univ. of Chi.*, 441 U.S. 677, 677–78 (1979); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 560 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 186 (1976); *Cort v. Ash*, 422 U.S. 66, 67 (1975).

366. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 (1975).

367. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 384–86 (1983) (footnotes omitted) (citation omitted).

Apparently, the guiding principle for this Court is “[a] foolish consistency is the hobgoblin of little minds.”³⁶⁸ The opinion is an exemplar of justification, not thoughtful and objective analysis. As will be developed in the balance of this Article, if there is a guiding principle for the Court in these cases, it is protecting wrongdoers at the expense of the public investor.

B. Stoneridge: *Direct Participant Liability*

1. The Contrast Between *Central Bank* and *Stoneridge*

The facts in *Stoneridge* bore no relation to those in *Central Bank*. *Central Bank* was a classic case of aiding and abetting. The elements of aiding and abetting traditionally have been (i) a primary violation, (ii) knowledge of the primary violation or recklessness in not being aware of the primary violation by the secondary actor, and (iii) substantial assistance to the primary violator by the secondary actor.³⁶⁹

In contrast to *Stoneridge*, as discussed earlier, the primary violator in *Central Bank* was a real estate development that had issued bonds in 1986 and planned a new issue in 1988, while Central Bank was the indenture trustee under both the existing and proposed bond offerings. The primary violation was the misrepresentations about the value of the real estate by the development company. Central Bank was charged with aiding and abetting, and it was with this issue that the Court dealt.

While it would be naïve to say that Central Bank did not benefit from deferring the appraisal and letting the second offering go forward—it had both a stake in the fees from acting as trustee under the second offering and a stake in keeping a client happy to secure business in the future—it clearly was not a direct participant in the primary violator’s fraud. Nonetheless, had it fulfilled its responsibilities and promptly obtained a new appraisal, the fraud on the investors probably would not have occurred.³⁷⁰

Although it would be hard to label Central Bank as a crook, that is exactly what the defendants in *Stoneridge* were. And the Supreme Court was hardly unaware of the situation. It set out the facts as follows:

For purposes of this proceeding, we take these facts, alleged by petitioner, to be true. Charter, a cable operator, engaged in a variety of fraudulent practices so its quarterly reports would meet Wall Street expectations for cable subscriber growth and operating cash flow. The fraud included misclassification of its customer base; delayed reporting of terminated customers; improper capitalization of costs

368. RALPH WALDO EMERSON, *Self-Reliance*, in *ESSAYS (FIRST SERIES)* 19 (Infomotions, Inc. 2001).

369. See *supra* note 331.

370. The Supreme Court apparently does not understand that it is engaging in risk allocation.

that should have been shown as expenses; and manipulation of the company's billing cutoff dates to inflate reported revenues. In late 2000, Charter executives realized that, despite these efforts, the company would miss projected operating cash flow numbers by \$15 to \$20 million. To help meet the shortfall, Charter decided to alter its existing arrangements with respondents, Scientific-Atlanta and Motorola.

....

Respondents supplied Charter with the digital cable converter (set top) boxes that Charter furnished to its customers. Charter arranged to overpay respondents \$20 for each set top box it purchased until the end of the year, with the understanding that respondents would return the overpayment by purchasing advertising from Charter. The transactions, it is alleged, had no economic substance; but, because Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes, in violation of generally accepting accounting principles, the transactions would enable Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cash flow numbers. Respondents agreed to the arrangement.

So that Arthur Andersen would not discover the link between Charter's increased payments for the boxes and the advertising purchases, the companies drafted documents to make it appear the transactions were unrelated and conducted in the ordinary course of business.³⁷¹

2. The Arguments for and Against Direct Liability

Thus, Scientific-Atlanta and Motorola jointly conspired with Charter to engage in a series of transactions for the purpose of inflating earnings and thereby inflating the price of Charter's stock. Scientific-Atlanta and Motorola directly benefitted from the arrangement through increased revenues and profits, and their direct participation in the fraud was essential to carrying out the fraud. With respect to the fraud, they were arguably primary violators, not secondary violators. The secondary characterization comes into play only because the purpose of the fraud was to inflate Charter's earnings and it was Charter that "made" the misrepresentation to the investing public about its earnings.

Yet, the Court in *Stoneridge* blithely took the position that its decision was controlled by *Central Bank* and arguably extended it, stating: "[t]he conduct of a secondary actor must satisfy each of the elements . . . for liability,"³⁷² including reliance.³⁷³ However, while the Court supposedly followed *Central Bank*, in which it had examined the express pri-

371. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 153-54 (2008).

372. *Stoneridge*, 552 U.S. at 158.

373. *Id.* at 159.

vate causes of action to discern congressional intent, an examination of the express liability provisions does not establish, or even support, the argument that the liability of secondary actors must meet all of the elements of liability for primary actors. The express liability provisions in the 1933 and 1934 Acts are complemented by liability imposed upon controlling persons who, in effect, are secondary actors. Section 15 of the 1933 Act provides:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.³⁷⁴

Section 20(a) of the 1933 Act provides:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.³⁷⁵

In none of these statutory secondary liability provisions is there any indication that, in order to hold the controlling person liable, a plaintiff must prove the same elements of a cause of action against the person secondarily liable as it does against the primary violator. Rather, Congress provided the direct opposite: plaintiff first must prove the cause of action against the primary violator and then the unique elements regarding the secondary violator's responsibility come into play.

3. Contorting Fact to Fit Bias

From a standpoint of common sense, the opinion goes downhill from this point. Let us briefly go back to the facts. The defendants executed documents and engaged in transactions with the issuer, Charter Communications, the sole purpose of which was to inflate Charter's earnings—which was exactly what was accomplished.

With respect to this fraud, the Court made the following statements:

374. 15 U.S.C. § 77o (2012).

375. 15 U.S.C. § 78t(a) (2012).

- (i) “[Respondents’] deceptive acts were not communicated to the public”;³⁷⁶
- (ii) “No member of the investing public had knowledge, either actual or presumed, of respondents’ deceptive acts”;³⁷⁷
- (iii) There is no authority for a rule “that in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect.”³⁷⁸
- (iv) Petitioner seeks to apply § 10(b) beyond the securities markets—“to purchase and supply contracts—the realm of ordinary business operations”;³⁷⁹
- (v) “§ 10(b) . . . does not reach all commercial transactions that are fraudulent and affect the price of a security in some *attenuated* way.”³⁸⁰
- (vi) “Here respondents were acting in concert with Charter in the *ordinary course* as suppliers and, as matters then evolved in the not so ordinary course, as customers”;³⁸¹
- (vii) “Unconventional as the arrangement was, it took place in the marketplace for goods and services, not in the investment sphere.”³⁸²
- (viii) “Charter was free to do as it chose in preparing its books” [i.e. it was not compelled by respondents to cook its books].³⁸³

The foregoing characterizations make little sense. First of all, the stock market is driven by earnings. Missing an earnings projection by a penny a share can send a stock plummeting.³⁸⁴ To say that an investor relies on the earnings but not the transactions that underlie such earnings is sophistry. The reported earnings have no relevance absent the integrity of the underlying transactions. In WorldCom, for example, the earnings were fraudulent because cash outflows that should have been expensed were capitalized.³⁸⁵ That was analogous to the fraud in the case at bar. Investors rely upon earnings as a surrogate for the integrity of the under-

376. *Stoneridge*, 552 U.S. at 159.

377. *Id.*

378. *Id.* at 160.

379. *Id.* at 161.

380. *Id.* at 162 (emphasis added).

381. *Id.* at 166 (emphasis added).

382. *Id.*

383. *Id.*

384. See, e.g., *Oracle Profit, Revenue Miss Expectations; Shares Drop*, CNBC.COM (Dec. 20, 2011, 5:39 PM ET), <http://www.cnbc.com/id/45736368> (Oracle reported its quarterly earnings were 54 cents per share, up from 51 cents per share for the previous year, but this was 3 cents per share lower than analysts expected, causing its stock to fall 14.6%).

385. See Peter Elstrom, *How to Hide \$3.8 Billion in Expenses*, BLOOMBERG BUSINESSWEEK MAG., July 7, 2002, available at http://www.businessweek.com/magazine/content/02_27/b3790022.htm.

lying transactions. It is the financial health of the company, and its ability to generate a stream of cash flow in the future, that determines stock price.³⁸⁶ Thus, as stated above, the reported earnings are a surrogate for the underlying health of the company. When the underlying transactions are fraudulent, the earnings based upon such transactions misinform the market about the underlying health of the company.

Moreover, this fraud did not affect the price of Charter stock *in some attenuated way*. As the Supreme Court expressly stated:

Charter, a cable operator, engaged in a variety of fraudulent practices so its quarterly reports would meet Wall Street expectations for cable subscriber growth and operating cash flow. . . . Charter executives realized that, despite these efforts, the company would miss projected operating cash flow numbers by \$15 to \$20 million. To help meet the shortfall, Charter decided to alter its existing arrangements with respondents, Scientific-Atlanta and Motorola.³⁸⁷

Rather than affecting the price of Charter stock in some attenuated way, the whole purpose of the fraud was to affect the price of the stock.

Finally, this fraud did not occur in the realm of ordinary business operations, the defendants were not acting in the ordinary course as suppliers, and the transactions did not take place in the marketplace for goods and services. Rather, the fraud was the antithesis of ordinary business operations. In ordinary business operations, buyers do not pay double the market price for goods and advertisers do not buy advertisements they do not want. These transactions were not in the marketplace for goods and services; they were outside the marketplace and involved privately orchestrated corruption.

For the Supreme Court to classify the present fraud as an ordinary commercial transaction is beyond naïve; the Court is consciously straining to present unconscionable activity as merely commercial. It is a little like Humpty-Dumpty in *Through the Looking Glass*: Words mean exactly what I mean them to mean; neither more nor less.³⁸⁸

C. Janus Capital: *Who "Makes" a Misrepresentation*

Just when you think Supreme Court jurisprudence cannot become any more detached from reality, the Court proceeds to outdo itself. A

386. Discounted cash flow is a norm for valuing a corporation. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712 (Del. 1983). The process involves projecting cash flows for a number of years in the future and then taking the present value of such cash flows in order to obtain the present value of the corporation. See CHARLES W. MURDOCK, *The Earnings Value of a Business*, in 8 ILLINOIS PRACTICE SERIES: BUSINESS ORGANIZATIONS § 19.3 (2d ed. 2013).

387. *Stoneridge*, 552 U.S. at 153.

388. LEWIS CARROLL, *THROUGH THE LOOKING-GLASS, AND WHAT ALICE FOUND THERE* 66 (Selwyn H. Goodacre ed., Univ. of Cal. Press 1983) (1871).

straight reading of *Janus Capital Group v. First Derivative Traders*³⁸⁹ suggests that the Court has eliminated management liability for securities fraud except for those members of management who sit on the board of directors. After *Janus Capital*, the new model for corporate governance could be a board composed only of one inside director, the CEO, and the balance of the board composed of outsiders who, if they are sufficiently uninformed, can escape liability for securities fraud. The rest of management need not worry.³⁹⁰ And the CEO need not worry if he did not expressly authorize the misrepresentation. Rather than encouraging an informed board, the decision does the converse. Rather than encouraging accountability, it discourages accountability.

1. The Facts

Janus Capital involved a mutual fund, Janus Investment Fund (the Fund), that stated in its prospectuses that it had taken steps to curb market timing,³⁹¹ when in fact it had not. Janus Capital Group (Janus Capital) is a publicly traded asset management company that created the Fund as a separate legal entity owned by the Fund's shareholders.³⁹² Janus Capital Management LLC (Management) is a wholly owned entity controlled by Janus Capital, which was engaged by the Fund to be its investment advisor.³⁹³

The investment advisory services provided by Management included "management and administrative services necessary for the operation

389. 131 S. Ct. 2296 (2011).

390. It is too early to predict with assurance how *Janus Capital* will play out. See *infra* text accompanying notes 413–20.

391. See, e.g., Gary D. Halbert, *The Hedge Fund/Mutual Fund Scandal*, PROFUTURES INV., <http://www.profitures.com/article.php/206/> (last visited Apr. 22, 2014). Halbert described the market timing scandal as follows:

Canary [Capital Partners LLC] (and perhaps other large hedge funds) allegedly obtained special trading opportunities with several leading mutual fund families—reportedly including Bank of America's Nations Funds, Banc One, Janus and Strong—by promising to make substantial investments in various mutual funds offered by these firms.

The special trading opportunities, in this case fraudulent trading opportunities, consisted primarily of so-called "late trading" of mutual funds after the stock markets close at 4:00 eastern time. If you or I, for example, want to make a purchase or sale of a mutual fund, we have to get our orders in to the fund family before the close of the markets, sometimes 30 minutes or more before the markets close. If you or I place our order after the markets close at 4:00 today, then we don't get that order filled until tomorrow at the 4:00 closing price.

In the case of Canary, the mutual funds noted above (and possibly others) allegedly allowed Canary (and others) to place its orders AFTER the markets closed and still get the closing price for the same day. As you know, there are frequently announcements just after the markets close that can have significant effects on the markets the following day. Allegedly, these hedge funds would trade on this after-market information and reap big profits the following day.

Allowing large hedge funds to trade after hours is illegal and it serves to reduce profits and/or increase losses to the other shareholders of the mutual funds!

Id.

392. *Janus*, 131 S. Ct. at 2299.

393. *Id.*

of [the Fund].”³⁹⁴ All the officers of the Fund were officers of Management; one member of the Fund’s board of directors was associated with Management.³⁹⁵

Plaintiffs alleged that Janus Capital and Management caused the Fund to issue prospectuses that created a misleading impression that Janus Capital and Management would implement measures to curb market timing in the Fund.³⁹⁶ The district court dismissed the complaint, but the Fourth Circuit reversed on the basis that “JCG [Janus Capital] and JCM [Management], by participating in the writing and dissemination of the prospectuses, *made* the misleading statements contained in the documents.”³⁹⁷ With respect to reliance, the Fourth Circuit also determined that investors would infer that Management “played a role in preparing or approving the content of the Janus fund prospectuses,” but would not infer the same about Janus Capital, “which could be liable only as a ‘control person.’”³⁹⁸

To this, the Supreme Court simply responded that, to be liable, “JCM [Management] must have ‘made’ the material misstatements in the prospectuses. We hold that it did not.”³⁹⁹

2. The Flawed Analysis of the Majority

The policy perspective from which the majority began its analysis is (i) contrary to the philosophy that formerly covered interpretation of the securities laws, namely, “to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry,” and to construe legislation enacted to avoid fraudulent activity “not technically and restrictively, but flexibly to effectuate its remedial purposes”;⁴⁰⁰ (ii) contrary to Congressional policy in enacting the 1934 Act “to insure the maintenance of fair and honest markets”;⁴⁰¹ and (iii) contrary to the policy of § 10 of that Act to further the public interest and to protect investors.⁴⁰² According to the majority, “[c]oncerns with the judicial creation of a private cause of action caution against its expansion,” and thus the Court must give “narrow dimensions” to a private cause of action under Rule 10b-5.⁴⁰³ It should be

394. *Id.* (internal quotation mark omitted).

395. *Id.* The opinion pointed out that the Fund’s board was more independent than required by the securities laws: “[U]p to 60 percent of the board of a mutual fund may be composed of ‘interested persons.’” *Id.* (citing 15 U.S.C. § 80a-10(a) (2006)).

396. *Id.* at 2300.

397. *Id.* at 2301 (internal quotation marks omitted) (citing *In re Mut. Funds Inv. Litig.*, 566 F.3d 111, 121 (4th Cir. 2009), *rev’d*, *Janus*, 131 S. Ct. 2296).

398. *Id.* (internal quotation marks omitted) (citing *In re Mut. Funds Inv. Litig.*, 566 F.3d at 127–30).

399. *Id.*

400. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186, 195 (1963).

401. Securities Exchange Act of 1934, 15 U.S.C. § 78b (2012).

402. 15 U.S.C. § 78i.

403. *Janus*, 131 S. Ct. at 2302 (alteration in original) (internal quotation marks omitted).

noted that the “concerns” about a private cause of action are those of the Supreme Court, not of Congress.⁴⁰⁴

After engaging in some wordsmithing, the majority determined that “the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.”⁴⁰⁵ According to the Court, “[a] broader reading of ‘make’ . . . would substantially undermine *Central Bank*” because, “[i]f persons or entities without control over the content of a statement could be considered primary violators who ‘made’ the statement, then aiders and abettors would be almost nonexistent.”⁴⁰⁶

The problem with this statement of the Court is that it is dead wrong, as indicated by the cases it was seeking to preserve and felt compelled to follow and protect. *Central Bank*⁴⁰⁷ dealt with an aider and abettor bank that failed to follow up on information that the land, which secured the debentures of which it was a trustee and which was the subject of a forthcoming offering, was substantially overvalued. On the other hand, *Stoneridge*⁴⁰⁸ dealt with businesses that conspired with the issuer to manipulate the prices each charged the other in order to inflate the issuer’s earnings. In *Central Bank*, there was no assertion that the aiders and abettors *made* any statement. On the other hand, in *Stoneridge*, while the defendants were not charged with directly making a statement, they were charged with knowingly participating in *transactions* which they knew would lead to an earnings statement that misled investors.

In the case at bar, the majority rejected the idea that Management could have “made” the statement in the Fund’s prospectus. The Court asserted that only the person with ultimate authority can “make” a statement and that attribution is strong evidence as to who is the maker.⁴⁰⁹ In so doing, the majority used the analogy of a speechwriter and a speaker.⁴¹⁰ While the speechwriter may draft a speech, it is the speaker who is responsible for the content.

But in this case, respondent’s analogy may be more apt: that of a playwright and the actor.⁴¹¹ While the actor speaks, it is the playwright who is responsible for the statements.

404. Courts first recognized a private cause of action in 1946. See *supra* text accompanying note 12. Until *Central Bank*, all eleven circuit courts of appeals had expressly recognized this private cause of action and understood that it included aiding and abetting liability. See *supra* text accompanying note 334. Congress amended the securities laws several times in the interim and never once mentioned any concerns about the application of the private right of action.

405. *Janus*, 131 S. Ct. at 2302.

406. *Id.*

407. See *supra* text accompanying note 324–33.

408. See *supra* text accompanying note 367–69.

409. *Janus*, 131 S. Ct. at 2302.

410. *Id.*

411. *Id.* at 2304.

The majority emphasized that the Fund had an independent board of directors.⁴¹² Thus, the board would be responsible for the misstatements in the prospectuses. But the Fund does not have its own employees.⁴¹³ The Fund's board is dependent upon Management for information and advice. As is well known: She who controls the information, controls the decision.⁴¹⁴ But this reality is beyond the ken of the majority. It concludes that, even though Management "was significantly involved in preparing the prospectuses," since Management was "subject to the ultimate control of" the Fund, the Fund, and not Management, made the statements in the prospectuses,⁴¹⁵ even though the board may not have had any knowledge that the statements in the prospectus were false and misleading.

This stance by the majority is even more irrational since the false statements related to a matter—namely, whether market timing had been stopped—which was totally in the control of Management, which drafted the prospectuses. You can rest assured that Management did not tell the board of the Fund that it continued to permit market timing, and that it would also be asserting the contrary in the prospectuses. The Court also relied upon the *Stoneridge* holding that the public could not have relied upon the actions of Motorola and Scientific-Atlanta in conspiring with Charter Communications to inflate the latter's sales, which thus inflated Charter Communications's earnings and stock price, because it was not "inevitable" that the company would use the increased sales to increase its earnings.⁴¹⁶ At the risk of wordsmithing like the majority, it depends upon what the word "inevitable" means. Of course, it is possible that Charter Communications's management might have had a conversion experience, realized the evil of inflating earnings, and reversed the inflated sales data. But is not the likelihood of a conversion experience by management so remote that any rational person would conclude that the pattern of inflated sales would "inevitably" be incorporated into the fi-

412. *Id.*

413. *See supra* Part IV.C.1 ("The Facts") and text accompanying notes 390–98.

414. This conclusion is based upon my experience as an expert in mutual fund litigation. Basically, the board does what the manager recommends. Portions of my opinion were quoted extensively by the Eighth Circuit in reversing the district court in *Gallus v. Ameriprise Financial, Inc.* (the American Express mutual fund advisor). 561 F.3d 816, 819 (8th Cir. 2009), *vacated*, 559 U.S. 1046 (2010). This experience is confirmed by the administrative proceedings in connection with the Janus Group market timing. *See* Lammert, Exchange Act Release No. ID-348, 2008 WL 6593436 (ALJ Apr. 28, 2008), where the administrative law judge stated:

The existence of approved market timing relationships was widely known no later than the completion of the Beery Report, which was circulated to dozens of Janus employees and executives. This knowledge was never shared with the Board. In the presentation to the Board on the use of redemption fees on market timing the legal department relied heavily on the Beery Report in the preparation of materials for the presentation. However, the final materials provided to the Board did not include any mention of the approved market timing relationships.

Id.

415. *Janus*, 131 S. Ct. at 2305.

416. *Id.* at 2303 (internal quotation mark omitted).

nancial statements? As indicated above, the thinking process of the majority is either outcome determinative or *Alice in Wonderland*. To suggest that management would orchestrate an elaborate series of fraudulent transactions, but then not “inevitably” incorporate them into the public financial statements, is again irrational.

Yet, the majority uses this twisted logic from *Stoneridge* to support its reasoning in *Janus Capital* that only the person with ultimate control over the statement and its communication can “make” a statement, because “[w]ithout such authority, it is not ‘necessary or inevitable’ that any falsehood will be contained in the statement.”⁴¹⁷ Again, refer back to the prior discussion. It was in the best interest of Janus Capital not to disclose that it had not terminated market timing. Janus Capital, through Management, controlled the drafting of the prospectus. Would any rational person expect Janus Capital to either disclose in the prospectuses that it had continued this illegal activity, or to disclose to the board of directors that it was denying the continuation of this activity in the prospectuses, even though it had not been terminated? The board and thus the Fund were at the mercy of Management. Clearly the statements were “made” by Management. But, since Management did not make the statement, according to the Court, it is not liable, nor is its control person, Janus Capital. And the board of directors is not liable because they lacked scienter as to the misleading nature of the prospectuses.

Once again, the Supreme Court provides a safe harbor for fraudulent activity. Moreover, as discussed below, it has choreographed the perfect crime.

The dissent took the majority to task, not only for the Court’s unwarranted reliance upon *Central Bank* and *Stoneridge*,⁴¹⁸ but also, and more importantly, for its unnecessary wordsmithing with regard to the scope of the word “make.” The dissent asserted:

But where can the majority find legal support for the rule that it enunciates? The English language does not impose upon the word “make” boundaries of the kind the majority finds determinative. Every day, hosts of corporate officials make statements with content that more senior officials or the board of directors have “ultimate authority” to control.⁴¹⁹

Whether this will be the case in the future is discussed below.

3. The Consequences of the Court’s Decision

Arguably, the Supreme Court has written the script for the perfect crime. According to the administrative law judge in the disciplinary pro-

417. *Id.*

418. *Id.* at 2307–08 (Breyer, J., dissenting).

419. *Id.* at 2307.

ceedings with respect to market timing by Janus Group, the board of directors was not informed of the market timing activities.⁴²⁰ If only the board of directors is deemed to make the statement because of its ultimate authority, and if the board is unaware of the truth, then there is no primary violation, which would also mean that, even in an SEC proceeding, there could be no aiding and abetting liability because of the lack of a primary violation.

Under the law prior to *Janus Capital*, as the dissent pointed out:

[B]oth language and case law indicate that, depending upon the circumstances, a management company, a board of trustees, individual company officers, or others, separately or together, might "make" statements contained in a firm's prospectus—even if a board of directors has ultimate content-related responsibility.⁴²¹

Additionally, the Supreme Court in 1983, in the process of determining that an express private cause of action under the 1933 Act did not exclude an implied cause of action under Rule 10b-5, stated:

Moreover, certain individuals who play a part in preparing the registration statement generally cannot be reached by a Section 11 action. These include corporate officers other than those specified in 15 U.S.C. § 77k(a), *lawyers not acting as "experts,"* and accountants If, as Herman & MacLean argues purchasers in registered offerings were required to rely solely on Section 11, they would have no recourse against such individuals even if the excluded parties engaged in fraudulent conduct while participating in the registration statement. The exempted individuals would be immune from federal liability for fraudulent conduct even though Section 10(b) extends to "any person" who engages in fraud in connection with a purchase or sale of securities.⁴²²

Thus, it is clear that, in 1983, the Supreme Court envisioned that someone who participated in the drafting of a document could be liable under Rule 10b-5.

The Supreme Court's approach in *Janus Capital* would also seem to make its warning in *Central Bank* that "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under Rule 10b-5,"⁴²³ illusory. Arguably, *Central Bank*, by eliminating aiding and abetting liability, reduced the likelihood that attorneys would act as gate-

420. See *Lammert* opinion cited *supra* note 414. "However, the final materials provided to the Board did not include any mention of the approved market timing relationships." *Id.*

421. *Janus*, 131 S. Ct. at 2306 (Breyer, J., dissenting).

422. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386 n.22 (1983) (emphasis added).

423. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

keepers in preventing their clients from making fraudulent representations.

In the wake of *Janus Capital*, one circuit court has employed the *Janus Capital* “only the person with ultimate authority can make a statement” test to insulate a corporation called during a conference call from liability for statements made during the call.⁴²⁴ In *Fulton County Employees Retirement System v. MGIC Investment Corp.*,⁴²⁵ MGIC owned 46% of the equity of Credit-Based Asset Servicing and Securitization LLC (C-BASS), Radian Group Inc. owned another 46%, and the managers at C-BASS owned the remaining 8%.⁴²⁶ Thus, C-BASS was essentially a joint venture between MGIC and Radian Group. C-BASS securitized sub-prime mortgages before the financial crisis destroyed its business.⁴²⁷ As the sub-prime mortgage market began to falter in the summer of 2007, C-BASS’s lenders increasingly began making margin calls, creating potential liquidity problems.⁴²⁸ One of the issues in the case was a conference call held by MGIC on July 19, 2007. According to plaintiffs, Williams, the CEO of C-BASS, and Draghi, its COO, made false or misleading statements.

The Seventh Circuit held that MGIC could not be liable under § 20(a) as a control entity because Radian also had 46% ownership.⁴²⁹ Consequently, according to the court, MGIC did not have control.⁴³⁰ With no liability under that section, the plaintiff’s other recourse was under § 10(b) and Rule 10b-5. However, because the two officers of C-BASS, Williams and Draghi, made the statements during the C-BASS conference call, MGIC could not be held liable under Rule 10b-5 because, under *Janus Capital*, only the person with ultimate control can be the maker of a statement and MGIC did not have control.⁴³¹ Moreover, the Seventh Circuit upheld the district court’s analysis rejecting the claims against Williams and Draghi.⁴³² The district court had opined that, even though much of the remaining money that the managers pointed to when stating that C-BASS had substantial liquidity had already been subject to margin calls before the conference call, this information “may not have made its way up corporate channels” by the time of the call.⁴³³

424. See generally *Fulton Cnty. Emps. Ret. Sys. v. MGIC Inv. Corp.*, 675 F.3d 1047, 1048–52 (7th Cir. 2012).

425. 675 F.3d 1047 (7th Cir. 2012).

426. *Id.* at 1048.

427. *Id.* at 1048–49.

428. *Id.* at 1049.

429. *Id.* at 1051.

430. *Id.* The Seventh Circuit noted that this type of investment structure is very common in joint ventures. *Id.* With § 20(a) liability precluded in all of these types of cases, the impact of *Janus* can be far-reaching.

431. *Id.*

432. *Id.* at 1052.

433. *Fulton Cnty. Emps. Ret. Sys. v. MGIC Inv. Corp.*, No. 08-C-0458, 2010 WL 601364, at *17 (E.D. Wis. Feb. 18, 2010), *aff’d*, 675 F.3d 1047 (7th Cir. 2012).

Without personal knowledge of the extent of these margin calls, Williams and Draghi could not have had the requisite scienter to be liable under Rule 10b-5.⁴³⁴ This fantasy by the district court was possible because, under the Private Securities Litigation Reform Act (PSLRA),⁴³⁵ plaintiffs must meet a severe pleading burden when met with a motion to dismiss without the benefit of discovery.⁴³⁶

Janus Capital may have limited impact with regard to statements made by corporate management, in light of the Supreme Court's own language and the enactment of the Sarbanes–Oxley Act.⁴³⁷ Justice Thomas accepted that “attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed.”⁴³⁸ And, pursuant to section 302 of the Sarbanes–Oxley Act,⁴³⁹ the CEO and CFO must sign and certify in each annual and quarterly report that they have reviewed the report, that to their knowledge it does not contain any material untrue statement or omission of a material fact, that the financial statement presents fairly the financial condition of the company and the results of its operations, that they are responsible for and have designed such internal controls as necessary to ensure the material information is made known to them, that they have evaluated the effectiveness of such internal controls, and that they have reported any significant deficiencies to the company's auditors and audit committee.⁴⁴⁰

Accordingly, several district courts have recognized that officials who make public statements cannot defend on the basis that they did not have the ultimate authority, but rather that it resided in the board of directors.⁴⁴¹ However, other courts have recognized this defense.⁴⁴² In any

434. *Id.*

435. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. (2012)).

436. *Id.* § 101. It is unfathomable that, with the subprime mortgage market collapsing, and with C-BASS in the first six months of the year having been subject to \$290 million of margin calls, that the CEO and COO would not be aware of the fact that another \$145 million of margin calls had been made between July 1 and July 19, the date of the conference call. The district court, in effect, indulges in a presumption that management is incompetent to save management from liability.

437. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

438. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011).

439. Sarbanes–Oxley Act of 2002 § 302.

440. See 17 C.F.R. § 240.13a-14 (2013); 17 C.F.R. § 229.601 tbl. Instruction (31) (2013).

441. See *In re Merck & Co.*, MDL No. 1658 (SRC), 2011 WL 3444199, at *24–25 (D.N.J. Aug. 8, 2011). In *In re Merck*, plaintiffs alleged that Merck overstated the commercial viability of its top-selling drug Vioxx. *Id.* at *1. Several of the individual defendants, all officers of Merck, raised defenses based on *Janus*, arguing that the statements attributed to them cannot lead to liability because the defendants did not have “ultimate authority over the statement[s].” *Id.* at *24 (quoting *Janus*, 131 S. Ct. at 2302) (internal quotation marks omitted). The district court used agency concepts to differentiate, arguing that Management in *Janus* was a separate entity from the Fund, meaning it was not an agent of the Fund. *Id.* at *25. In *In re Merck*, the officers were agents of Merck. *Id.* Because corporations can only act through agents, it would be unreasonable to absolve corporate officers of primary liability for all 10b-5 claims just because the statements they make are ultimately within control of the corporation that employs them. See *id.*; see also *Monk v. Johnson & Johnson*, No. 10-4841 (FLW), 2011 WL 6339824, at *17 n.19 (D.N.J. Dec. 19, 2011) (defendants raised

event, the confusion caused by *Janus Capital* has added to the cost and inefficiency of litigation by creating another issue that needs to be dealt with by litigants and the courts.

Other courts have suggested that the *Janus Capital* limitation is applicable only to third parties who now cannot be liable for statements made by their clients.⁴⁴³ Unfortunately, even if *Janus Capital* were so limited, it would undercut the effectiveness of the securities laws in holding gatekeepers accountable. The idea that a lawyer, in drafting documents in connection with a securities transaction, can be held liable as a primary violator for co-authoring or co-creating the document was first developed in *Klein v. Boyd*,⁴⁴⁴ a case that was later settled on appeal and the opinion withdrawn. This was further developed in *In re Enron Corp. Securities, Derivative, and ERISA Litigation*.⁴⁴⁵

Consider the massive fraud perpetrated at the turn-of-the-century by Enron, assisted by its attorneys. In litigation arising out of Enron's massive fraud, plaintiffs sued two law firms, Vinson & Elkins and Kirkland

claims almost identical to those in *In re Merck*, and the district court used the same analysis from *In re Merck* to refute them); *SEC v. Brown*, 878 F. Supp. 2d 109, 116 (D.D.C. 2012).

442. In *Hawaii Ironworkers Annuity Trust Fund v. Cole*, No. 3:10CV371, 2011 WL 3862206 (N.D. Ohio Sept. 1, 2011), the court stated that there was nothing in *Janus* that would limit its holding "to legally separate entities." *Id.* at *3. The court concluded that "[t]he complaint does not state a claim for primary liability under *Janus*, because the defendants[, former officers of the company,] did not have ultimate authority over the content of the statement." *Id.* at *5.

443. *City of Pontiac Gen. Emps. Ret. Sys. v. Lockheed Martin Corp.*, 875 F. Supp. 2d 359, 374 (S.D.N.Y. 2012).

As for *Janus Capital*, that case addressed only whether *third parties* can be held liable for statements made by their clients. Its logic rested on the distinction between secondary liability and primary liability and has no bearing on how corporate officers who work together in the same entity can be held jointly responsible on a theory of primary liability. It is not inconsistent with *Janus Capital* to presume that multiple people in a single corporation have the joint authority to "make" an SEC filing, such that a misstatement has more than one "maker."

Id. (citations omitted).

444. 949 F. Supp. 280, 284 (E.D. Pa. 1996), *aff'd*, Nos. 97-1143, 97-1261 (3d Cir. Mar. 9, 1998), 1998 WL 55245, *reh'g en banc granted, vacated*.

445. *In re Enron Corp. Sec.*, 235 F. Supp. 2d 549, 586 (S.D. Tex. 2002). *In re Enron Corp.* summarized *Klein* as follows:

[I]n *Klein v. Boyd*, a panel of the Third Circuit Court of Appeals [found that the law firm in the dispute could be liable as a primary violator of securities fraud even though the attorney did not sign the documents and was never known to the investor as a participant in the documents' creation. The appellate court concluded] that once the law firm "elected to speak" by creating or participating in the creation of [the] documents . . . it could not make material misrepresentations or omit material facts in drafting the non-confidential documents[, such as opinion letters]. The law firm's duty did "not arise from a fiduciary duty to the investors; rather, the duty arose when the law firm undertook the affirmative act of communicating with investors . . ." Thus the Third Circuit panel concluded that although the firm may not have a duty to blow the whistle on its client, once it chooses to speak, a law firm does have a duty to speak truthfully, to make accurate or correct material statements, [even though the document may not be facially attributed to the lawyer]. The panel did require that the lawyer's "participation in the statement containing a misrepresentation or omission of a material fact [be] sufficiently significant that the statement can properly be attributed to the person as its author or co-author," so that it would not fall within the parameter of conduct constituting aiding and abetting.

Id. at 602 (last alteration in original) (citations omitted).

& Ellis, in connection with their participation with the fraud.⁴⁴⁶ Vinson & Elkins was the *general* counsel for Enron and not only represented it in structuring illicit partnerships and special purpose entities for the purpose of inflating Enron's earnings, but also drafted numerous disclosure documents, including registration statements and SEC filings,⁴⁴⁷ which incorporated misrepresentations about the nature and purpose of these entities and their effect upon Enron's earnings. According to the court, the law firm effected the "deceptive devices and contrivances that were the heart of the alleged Ponzi scheme."⁴⁴⁸ Vinson & Elkins' "voluntary, essential, material, and deep involvement"⁴⁴⁹ made it a primary violator in Enron's fraudulent scheme. Moreover, "Vinson & Elkins was not merely a drafter, but essentially a co-author of the documents it created for public consumption concealing its own and other participants' actions."⁴⁵⁰ The court determined that the law firm "deliberately or with severe recklessness" put these misrepresentations in the public domain in order to "influence those investors to purchase more securities, credit agencies to keep Enron's credit high, and banks to continue providing loans to keep the Ponzi scheme afloat. Therefore Vinson & Elkins had a duty to be accurate and truthful."⁴⁵¹

According to the court, this was not a situation where Vinson & Elkins "merely" violated its professional principles and ethics. On the other hand, the court determined that this was the case for Kirkland & Ellis since, while "Kirkland & Ellis represented some of the illicit Enron-controlled, non-public SPEs and partnerships that Enron . . . used . . . to

446. *Id.* at 563–64.

447. *See, e.g., id.* at 660–61.

Disclosures in the following SEC filings, drafted and approved by Vinson & Elkins, concealed material facts about the JEDI/Chewco, LJM, and/or Raptor transactions:

A. Quarterly Reports (on Form 10-Q) filed on: 8/16/99; 11/15/99; 5/15/00; 8/14/00; 11/14/00; 5/15/01; and 8/14/01.

B. Annual Reports (on Form 10-K) filed on 3/31/98; 3/31/99; 3/30/00; and 4/02/01.

C. Annual Proxies filed on: 3/30/99; 5/02/00; 5/01/01.

D. Report on Form 8-K, filed 2/28/01.

Furthermore, Enron related-party disclosures from Enron's previous Report on Form 10-K and Report on Form 10-Q were incorporated by reference into the following Registration Statements and Prospectuses for Enron securities offerings: the resale of zero coupon convertible senior notes, due 2021, filed 7/25/01; 7.875% notes due 6/15/03, filed 6/2/00; 8.375% notes due 5/23/05, filed 5/19/00; 7% exchangeable notes due 7/31/02, filed 8/11/99; 7.375% notes due 5/15/2019, filed 5/20/99; common stock, filed 2/12/99; 6.95% notes due 7/15/2028, filed 11/30/98; and floating notes due 3/30/00, filed 9/28/98. The disclosures consistently misrepresented that terms of Enron's transactions with related third parties were representative of terms that could have been obtained from independent third parties. Both Sherron Watkins' letter and the Powers' Report concluded that the transactions were not arm's length, lacked true economic import, and were such that no independent third party would have accepted.

Id.

448. *Id.* at 704.

449. *Id.* at 705.

450. *Id.*

451. *Id.*

hide its debt and record sham profits,”⁴⁵² it never made any misstatements or misrepresentations to the public. While it also breached professional ethical standards, its conduct was not actionable under Rule 10b-5.

The difference in approach between the Texas District Court and the U.S. Supreme Court is striking. The conduct of the investment advisor in *Janus Capital* was even more pervasive than the conduct of Vinson & Elkins. The investment advisor had complete practical control over the misrepresentations and hid their true nature from the directors of the mutual fund. The district court’s focus was, appropriately, on the existence of wrongdoing and whether this wrongdoing was directed to the investing public. The fact that the client had “the final authority to control the contents of the registration statement”⁴⁵³ was irrelevant in view of the deep involvement of the law firm in the preparation of the registration statement and the law firm’s knowledge of the true state of affairs. The focus of the Supreme Court was on a hypertechnical definition of “make,” which it utilized to ensure that wrongdoing would go unpunished. The effect of the district court’s decision was to send a sober warning to gatekeepers that they are not hired guns, but have a responsibility to the public. The effect of the Supreme Court decision is to create a “what, me worry” attitude in attorneys and other gatekeepers.

Cases such as the foregoing, which required that a lawyer be a counselor and not just a hired gun, are now eviscerated by the Supreme Court’s decision in *Janus Capital*.

CONCLUSION

The evolution of Supreme Court jurisprudence over the past forty years reflects a sea of change in judicial philosophy. At the start of the 1970s, the liberal trend characterized by the Warren Court still prevailed. An implied private cause of action was still in favor and litigators were viewed as private attorneys general,⁴⁵⁴ enforcing the securities laws to further the policy of protecting investors. Arguably, judicial over-exuberance led to some loose reasoning in cases such as *Superintendent of Insurance and Affiliated Ute*.

The expansion of Rule 10b-5 was slowed and more judicial discipline was injected by the Burger Court in the mid-1970s. A trilogy of well-reasoned conservative decisions put Rule 10b-5 jurisprudence in a proper perspective: plaintiffs needed to be buyers or sellers to have standing, scienter was required to distinguish the implied cause of action

452. *Id.* at 705–06.

453. *Id.* at 704 (internal quotation mark omitted).

454. *See, e.g., J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (“Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in anti-trust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements.”).

from the express remedies in the securities acts, and deception was the touchstone for an action predicated upon a statute giving the SEC the authority to prohibit only manipulative or deception conduct.

In the 1980s the Rehnquist Court began a naïve and reactionary trend—ignoring fraudulent conduct in order to further circumscribe the reach of Rule 10b-5. Although the securities laws were enacted because the common law was inadequate, the Court in *Chiarella* introduced the common law concept of fiduciary duty to curtail the application of the securities laws, while citing authority that took a diametrically opposed interpretation. This was the beginning of an outcome-determinative analysis that was expanded in *Dirks* to add a naïve quality when the Court ignored the SEC's warning that some excuse could always be fabricated⁴⁵⁵ to evade the test for liability formulated by the *Dirks* majority.

The final trilogy began with the Rehnquist Court and ended with the Roberts Court. Conservative jurisprudence has now been abandoned, and the Court used one ill-reasoned decision to awkwardly justify an even more ill-reasoned decision. *Central Bank* was the epitome of judicial activism. The Court instructed the parties to brief an issue that had not been considered in the courts below nor raised by the parties on appeal; the Court rejected the unanimous position of all the judicial circuit courts that aiding and abetting liability did attach to a primary violation under Rule 10b-5; the Court ignored statutory language and legislative history that dictated a contrary result; and the Court relied upon the lack of aiding and abetting provisions with respect to express private causes of action sounding in negligence to justify the elimination of aiding and abetting liability under Rule 10b-5, which requires scienter—ignoring the fact that aiding and abetting liability traditionally had not been applicable with respect to negligence actions.

In the *Stoneridge* and *Janus Capital* cases, the Court then strained to contort these cases as being controlled by *Central Bank*, even though they involved direct participation in the fraud, rather than aiding and abetting liability. It then articulated an absurd interpretation of the word "make" in *Janus Capital* to exculpate the person who not only drafted the document but also controlled the "facts" in the document that made it misleading.

Since the 1980s, the fact is inescapable that the Supreme Court, confronting activity that it acknowledged as fraudulent,⁴⁵⁶ has engaged in

455. See *Dirks v. SEC*, 463 U.S. 646, 663 (1983) ("The SEC argues that, if inside-trading liability does not exist when the information is transmitted for a proper purpose but is used for trading, it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information. We think the SEC is unduly concerned.")

456. Arguably, this is not true of the defendant in *Dirks*: the majority saw him as a hero even though he personally profited by enabling his clients to dump stock and depress the market, to the detriment of uninformed public investors. *Id.* at 665-67.

tortuous, outcome-determinative reasoning to create, in effect, safe harbors for fraudulent activity. In so doing, the Court reflects not a conservative philosophy, but a reactionary one. Its advocacy for conduct that in some instances could be criminal stands in stark contrast to the Warren Court. The Warren Court sought to protect the uninformed from the power of the State; the Roberts Court appears to protect the powerful from the uninformed investing public.

While correlation is not causation, it is noteworthy that a rash of insider trading followed the insider trading trilogy, and that the corporate corruption scandals⁴⁵⁷ of the 2000s followed *Central Bank* and PSLRA.⁴⁵⁸ The impact of the insider trading cases has been dampened by the enactment of the Insider Trading Sanctions Act and the Insider Trading Securities Fraud Enforcement Act,⁴⁵⁹ and the reluctant acceptance of the misappropriation theory by the Supreme Court in *O'Hagan*.⁴⁶⁰ On the other hand, the Court's ill-advised emasculation of liability for collateral participants needs to be reversed legislatively. Congress went part way when it reinstated aiding and abetting liability in actions brought by the SEC. It now needs to complete this effort by extending aiding and abetting liability to private litigation. By reversing *Central Bank*, it will also take down *Stoneridge* and *Janus Capital*, and close the judicially created loopholes that have enabled corrupt actors to act with impunity and avoid accountability.

457. See HAROLD S. BLOOMENTHAL, *SARBANES-OXLEY ACT IN PERSPECTIVE* app. D at 869–70 (2006–2007 ed. 2006) (listing over twenty of the more spectacular examples of corporate corruption during this period).

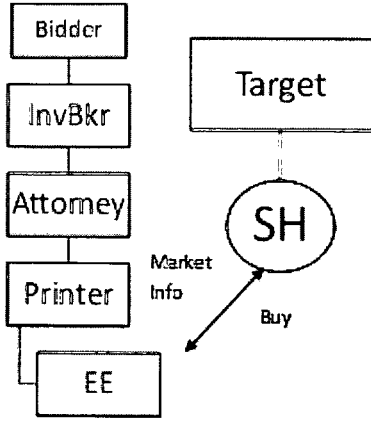
458. See, e.g., 15 U.S.C. § 78u-5(c)(1) (2012) (the effect of this provision is to exculpate a person who, with knowledge, makes a fraudulent forward-looking statement, if the statement is accompanied with cautionary language).

459. See *supra* text accompanying notes 295–96 (discussing the impact of these legislative enactments).

460. Chief Justice Rehnquist and Justices Scalia and Thomas dissented from the Court's acceptance of the misappropriation theory. *United States v. O'Hagan*, 521 U.S. 642, 646, 650 (1997).

EXHIBIT A
Insider Trading Models

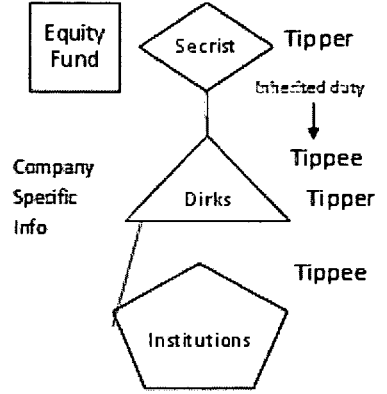
Chiarella



(Temporary Insiders)

Tender Offer
Insider Trading

Dirks



Classical Insider Trading