A Brief (and Partial) History of Securities Litigation

Law Working Paper N° 845/2025
May 2025

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ECGI Working Paper Series in Law

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Abstract

Most legal scholars who have focused on securities fraud class actions seem to agree that such lawsuits ill-serve both investors and issuers. Since most investors are diversified, they have little need for such a remedy. And because the settlement (if any) is paid by the corporation-thus causing stock price to decline further in most casesthe deterrent effect is both misplaced and excessive, chilling voluntary disclosure. To understand how we ended up with this dysfunctional system-and perhaps how to fix it-this article traces the evolution of federal securities law and private civil actions thereunder from the Securities Act of 1933 to Rule 10b-5 of the Securities & Exchange Act of 1934 and beyond. Although it is tempting to look for some unique decision or event-a wrong turn that explains everything-the truth tends to be messy. There are several factors that led us to where we are today. It would be an exaggeration to call it a perfect storm. It is more accurate to see it as the result of a series of seemingly minor events with bizarre cumulative consequences. Nevertheless, there is one central misconception at the heart of the problem: That investors should be compensated when they buy (or sell) at a price affected by misinformation emanating from the issuer. To be sure, the 1933 Act permits an investor who purchases securities directly from a corporation to recover from the corporation if there is a material misstatement of fact in the prospectus. In other words, the corporation is required to give back the money. In contrast, Rule 10b-5 is a catch-all anti-fraud rule that applies to all trading in securities-including trades in which the corporation itself does not participate. The crucial mistake was extending the narrowly tailored remedy under the 1933 Act-disgorgement by the corporation-to situations in which the corporation itself is neither seller nor buyer. As will be seen, this error was the result of a series of court decisions, which seem quite sensible when considered one at a time. Moreover, the effect of these decisions was compounded by changing procedural rules relating to class actions and derivative actions that interacted with substantive law. Taken together these missteps have led the law horribly astray.

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ABSTRACT

Most legal scholars who have focused on securities fraud class actions seem to agree that such lawsuits ill-serve both investors and issuers. Since most investors are diversified, they have little need for such a remedy. And because the settlement (if any) is paid by the corporation – thus causing stock price to decline further in most cases – the deterrent effect is both misplaced and excessive, chilling voluntary disclosure. To understand how we ended up with this dysfunctional system – and perhaps how to fix it – this article traces the evolution of federal securities law and private civil actions thereunder from the Securities Act of 1933 to Rule 10b-5 of the Securities & Exchange Act of 1934 and beyond.

Although it is tempting to look for some unique decision or event – a wrong turn that explains everything – the truth tends to be messy. There are several factors that led us to where we are today. It would be an exaggeration to call it a perfect storm. It is more accurate to see it as the result of a series of seemingly minor events with bizarre cumulative consequences. Nevertheless, there is one central misconception at the heart of the problem: That investors should be compensated when they buy (or sell) at a price affected by misinformation emanating from the issuer. To be sure, the 1933 Act permits an investor who purchases securities directly from a corporation to recover *from the corporation* if there is a material misstatement of fact in the prospectus. In other words, the corporation is required to give back the money. In contrast, Rule 10b-5 is a catch-all anti-fraud rule that applies to all trading in securities – including trades in which the corporation itself does not participate. The crucial mistake was extending the narrowly tailored remedy under the 1933 Act – disgorgement by the corporation – to situations in which the corporation itself is neither seller nor buyer. As will be seen, this error was the result of a series of court decisions, which seem quite sensible when considered one at a time. Moreover, the effect of these decisions was compounded by changing procedural rules relating to class actions and derivative actions that interacted with substantive law. Taken together these missteps have led the law horribly astray.

Key Words & Phrases: securities fraud, class action, echo effect, direct suit, derivative suit, 1933 Act, 1934 Act, Rule 10b-5, insider trading, public offering, strict liability, materiality, due diligence, tracing, aftermarket, price pop, compensation, unjust enrichment, deterrence, punitive damages, underpricing, rescission, tracing, connection, private right of action, fiduciary duty, privity, reliance, causation, standing, fraud on the market, PSLRA, SLUSA, tender offer, enforcement action, misrepresentation, omission.

JEL Codes: K22, K41

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You may ask yourself, “Well, how did I get here?” ∗∗∗ And you may ask yourself, “How do I work this?” ∗∗∗ And you may ask yourself “Am I right? Am I wrong?” And you may say to yourself, "My God! What have I done?"

Talking Heads, *Once in a Lifetime*

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This essay seeks to answer the question: Where did the law go wrong such that we ended up with the dysfunctional system of securities litigation that we have today – one in which excessive awards are paid BY the wrong party TO the wrong party and – in the process – magnify investor losses. Although it is tempting to look for some unique decision or event – a wrong turn that explains everything – the truth is messy.

The central problem with securities litigation is that class actions are based on the idea that defendant corporations should be held liable for the losses suffered by buyers (and sometimes sellers) if stock price has been affected by a misstatement made by the company even though the company itself typically has not sold (or bought) any stock.[1] Moreover, the law permits plaintiffs to recover the entire loss they suffer even if the loss is the result of an *accident* that reveals an earlier statement to be false.[2]

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[1] Some might object to this summary statement of the situation because it does not really assign any blame to the company. They might argue that liability results when the company makes a misrepresentation of a material fact to the public (and is shown to have been at least reckless in doing so) upon which investors rely in buying (or selling) at a too high (or to low) price. Technically, this is a more precise statement of the law. But given that these cases almost always settle if they survive a motion to dismiss for failure to state a claim, the statement in the text is a more accurate reflection of the reality. In other words, the only real hurdle for a plaintiff is to offer a plausible story. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions,* 43 Stan. L. Rev. 497 (1991).

Incidentally, I use the word *company* here – even though almost all entity defendants are corporations – because the type of entity involved almost never matters for purposes of federal securities law. *Cf.* Corwin v. KKR Fin. Holdings, LLC, 125 A.3d 304 (Del. 2015) (construing corporation law in dispute involving alterative entities).

[2] Some legal scholars have sought to justify this arrangement. *See e.g.,* Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation,* 2009 Wisconsin L. Rev. 333; James Park, *Shareholder Compensation as Dividend,* 108 Michigan Law Review 323 (2009); James Cameron Spindler, *We Have a Consensus on Fraud on the Market – And It’s Wrong*, 7 Harv. Bus. L. Rev. 67 (2017).

To explain: When a company pays to settle a class action, its value (market capitalization) is reduced dollar-for-dollar by the payout (in addition to the loss caused by disclosure of bad news).[3] That loss ultimately falls on pre-existing (legacy) stockholders who held their shares from before the company misspoke while new stockholders who bought at a price inflated by the so-called fraud are compensated (less the fee collected by the lawyer for the class).[4]

Moreover, because the market understands how this works, stock price will fall further in the first place to reflect the likelihood of payout. In other words, class actions make things worse. They magnify the size of the claim through an echo effect.[5]

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[3] To be precise, a claim may arise from the cover up of *either* bad news about the company (which causes stock price to fall and buyers to lose) or good news about the company (which causes stock price to rise and sellers to lose). But 98% of cases involve bad news. So the discussion here presumes a bad news setting. *Cf.* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005) (opinion by Breyer disclaiming applicability of holding to good news cases). One obvious explanation for the preponderance of bad news cases is that companies are more reluctant to disclose bad news (for various reasons). *See generally* James C. Spindler, *Why Shareholders Want Their CEOs to Lie More After Dura Pharmaceuticals*, 95 GEO. L.J. 653 (2007) (discussing company tactic of delay and bundling disclosures of bad news with subsequent good news). Another explanation is that securities fraud class actions have the effect of magnifying the size of bad news claims and muting good news claims, as discussed further below.

The notion of price inflation is confusing and controversial. Generally speaking, it is enough for a misstatement to have the effect of maintaining stock price at a too-high level. It need not cause stock price to increase. *See* Richard A. Booth, *Price Inflation and Price Maintenance in Securities Fraud Class Actions,* 30 Stanford J. L. Econ. & Bus. 133 (2025).

[4] Few (if any) securities fraud class actions result in full compensation for the plaintiff class even if one ignores the 20% or so of the payout that goes to the lawyers.

[5] This echo effect might also be called *feedback* – the term I first used to describe it – or even *positive feedback* akin to the effect of holding a microphone to close to a speaker. *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It,* 4 Berkeley Bus. L.J. 1 (2007). But that appellation can be confusing because it might suggest there is something good about it. Some commentators favor the term circularity which focuses on the fact that stockholders effectively pay themselves but which misses the distribution and magnification effects. Note also that positive feedback occurs only in bad news cases where buyers allegedly pay too much. In a good news case where sellers sell for too little – where stock price rises with corrective disclosure – a negative feedback effect ensues which dampens or mutes the price change – because payout by the now more valuable company to stockholders who sold into the fraud reduces the price at which the stock finally settles. It is thus little wonder that almost all securities fraud class actions involve the cover up of bad news. *See* id.

One obvious response to this problem is to deny that it exists: Defendant companies do not really foot the bill. Rather, the settlement of such actions is almost always paid wholly by insurance. The equally obvious rejoinder is that companies must buy insurance against such claims in the first place. Although Kramer might dismiss the cost of class actions as a mere write-off, the write-off is one that flows through to other investors in the form of lower returns.[6]

So how did we get here? There are several factors that led us to where we are today. It would be an exaggeration to call it a perfect storm. It is more accurate to see the law we have today is the result of a series of seemingly minor events and decisions with bizarre cumulative consequences. In other words, it is more akin to the butterfly effect of chaos theory.[7]

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The story begins at the beginning. Before 1875, when New Jersey enacted the first general corporation law, it was difficult to form a corporation and thus difficult for a business to raise capital by selling stock to the public. But once it became possible to form a corporation pretty much at will, it is hardly surprising that fraudsters emerged to exploit the possibilities.

One popular scheme was for a promoter to form a corporation and to transfer worthless assets to the corporation in exchange for (say) 1000 shares of stock. Then, the promoter sells 1000 shares to the public for $100 per share. The end result is that there are 2000 shares outstanding and the corporation is worth $100,000. So each share is worth $500. The promoter who paid in nothing of value now has shares worth $50,000. And the outside stockholders who paid $100 per share now have shares that are worth $50 per share. It's called *dilution.*

The natural reaction is: There oughta be a law. But technically speaking the wrong here is one suffered by the corporation that bought worthless assets from the promoter who was in control of the corporation at the time. And the law is that a Johnny-come-lately

[6] It is easy to understand that plaintiffs would want to sue a wealthy corporation rather than the individuals responsible for misleading the market. But the first thing one learns in law school is that deep pockets do not justify liability. The second thing one learns is that one must ignore whether the defendant carries insurance against the subject loss since the payout from insurance depends on the liability determined by the law.

[7] Although it may go without saying, the butterfly effect is the idea that a butterfly flitting its wings in Africa may lead to a hurricane in Florida. The phrase was reportedly coined by mathematician and meteorologist Edward Norton Lorenz who in 1972 surmised that the timing and path of a tornado might be influenced by turbulence from a butterfly flapping its wings. Reportedly, the original example involved a seagull, but Lorenz was persuaded that a butterfly would be more poetic. Similar advice led me to rename the feedback effect – now echo effect – noted above, although it has yet to become an almost household phrase. Vectral Vandrometer. Catalytic Effect.

stockholder cannot complain about a wrong suffered by the corporation before the stockholder became a stockholder. Or so ruled SCOTUS in a notable 1908 decision written by Justice Oliver Wendell Holmes.[8]

Some states carved out an exception to this rule if the offering was part of a larger plan designed to issue stock to the promoter on the cheap.[9] Other states sought (beginning with Kansas in 1911) to address such abuses by enacting so-called blue sky laws, under which a state official would decide whether the terms of a given offering were *fair, just, and equitable* for purposes of sale to its residents. But such regulations were never very effective because it was quite easy for fraudsters to take the money and flee the jurisdiction.

Needless to say, the crash of 1929 and the ensuing Great Depression emphasized the need for (better) regulation of the stock market. And the election of Franklin Roosevelt in 1932 provided a political mandate to do something. So FDR prevailed on his friend Felix Frankfurter (who was a Harvard law professor at the time) to draft what turned out to be the Securities Act of 1933 – which Frankfurter reportedly did over the course of a weekend with the help of two former law students – Thomas Corcoran (AKA Tommy the Cork) and Benjamin Cohen.[10]

The gist of the 1933 Act is that a company that sells securities without disclosing all material facts that an investor would want to know must compensate investors for any losses they suffer – pretty much no questions asked. Under Section 11 of the Act, an investor need only prove that the offering materials included a false statement (or omission) of a material fact. The only defense that may be asserted *by the issuer* is that the loss was caused by other factors (or that the buyer knew the truth).[11] Liability also

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[8] *See* Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U.S. 206 (1908). To be clear, this was a minority rule at the time. *See* George D. Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York,* 32 Calif. L. Rev. 123 (1944). For example, New York did not adopt the contemporaneous ownership rule until xxxx. Nevertheless, the rule is almost universally recognized today. *See* MBCA 7.41; FRCP Rule 23.1. *See also* Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad Co., 417 U.S. 703 (1974) (precluding action by corporation on claim arising before change in control). This issue is noted further below in the discussion of the *Shapiro* and *Fridrich* cases.

[9] *See* Old Dominion Copper Mining & Smelting Co. v. Bigelow, 89 N.E. 193 (Mass.1909) (a corporation may attack an earlier transaction if the subsequent sale to public investors was contemplated at the time of the earlier transaction).

[10] *See* Adam C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices,* 95 Va. L. Rev. 95 841 (2009). Congress had dithered for months about securities legislation before Frankfurter came to the rescue with the bill, which largely codified best practices at the time. To be fair, Congress had a lot on its plate: The Glass-Steagall Act – which forced the separation of investment banking from commercial banking – was also passed in 1933 and was undoubtedly a bigger shock for Wall Street.

[11]

extends to investment bankers and others who participate in the offering (as well as directors and officers of the issuer and the accountants, lawyers, and other experts involved in the offering), although these other parties may escape liability if they can prove they exercised *due diligence* in connection with the offering. In any case, the remedy obtains even if the misstatement is completely inadvertent.[12] Investors need not prove so much as negligence. As a result, the onus is on the issuer. Thus, the 1933 Act is largely self-executing. And as such, the act reflects the technocratic tendencies of the time.[13]

To be clear, the 1933 Act requires the issuer company to disgorge any ill-gotten funds. Accordingly, it permits investors to file a *direct* suit against the issuer to get their money back.[14] Again, before passage of the 1933 Act, the standard state-law remedy – if it was available at all – was for the *corporation* to recover from the promoter by means of a derivative suit. This was not much of a remedy even when it worked as intended. Typically, the promoter remained in control of the corporation. So the ultimate effect of recovery by the corporation is for the promoter simply to transfer money from one pocket to another. So direct recovery by investors makes sense. And the 1933 Act establishes the principle that investors may recover from the corporation.[15]

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[12] In other words, no fraud is required (as the framers of the 1933 Act would have understood well). But that distinction has been largely lost in the meantime as evinced by PSLRA and as discussed further below.

[13] See William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and 'The Modern Corporation'* 34 J. Corp. L. 99 (2008). *Cf.* Jones v. SEC, 298 U.S. 1 (1936), (holding SEC refusal to permit withdrawal of registration statement following commencement of stop order proceeding to be unauthorized and arbitrary); SEC v. Chenery Corp., 318 U.S. 80 (1943) (Chenery I) (opinion by Frankfurter) (reversing SEC ruling that insider purchase of shares during pendency of utility reorganization was unfair as unsupported by any finding or rulemaking based on expertise of agency); SEC v. Chenery Corp., 332 U.S. 194 (1947) (Chenery II) (argument for SEC by Foster) (upholding subsequent SEC ruling to same effect based on evidence and application of statutory authority).

[14] Again, the act also provides for recovery against the underwriter (the investment bank(s) handling the offering) as well as directors and certain officers and experts (including accountants and lawyers) involved in the offering (subject to a due diligence defense).

[15] Moreover, the 1933 Act was arguably intended to effect a change to state corporation law, as evidenced by the Plaintiff may sue either in federal court or state court. *See* Richard A. Booth, *OOPs! The Inherent Ambiguity of Out-of-Pocket Damages in Securities Fraud Class Actions,* 46 J. Corp. L. 319, 338-41 (2021). *See also* Cyan, Inc. v. Beaver County Employees Retirement Fund, 583 U.S. 416 (2018) (holding that SLUSA did not repeal concurrent federal and state jurisdiction under the Securities Act of 1933); Salzberg v. Sciabacucchi, 227 A.3d 102 (Del. 2020) (upholding federal forum provision requiring litigation of 1933 Act claims in federal court as proper subject of articles of incorporation in a Delaware corporation). *See further* Richard A. Booth, *Loss Causation and the*

This remedy makes perfect sense in the context of a public offering: It compensates investors for exactly what they lose by requiring the issuer company to give back exactly what it gained (ignoring legal expenses). Consistent with this no-fault disgorgement approach, the 1933 Act sets a firm limit on liability at the amount of the offering: Investors may never recover more than the amount raised by the issuer. Thus, the act does not really seek to *punish* issuers who get it wrong (although the act does provide that willful violation is a crime).

The point for present purposes is that the 1933 Act establishes the idea that investors should be able to recover directly from an issuer company. But it does so without punishing the company and its existing stockholders. As noted at the above, the central problem with securities fraud class actions is that they magnify investor losses because the company pays even though in most cases it has not taken in any investor funds through the sale of stock. Thus, pre-existing (legacy) stockholders effectively compensate buyers for their losses – which losses are multiplied through an echo effect. The result is overcompensation and too much litigation as well as over-deterrence and a chilling effect on voluntary disclosure by public companies. In contrast, there is relatively little litigation under the 1933 Act.

To be sure, the company must pay in a successful action under the 1933 Act and its aggregate value is thus reduced. But the remedy follows an offering by which the company increased in value – wrongfully – by the amount of the illegal offering. Although one might argue that pre-existing stockholders thus foot the bill because their corporation is worth less than it was following the offering, the result is a wash if the new shares were sold at fair market value and the remedy is that investors get their money back. In other words, the 1933 Act seeks simply to restore investors and issuers to the *status quo ante* (as we lawyers like to say in Latin). There is no echo effect because it is the corporation itself that was the seller in the first place.

So the question remains: How did we get from the seemingly sensible reform embodied in the 1933 Act to the irrational system we have today?

The law and the law of unintended consequences.

Perhaps because of the stringent liability provisions in the 1933 Act – and the *in terrorem* effect created thereby – it has become common practice for initial public offerings (IPOs) to be underpriced. By definition, a company that seeks to go public has no market price. So it can be tricky to set the price for an offering. If the price is too high and it then falls in the aftermarket when the stock begins to trade, the company will almost certainly get sued under the 1933 Act. And as noted above, its investment banker (among others) may also face liability under the 1933 Act – which is one reason why investment bankers are so well paid.

Materialization of Risk Doctrine in Securities Fraud Class Actions, 75 Bus. Law. 1791, 1796 (note 15) (2020) (making the same point in a slightly different context).

One way for issuers (and investment bankers) to protect themselves from liability under the 1933 Act is to sell the stock cheap. There can be no liability under the 1933 Act if the price does not decline below the offering price. This does not necessarily mean that issuers must leave money on the table. Rather, it is common for a company to make a small IPO in order to establish a trading market for its shares and then later to go back to the well to offer more stock when the market can be used for pricing purposes. In any event, investors as well as issuers have come to expect a **price pop** on the first day of trading – which is why investors are so eager to be allocated shares in an IPO. Indeed, if there is no price pop, the worry is that something is wrong.

It is not clear that underpricing was all that common before the 1933 Act. The phenomenon of a hot-issue market seems not to have been noticed until 1959 and even then it was thought to be the product of manipulative practices by brokers.[16] But IPO underpricing, which is exacerbated if not caused by the 1933 Act, leads to a whole new set of legal issues. If stock price rises in the aftermarket following an IPO, investors may find that the remedy provided by the 1933 Act leaves something to be desired.

Suppose that ABC Corporation goes public selling one million shares at $20 per share. The price quickly rises to $40 per share in aftermarket trading. Then a mistake is discovered in the financial statements. The price plummets to $10 per share. The most

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[16] *See* Preliminary Report of Practices in Distribution of "Hot Issues," SEC Securities Act Release No. 4150 & Exchange Act Release No. 6097 (October 23, 1959), [1957-61 Transfer Binder] CCH FED. SEC. L. REP. ¶76,671 at 80,524; Comment, *Securities Regulation: Legislative and Administrative Treatment of the "Hot Issue" Phenomenon,* 1968 Duke L. J. 1137; The Obligations of Underwriters, Brokers and Dealers in Distributing and Trading Securities, Particularly of New High Risk Ventures, Securities Act Release No. 5275 & Securities Exchange Act Release No. 34-9671, 2 Fed. Sec. L. Rep. (CCH) 4506B (July 26, 1972). The problem was rediscovered in the late 1970s. *See* Practices in Fixed Price Offerings, Exchange Act Release No. 15,807, 1979 Transfer Binder Fed. Sec. L. Rep. (CCH) 82,073 (May 9, 1979); In re National Ass'n of Sec. Dealers, Exchange Act Release No. 17,371, 1980 Transfer Binder Fed. Sec. L. Rep. (CCH) 82,705 (Dec. 12, 1980). See also In re First California Company, 40 S.E.C. 768, 1961 SEC LEXIS 353 (July 6, 1961) (affirming violation of published NASD interpretation prohibiting free-riding and withholding in offerings). The SEC decision notes that the interpretation was issued in 1950, amended in 1957, and further clarified by a 1959 letter to NASD members, as incorporated into the interpretation and published in the NASD Manual on May 1, 1959. This so-called Free Riding & Withholding Interpretation (AKA NASD Rules 5130 & 5131) was replaced by FINRA Rule 2790, Restrictions on the Purchase and Sale of IPOs of Equity Securities, in 2003.

SCOTUS addressed the issue in part in *Credit Suisse Securities (USA) LLC v. Billing,* 551 U.S. 264 (2007), wherein investors alleged that the underwriters conspired not sell IPO shares to an investor unless that investor committed (1) to buy additional shares at escalating prices (laddering), (2) to pay unusually high commissions on such subsequent purchases, or (3) to buy into other less desirable IPOs (tying). SCOTUS ultimately ruled that the antitrust claim based on the manner of the offering was preëmpted by the comprehensive scheme of federal securities law as administered by the SEC.

that investors can recover under the 1933 Act is $10 per share (the difference between the $20 offering price and $10). So the most the corporation must pay out is $10 million in total. But what about investors who bought in the aftermarket at $40 per share? The 1933 Act does not clearly address the situation.

Then again, although investors who bought at $40 might feel cheated, it is not clear that they should have a remedy for anything more than the $10 loss. If the point of the statute is that the *company* should give back the money it raised by false pretenses, damages of $10 per share achieves that purpose. Compensation is a side-benefit. At least that is what the statute seems to imply given the cap on issuer liability. Moreover, one might argue that denying a remedy based on aftermarket price inflation promotes that policy by discouraging frenetic trading following an IPO whereas providing such a remedy might encourage trading dynamics that make the situation worse.[17]

On the other hand, underpricing may be part of a scheme to whip investors into a buying frenzy. Suppose that the CEO – or an investment adviser with ties to the underwriter investment bank – talked up the price by misrepresenting company prospects? The 1933 Act arguably addresses this possibility by providing a right of rescission against sellers (as opposed to issuers) (in §12) as well as a catch-all antifraud provision (in §17).[18]

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[17] In any event, it is remarkable that few of the many commentators who have addressed the problems with securities fraud class actions have noticed the implication inherent in the 1933 Act that the company should not be liable for trading losses.

[18] Section 17 reads as follows: "(a) It shall be unlawful for any person in the offer or sale of any securities *** directly or indirectly — (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

To be clear, Section 17 applies to all offers and sales of securities in interstate commerce – whether public or private. The primary thrust of the 1933 Act is to require registration (and disclosure) in connection with the issue of securities to the general public. Accordingly, the 1933 Act includes several provisions exempting specified transactions (as well as certain securities such as government securities). But the above provision applies to *all* offers and sales of securities whether or not exempted (with a few notable exceptions). Thus, much of the early litigation under the act focused on what constitutes a security, with the SEC flexing its enforcement muscle against orange groves, chinchilla breeding programs, earthworm farms, and various pyramid schemes.

Most courts have held that there is no private right of action under Section 17 of the 1933 Act even though it is virtually identical in wording to Rule 10b-5 – which was cloned from Section 17 – as discussed further below. *See* United States v. Naftalin, 441 U.S. 768 (1979).

Nevertheless, the 1933 Act is a reasonably good fit in the context of an IPO. But the fit is not so good in a situation in which an already public company offers additional stock to the public. Suppose the prospectus for such a follow-on offering contains a material falsehood. When the truth comes out, stock price plummets to a price well below the offering price. Investors who bought the new shares may recover under the 1933 Act. But an investor who buys in the aftermarket usually has no way of knowing whether the shares they bought are new shares or old shares. Popular conceptions notwithstanding, very few shares are represented today by certificates with serial numbers. In practice, shares are simply transferred from one investor account to another within and among the various brokerage houses. So when you buy, there is no way to know whose shares you bought. No one keeps track. All that matters is that shares bought equal shares sold at the end of the day. Only your broker knows for sure.[19]

In an offering by an already-public company, the courts have held that a buyer cannot recover under the 1933 Act unless the shares can be traced to the offering.[20] Otherwise, the issuer might be held liable for damages in excess of the amount of the offering. So unless the aggrieved investor has received an allocation of shares that are part of the new offering – because they happen to be a customer of the brokerage house that is handling the offering and the new shares are deposited directly into their customer account – it is usually impossible to prove that the shares bought were newly issued shares as opposed to shares that were already outstanding.

The bottom line is that even if the primary goal of the 1933 Act is disgorgement, it fails to work in the context of a follow-on offering where many investors will not be able to establish the provenance of their shares. So it is understandable that investors and their lawyers would seek out some other remedy. That remedy would ultimately be found in the catch-all antifraud rule adopted under the 1934 Act – Rule 10b-5 – but not without some growing pains.

Although Section 12 may have been intended to create a remedy for aftermarket purchasers (as indicated by its provision of an alternative damages remedy for buyers who have sold the subject securities before obtaining a judgment), it seems likely that the §11 cap on damages would apply to any such claim.

Moreover, SCOTUS has generally limited the applicability of the 1933 Act to offerings. *See* Pinter v. Dahl, 486 U.S. 622 (1988) (one who assists in the sale of securities may be liable as a seller); Gustafson v. Alloyd Co., 513 U.S. 561 (1995) (false statement must appear in a formal prospectus or equivalent document).

[19] For a discussion of the book entry system and its implications, see In re Appraisal of Transkaryotic Therapies, Inc., 2007 Del. Ch. LEXIS 57, 2007 WL 1378345 (opinion by Chandler) (explaining why it is impossible to trace individual shares within book entry system of ownership records used by the market).

[20] *See* Slack Techs., LLC v. Pirani, 598 U.S. 759 (2023) (direct listing). The tracing requirement was first established in Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967) (opinion by Friendly).

Birth of a notion: A private right of action under SEC Rule 10b-5.

Quite aside from gaps in coverage relating to offerings, the 1933 Act is utterly silent about fraud in connection with the *purchase* of shares. For example, suppose that a mining company discovers gold in them-thar hills and before announcing the strike, undertakes to buy back its own shares before the price increases. Nothing in the 1933 Act addresses the possibility of fraud on sellers – what might be called **good news fraud**. Rather, the 1933 Act is focused on sales of stock by issuers and related parties. In short, the 1933 Act provides a remedy only against sellers in connection with offerings.

Thus, when the SEC learned (in 1942) that a Boston CEO was bad-mouthing his own company – spreading untrue *negative* information – in order to buy up shares on the cheap, the Commission discovered that there was nothing in the law that addressed fraudulent *purchases.* But there is a provision in the 1934 Act – Section 10(b) – that permits the SEC to adopt rules to deal with fraudulent and manipulative acts and practices in connection with *both* purchases and sales. So using language from the catch-all antifraud provision in the 1933 Act (Section 17) as a model, the SEC adopted Rule 10b-5 under the 1934 Act. In effect, Rule 10b-5 says simply that fraud **in connection with** the *purchase or sale* of securities is illegal.[21] Although one might have thought that fraud was illegal anyway, Rule 10b-5 turned it into a federal case –literally. Using this rule as authority, the SEC was able to deal with the Boston CEO.[22]

It took just four years for a court to hold in *Kardon v. National Gypsum, Inc.,* that Rule 10b-5 can be used by investors as the basis for a *private* lawsuit in cases against

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[21] Accordingly, Rule 10b-5 was thought at first to apply only to purchases as discussed further below. Rule 10b-5 is short and sweet. It reads in its entirety: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

[22] The story of the adoption of Rule 10b-5 is recounted in Milton Freeman, Comment, Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967) (comment by Milton Freeman, Attorney and Assistant Solicitor, SEC, 1934-46). To be clear, Rule 10b-5 is the fifth rule adopted under Section 10(b) of the 1934 Act. There are at least twenty other rules adopted under the same section. But for the most part they deal with particular practices. For example, insider trading, pricing of OTC stocks, open market repurchases, etc.

buyers like the Boston CEO.[23] If Rule 10b-5 makes fraud illegal under the federal securities laws, then it would seem to follow that an aggrieved investor can make a claim based thereon. After all, if investors can recover under the 1933 Act when they pay too much, why should they not be able to recover under Rule 10b-5 when they sell for too little?

Or should they? There are good reasons for a law that prevents sketchy companies from sucking up scarce capital. But it does not necessarily follow that we should be equally worried about subsequent trading in shares. Indeed, the traditional wisdom was that it is no business of an issuer company what happens to its shares after they are issued. Still, if investors can be cheated out of returns, it may be just as bad for business (and the markets) as is a fraudulent offering.

It is also troubling that Rule 10b-5 is a rule adopted by an administrative agency under a section that says simply that the SEC has the authority to adopt rules to deal with fraud. To be clear, Section 10(b) itself does nothing other than give the SEC the power to adopt rules. It does not itself state that any act or practice is illegal. So if the SEC had not adopted any rules thereunder, the section itself would have had no effect on anything.[24]

Moreover, there is no hint in Section 10(b) that it is intended to permit the SEC to do what Congress did in Section 11 of the 1933 Act – to enact a law that permits investors to sue for compensation.[25] That is one possible interpretation. But another is that the

[23] *See* Kardon v. National Gypsum, Inc., 69 F. Supp. 512 (E.D. Pa. 1946). Although *Kardon* was the first case to rule affirmatively that Rule 10b-5 gave rise to a private right of action, so much was assumed in *Speed v. Transamerica Corp.,* 5 F.R.D. 56 (D. Del. 1945).

[24] Nevertheless, it is common for the courts to misspeak and say that a lawsuit is based on a violation of Section 10(b). *See, e.g.,* In re Vivendi, SA Securities Litigation, 838 F.3d 223 (2d Cir. 2016).

[25] As noted by Justice Rehnquist in *Blue Chip Stamps*, there is no indication that either Congress or the SEC thought about whether Section 10(b) or Rule 10b-5 would or should give rise to a private right of action. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729-30 (1975). *See also* Fridrich v. Bradford, 542 F.2d 307, 314 (6th Cir. 1976) (same). On the other hand, one could argue that independent agencies like the SEC depend on private litigation not only as a practical matter but also constitutionally. *See* Harris v. Bessent, 2025 U.S. App. LEXIS 7301, 2025 WL 980278 (March 28, 2025) (Millett dissenting and discussing practice of NLRB to depend on private litigants). *But see* SEC v. Chenery Corp., 318 U.S. 80 (1943) (Chenery I) (opinion by Frankfurter) (reversing SEC ruling because agency effectively acted as court of equity to assess fairness of proposed subject-company transaction rather than adopting a rule or otherwise applying its designated expertise to the situation). Notably, the dissenters in *Chenery I* argued that the SEC had acted properly in the same way as was NLRB practice.

section gives the SEC the power to set the rules that govern the market and then to enforce them.

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Quite aside from these big questions of how the law works – or should work – the transaction that gave rise to *Kardon* is quite extraordinary in many ways. At least it seems so in retrospect.

Two families – the Kardons (of Philadelphia) and the Slavins (of Kalamazoo) – owned a small cardboard business in southwest Michigan. A major corporation – National Gypsum – approached the Slavins about the possibility of buying the business. The Slavins made a deal to sell the company, but they did not tell the Kardons about it. Instead, they offered to buy the Kardon stock, and the Kardons agreed to sell their 50% interest for $504K. A week later, the Slavins sold the company to National Gypsum for $1.5M. Big money in those days. When the Kardons discovered that they had been cheated by their partners (so to speak), they looked for a way to sue and (incidentally) sought the help of the SEC (which at the time had its headquarters in Philadelphia).

The trial court reckoned that the 1934 Act through Rule 10b-5 outlaws fraud and that if fraud is illegal, there must be a remedy for it. In other words, where there is a right (and wrong), there is a remedy. Ubi jus ibi remedium, as we lawyers like to say. Moreover, since the 1933 Act provides a private civil remedy against sellers, it seems only natural to conclude that Rule 10b-5 provides a private civil remedy remedy against buyers. Note that nothing yet suggests that there should be any remedy other than one against the counterparty to a trade – that there should be a remedy against the company because those in control should be seen as speaking for the company.[26]

As a factual matter, the court ultimately found that the Slavins had lied to the Kardons. Specifically, the Slavins denied (in response to a direct question from the Kardons) that they had found a buyer for the company. There was some dispute as to the exact question posed by the Kardons – whether it was limited to a potential buyer for the stock or included the possibility of a sale of assets as ultimately occurred. In the end, the court

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that insider purchase of shares during pendency of utility reorganization was unfair as unsupported by any finding or rulemaking based on expertise of agency)

See also Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007), *citing* Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005) and J. I. Case Co. v. Borak, 377 U.S. 426 (1964) (for proposition that meritorious private actions to enforce federal antifraud securities laws are essential supplement to criminal prosecutions and civil enforcement actions). *See* Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis, 444 U.S. 11 (1979).

[26] For historical perspective, it was not until 2006 that the Restatement of Agency included a provision reflecting this idea. *See* ALI, Restatement (Third) of Agency 7.08 (2006).

found that the question included both possibilities. But the court went on to say that it made "little difference because even if the version given by the defendants is accepted it is perfectly clear that, in the light of the circumstances under which Leon Slavin's answer was made, he omitted to state a material fact necessary to make his answer not misleading." The court here referred expressly to the second clause of Rule 10b-5, which extends to fraud by omission (so to speak).[27]

While the *Kardon* court supposedly held that Rule 10b-5 creates a duty of disclosure and a private right of action for a remedy, the *Kardon* court also recognizes (more than once) that there is both a right and a remedy under the common law based not only on the law of deceit but also on the law of fiduciary duty as it relates to corporations and directors. Although the court suggests in one passage that mere silence might not suffice to state a claim (at least as against National Gypsum as a third-party buyer), the court was well aware that the law required complete candor from directors and officers when dealing with fellow stockholders as shown by its citation to a 1934 Tenth Circuit decision that gathered pretty much all of the law on the subject.[28] Indeed, the *Kardon* court noted that "as a practical matter, it does not make much difference *** whether the complaint states a cause of action under [Rule 10b-5] or under the common law because there is diversity of citizenship." In other words, fraud is illegal anyway. This suggests that the court was more focused on jurisdiction and procedure than it was on substance, as further borne out by numerous references to service of process.

To be clear, the *Kardon* court made two crucial moves. One was to hold that Rule 10b-5 could be used by private litigants to file a claim in federal court. The other was to hold that silence constitutes deception at least where the non-speaker owes a fiduciary duty to the counterparty. Without both of these legal moves, the Slavins' purchase of shares from the Kardons would have been no different from a developer buying up land where a new highway is about to built.[29]

It seems curious today that the case in which Rule 10b-5 is first found to give rise to a private right of action should involve a face-to-face transaction that was part of the sale of a closely held business (as a business) to a new owner – and by a sale of assets no less.[30] But most of the early Rule 10b-5 cases arose in connection with face-to-face

[27] As should be clear, the real defendants in *Kardon* were the Slavins. Although the original complaint named National Gypsum as a conspirator, that claim was dropped. But National Gypsum remained in the case because it agreed to abide by the court's ruling – whatever it might turn out to be.

[28] Dunnett v. Arn, 71 F.2d 912, 919 (10th Cir. 1934).

[29] *But see* Strong v. Repide, 213 U.S. 419 (1909) (finding breach in purchase of stock by insider where *special facts* gave rise to fiduciary duty to disclose to fellow stockholder). Thank you, Church Lady.

[30] Indeed, Louis Loss himself found the case quite curious. Nevertheless, SCOTUS would eventually agree that the catch-all anti-fraud rule in the 1934 Act also applies to *sales* of

frauds involving closely held corporations. And such cases remain quite common.[31] Moreover, two of the very earliest cases to reach SCOTUS arose from SEC enforcement actions focused on small-time schemes and raising the question of what is a security.[32] Indeed, the 1933 Act was arguably aimed at small not-yet-public companies.

It is also possible that the SEC chose to beat up on small business before challenging big business. But as we will see, there was significant doubt about whether Rule 10b-5 could even apply in connection with anonymous trading on an open market, which question persisted into the 1970s. To be sure, the 1934 Act was clearly aimed at exchanges and trading (although it largely overlooked the OTC market until 1939).[33] Then again, it would have been difficult to prove fraud in connection with an anonymous open-market purchase. As in *Kardon,* most cases of securities fraud theretofore had involved positive efforts by the fraudster to induce the counterparty to act – more than merely taking advantage of bad timing on the part of the seller (or buyer) who had decided to trade for their own reasons. After all, the seller is going to lose regardless of the identity of the buyer.

Again, the thinking at the time was that it was no business of a corporation how anyone might deal in its stock after issuance – including directors and officers.[34] So it might be

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stock in closely held corporations. *See, e.g.,* Tcherepnin v. Knight, 389 U.S. 332 (1967). *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (construing rule in context of receipt of investor funds by broker-dealer). The question whether Rule 10b-5 should apply in the context of a sale of a business – merely because the sale is effected by transfer of stock rather than by merger or sale of assets – remained open until 1985 when it was finally resolved by SCOTUS, which held as did *Kardon* that Rule 10b-5 did indeed extend to such cases. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985). SCOTUS reasoned that the statute (and rule) apply to trading in securities. Common stock is a security whether a few shares or a controlling block. QED. But see United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975) (holding that shares in business corporation formed to own and operate state-subsidized cooperative apartment complex were not securities under federal law). Still, it is striking that none of these questions seemed to trouble the *Kardon* court.

[31] *See, e.g.,* Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987).

[32] *See* SEC v. C. M. Joiner Leasing Co., 320 U.S. 344 (1943); SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

[33] See Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976). Note Maloney Act. *See generally* Richard A. Booth, *Self-Regulation in a Democratic Society,* 50 J. Air L. & Com. 1301 (1985).

[34] *See* Brophy v. Cities Service Co., Del. Ch., 31 Del. Ch. 241, 70 A.2d 5, 7 (1949). *But see* Gratz v. Claughton, 187 F. 2d 46, 49 (2d Cir. 1951), as quoted in *Cady Roberts* at note 23 where Judge Learned Hand states in the context of Section 16(b) of the Exchange Act: "For many years a grave omission in our corporation law had been its indifference to dealings of directors or other corporate officers in the shares of their companies. When they bought shares they came literally within the conventional prohibitions of the law of trusts; yet the decisions were strangely slack in so deciding. When they sold shares, it could indeed be

difficult to hold that an insider who used their position (and knowledge) for personal profit – while remaining silent – had violated any duty to the corporation or other stockholders. On the other hand, the Delaware Chancery Court so found as early as 1949 in *Brophy v. Cities Service Co.,* despite significant precedent to the contrary.[35]

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argued that they were not dealing with a beneficiary, but with one whom his purchase made a beneficiary. That should not, however, have obscured the fact that the director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one."

[35] *Brophy* was an apparent derivative action seeking recovery from several directors and one non-director executive officer who profited from buying company stock on the open market ahead of an increase in market price caused by a large repurchase of shares. Despite the context, the Brophy court held as it did based on the fundamental proposition that an agent may not use information obtained from the principal for personal profit without permission – that the information is the property of the principal. *Accord* Diamond v. Oreamuno, 248 N.E.2d 910 (N.Y. 1969). *See also* In re ORFA Securities Litigation, 654 F.Supp. 1449 (D.N.J. 1987); National Westminster Bancorp NJ v. Leone, 702 F.Supp. 1132 (D.N.J. 1988) (both finding that Diamond would likely be followed by NJ courts). *But see* Schein v. Chasen, 313 So.2d 739 (Fla. 1975); Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978) (Indiana law) (both declining to follow the *Diamond* reasoning). Delaware has recently reaffirmed *Brophy* despite the argument that federal law has occupied the field of insider trading.

Yet another factor that might have influenced the *Kardon* court was general hostility toward derivative actions. In 1944, New York enacted legislation requiring ownership of stock worth at least $50K or a bond for expenses as a condition for maintaining a derivative action. NYBCL 61-b. At the same session, the legislature also adopted a contemporaneous ownership rule, requiring that the plaintiff in a derivative action have owned stock in the subject corporation at the time of the offending transaction, overruling *Pollitz v. Gould,* 202 N.Y. 11 (1911). *See* George D. Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York,* 32 Cal. L. Rev. 123 (1944). The bill was promoted by the Chamber of Commerce but was opposed by virtually every relevant bar association.

In *Kardon,* the Slavins bought stock from the Kardons but then caused the corporation distribute its assets to the Slavins who then sold the assets to National Gypsum. Although the *Kardon* court poo-pooed the form of the transaction, one could argue that *the corporation* should recover for the gain it would have enjoyed if it had sold the assets to National Gypsum. Thus, the *Kardon* court might have been worried that more formalistic state courts might stifle stockholder rights in the name of procedural nit-picking.

On the other hand, SCOTUS has been hostile to derivative actions. *See supra* note 6.

To be sure, the 1933 Act permits a trial court to require an *undertaking for expenses* to cover even the legal fees of the defendant, but there is no record that the provision was ever been used. *Cf.* Fischman, *supra,* at 12-14 (reversing imposition of bond by trial court as premature). And there is no such provision in the 1934 Act that would permit the requirement of a bond in a case arising under Rule 10b-5.

This rather suggests that the anti-fraud Kool-Aid was widely consumed in post-war courthouses. Nevertheless, *Brophy* remains good law. Indeed, the Delaware Supreme Court reaffirmed so in 2011 despite a lower court ruling that federal law had essentially occupied the field in connection with insider trading.[36]

It may be significant that *Kardon* was decided a mere eight years after *Erie R. Co. v. Tompkins,* in which the Supreme Court required federal courts thereafter to use applicable state law in diversity cases rather than to develop a body of federal common law.[37] It could be that the *Kardon* court (not to mention the SEC) was worried that the federal courts would be denied a role in shaping the law. And it would have been quite odd for sales to give rise to a federal question but for purchases to be relegated to state court.[38] By ruling as it did, the *Kardon* court transformed securities fraud into a federal question and assured that the federal courts would have a role in the evolution of securities law.[39] In 1998, Congress would take the further step of eliminating the jurisdiction of state courts over securities fraud class actions although the federal courts had always had exclusive jurisdiction over violations of the 1934 Act and thus Rule 10b-5.[40]

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[36] *See* Kahn v. Kolberg Kravis Roberts & Co., L.P., 23 A.3d 831 (Del. 2011).

[37] Erie R. Co. v. Tompkins, 304 U.S. 64 (1938). *See generally* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 Yale L. J. 663 (1974). But under Erie, federal courts follow federal rules of procedure. And federal courts generally treat bond requirements as matters of procedure rather than substantive state law. *See* J.I. Case v. Borak, 377 U.S. 426, 432 (1964). *See also* In re Cady Roberts, 40 S.E.C. 907; 1961 SEC LEXIS 385 (November 8, 1961) (discussing the issue).

[38] Then again, cases arising under the 1933 Act may be litigated in state court. But cases arising under the 1934 Act may be litigated only in federal court. *See* Cyan, Inc. v. Beaver County Employees Retirement Fund, 583 U.S. 416 (2018). *But cf.* Matsushita Electric Industrial Co. v. Epstein, 516 U.S. 367 (1996) (settlement of state law claim may extend to federal claims).

[39] This suggests that the courts (like some prominent commentators) saw federal securities law as a potential replacement for a system of corporate governance based on state law. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 Yale L. J. 663 (1974). It is also curious that *Kardon* was litigated in a Philadelphia federal court (by Philadelphia lawyers) even though the Slavins were residents of Michigan and National Gypsum was a Delaware corporation with its headquarters in Buffalo. On the other hand, the Kardons were residents of Philadelphia. And it is likely no mere coincidence that the SEC had relocated to Philadelphia during WWII, where it remained until 1948. Indeed, the SEC's Roger Foster participated in the litigation of the case as amicus curiae.

[40] To be specific, Congress did so in the Securities Litigation Uniform Standards Act (SLUSA), which was prompted by the flow of class actions to state courts in reaction to PSLRA (as discussed further below). *See* Cyan, Inc. v. Beaver County Employees Retirement Fund, 583 U.S. 416 (2018).

The hobgoblin of little minds.

Consistent with its roots, almost all early cases arising under Rule 10b-5 involved frauds perpetrated by buyers. Indeed, some observers (led by Harvard Professor Louis Loss) were of the view that Rule 10b-5 applied only to buy-side frauds. The idea was that Congress had intended in the 1933 Act to create a carefully structured and symmetrical system governing offerings of stock, whereas fraudulent trading was governed by the 1934 Act.

This view was bolstered by the original title of the rule: *Employment of Manipulative and Deceptive Devices by a Purchaser.* As noted in the SEC decision *In re yy Roberts* – which is discussed in some detail below -- the name of the rule was changed in 1951 to eliminate the last three words.[41]

The truth is that the 1934 Act is a random collection of provisions that did not fit well in the 1933 Act and that do not fit particularly well with each other. It includes sections focusing on the registration of exchanges and securities professionals, market structure, manipulation, short sales, fraud, company reporting, proxy regulation, tender offers, trading by insiders, and anything else that comes up after lunch.

Nevertheless, the Louis Loss view seems to have been widely shared. As in *Kardon,* most of the early cases arising under Rule 10b-5 involved symmetrical frauds based on

[41] *See* In re Cady Roberts, 40 S.E.C. 907; 1961 SEC LEXIS 385 (November 8, 1961) at note 22. Nevertheless, the Commission in *Cady Roberts* (at 15-16) seems to have felt compelled to explain that Rule 10b-5 applies to fraud on buyers:

> Neither the statutes nor Rule 10b-5 establish artificial walls of responsibility. Section 17 of the Securities Act explicitly states that it shall be unlawful for any person in the offer or sale of securities to do certain prescribed acts. Although the primary function of Rule 10b-5 was to extend a remedy to a defrauded seller, the courts and this Commission have held that it is also applicable to a defrauded buyer. [See Ellis v. Carter, 291 F. 2d 270 (C.A. 9, 1961); Matheson v. Armbrust, 284 F. 2d 670 (C.A. 9, 1960), cert. den., 365 U.S. 870 (1961); Fischman v. Raytheon, 188 F. 2d 783 (C.A. 2, 1951).] There is no valid reason why persons who purchase stock from an officer, director or other person having the responsibilities of an "insider" should not have the same protection afforded by disclosure of special information as persons who sell stock to them. 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. (emphasis in original) (footnote omitted).

affirmative misrepresentations or omissions where the buyer owed a fiduciary duty to the seller and where the loss to the seller was matched by the gain to the buyer. [42]

Today, courts and commentators do not make much distinction between a violation of the 1933 Act and the idea of securities fraud. Few would hesitate to call the former fraud. Nor did Congress seem to recognize any such distinction when it passed the Private Securities Litigation Reform Act (PSLRA) in 1995.[43] But in the first few decades after 1933, the courts were quite careful to distinguish between a violation of the no-fault 1933 Act and fraud (so-called) under Rule 10b-5 where some sort of intent must be proven.[44]

On the other hand, Rule 10b-5 clearly had the potential to provide a remedy for the plight of investors who *buy* at inflated prices in the aftermarket or who buy in a follow-on offering but cannot trace their shares to the offering. It was not the slam-dunk no-fault remedy that Frankfurter wrote into the 1933 Act. But if a buyer could show that the offering materials – which were available for anyone to read – contained a material falsehood and that the company knew of the falsehood or was at least reckless in its public statements about the company, Rule 10b-5 could provide a remedy.[45]

The first such case appears to be *Fischman v. Raytheon Manufacturing Co.,* which arose from an offering of preferred stock by Raytheon wherein the company failed to disclose its tax problems in the prospectus.[46] Investors who bought the preferred stock

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[42] As noted earlier, a disproportionate number of important cases construing Rule 10b-5 have involved frauds against sellers – good news cases – even though such cases account for less than one in fifty cases. Aside from Kardon itself, see (in chronological order) SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Basic v. Levinson, 485 U.S. 224 (1988). Since SCOTUS decides only cases that it chooses to decide, it is difficult to believe that the disproportionate number of good-news cases has resulted from the luck of the draw. It is not clear why the Court should be more inclined to consider good news cases. It is possible that some sort of vestigial memory is involved. Or it may be that the Court has intuited that less is at stake in such cases because the echo effect works to reduce investor losses rather than magnify them.

[43] Witness the fact that almost all of the reforms embodied in PSLRA apply equally to both the 1933 Act and the 1934 Act, which has given rise to some thorny questions of interpretation. *See, e.g.,* Cyan, Inc. v. Beaver County Employees Ret. Fund, 583 U.S. 416 (2018) (addressing concurrent jurisdiction of state and federal courts under the 1933 Act).

[44] *See, e.g.,* Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786-87 (2d Cir. 1951).

[45] Note that such a case would involve a positive duty of disclosure (at least to someone) and would arise under Clause (2) of Rule 10b-5.

[46] Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786-87 (opinion by Frank).

filed suit under the 1933 Act. But the lawsuit included plaintiff investors who had purchased *common* stock – having read the misleading prospectus for the offering of preferred stock – at a time when Raytheon insiders were selling their own common stock.[47]

Although the lower court held that Rule 10b-5 did not support a claim based on a false prospectus, the Second Circuit disagreed. The court was unmoved by the argument that Rule 10b-5 could not apply where Congress had provided an express but narrower remedy for claims based on a false prospectus given that the additional implied remedy under Rule 10b-5 required the plaintiff to clear the higher hurdle of proving actual fraud.

Incidentally, *Fischman* appears to be the first appellate decision – by the Second Circuit no less – holding that Rule 10b-5 gives rise to a private cause of action. Note also that the claim by purchasers of common stock seems to have been based on something like insider trading and to have sought recovery from the insiders who profited rather than from the company itself. Thus, there was still no indication as of 1951 that *the company* might be held liable other than to the extent that it sold securities itself.[48]

By 1961, several other courts had followed suit in holding that Rule 10b-5 could apply even though the 1933 Act might also apply.[49] And it became standard practice in offerings gone sour for plaintiffs to file claims under both the 1933 Act and Rule 10b-5.[50]

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[47] I was involved in a somewhat similar case, wherein it was argued that institutional investors had been tipped off about the impending collapse of PennCentral by a disclosure in an offering statement for debentures that the company was having difficulty rolling over its commercial paper. The claim was that the defendants who sold PennCentral common stock in the days following distribution of the offering statement had (in effect) traded on inside information to the detriment of those who bought during the same period. *See* Dura-Bilt Corp. v. Chase Manhattan Corp., 89 F.R.D. 87 (SDNY 1981). I argued that we should seek dismissal of the claim because our client should not be faulted for gleaning information from documents disseminated for the very purpose of informing investors, but the partner to whom I made the argument though otherwise. I was vindicated (in essence) shortly thereafter by *Dirks v. SEC,* 463 U.S. 646 (1983). But I am happy to report that our client did not join the settlement to which most of the defendants subscribed, and got much better terms in the end.

[48] A prospectus is a filed document, which might give rise to a claim under section 18 of the 1934 Act. *See* Gustafson v. Alloyd Co., 513 U.S. 561 (1995).

[49] *See* Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960); Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961).

[50] The argument from symmetry persisted until 1983 when the Supreme Court finally administered the coup de grace in *Herman & Maclean v. Huddleston,* 459 U.S. 375 (1983). By that time, Rule 10b-5 was so well established in so many settings that the argument from symmetry seemed almost quaint. (Indeed, when I first heard – in my first year as a law professor – that SCOTUS would consider the question, I found the argument contrived and verging on frivolous.) Despite the seeming demise of the argument from symmetry, the

The obvious next question is: Why should such a remedy be limited to situations in which the company offers additional stock to the public or insiders sell their shares? Arguably, investors suffer the same harm when they buy at a price inflated by misinformation whatever the source – whether a filed document or a press release or an earnings call.

At first blush, the logic of this rhetorical question seems convincing. But all the cases considered up to this point have involved a gain (or loss avoided) by defendant that is more or less matched by an equal loss suffered by plaintiff. To permit disappointed investors to recover from the company – when the company has not sold or bought any shares – is to cause the company to pay for gains enjoyed by others. In effect, legacy stockholders foot the bill by suffering a reduction in the value of their shares in addition to the loss in value when the truth comes out. So the real question is whether Rule 10b-5 is about compensating investor victims or forcing disgorgement by fraudsters.

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It might seem as if Rule 10b-5 was seen in the early days to extend to any transaction *touching* on a purchase or sale of a security (or *in connection with* such in the words of the rule itself).[51] But there were notable cases even in the 1950s in which the courts declined to find that the rule applied. For example, in *Birnbaum v. Newport Steel Corp.,* plaintiffs were stockholders of Newport Steel whose stock was trading for about $10 per share.[52] The company had reached a deal to merge with Follansbee Steel under which

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Court has tended to take cases involving disappointed sellers (good-news cases) disproportionately even though the vast majority of securities fraud class actions involve bad-news scenarios, which suggests some lingering doubt that Rule 10b-5 is at least more fitting in such a setting. Incidentally, *Herman & Maclean* also rules that there is a private right of action under Rule 10b-5 and that proof of liability thereunder need not be by clear and convincing (as is sometimes required for fraud) – but rather may be by a preponderance of the evidence.

Although *Herman & Maclean* is the case that actually holds that Rule 10b-5 gives rise to a private right of action, the Court had already decided several such cases without questioning the proposition.

[51] *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005) (rejecting idea that *touching* will suffice).

[52] Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952). *See also* List v. Fashion Park, Inc., 340 F.2d 457 (2 Cir.), cert. denied, 382 U.S. 811 (1965) (omission may be actionable if material thus permitting inference of reliance; affirmative misrepresentation and privity not required; but fact that counterparty was director of issuer is not per se material). *Compare* Joseph v. Farnsworth Radio & Television Corp., 99 F.Supp. 701 (S.D.N.Y.1951), *aff'd per curiam,* 198 F.2d 883 (2d Cir. 1952) (action by investors who bought stock after defendants had ceased to sell dismissed; semblance of privity required)

Newport stockholders would receive $15 per share. But at the last minute, the controlling stockholder of Newport (one C. Russell Feldmann) cancelled the merger and sold his shares to a different bidder (Wilport Steel) for $20 per share. The minority stockholders sued claiming (among other things) that they had been defrauded within the meaning of Rule 10b-5 by being denied the very real opportunity to sell at $15 because Feldmann had been effectively bribed to take another deal. In other words, Feldmann diverted the opportunity to sell to himself. The trial court dismissed the complaint for failure to state a cause of action, and the Second Circuit through a panel comprising both Judges Hand (as well as Judge Swan) affirmed.

The opinion by Augustus Hand is remarkable because it is based solely on the language of Rule 10b-5 together with its history. The court, in a 1500 word opinion without a single footnote, does not cite even one other case as precedent for the decision.[53] Rather, the court reasons that Rule 10b-5 was adopted (in the words of the SEC itself) "to close a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase" because before adopting the rule the prohibition against fraud extended only to sellers (under §17 of the 1933 Act) and broker-dealers (under §15(c) of the 1934 Act).[54] Responding to the argument by plaintiffs that such a narrow reading of the rule was inconsistent with the purpose of the 1934 Act to protect investors "from exploitation by corporate insiders" (as reflected in the Senate committee report), the court agreed but noted that Section 16(b) of the Act gave the corporation (and its stockholders derivatively) an express right of action against insiders who use their position to profit from the purchase or sale of securities. Thus, as the court stated, " When Congress intended to protect … stockholders … against a breach of fiduciary duty by corporate insiders, it left no doubt as to its meaning."[55] Although *Birnbaum* is usually cited for the rule that only a purchaser or seller may sue under Rule 10b-5, it also strongly suggests that only a purchaser or seller may *be sued* – that the remedy is limited in effect to rescission or the monetary equivalent thereof.[56]

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with Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962) (privity is not necessarily required if plaintiff can show that stockholder who gained control of corporation caused dividend cut to depress stock price thus facilitating further purchases). *But see* Chasins v. Smith, Barney & Co., 438 F.2d 1167 (1970). *Cf.* Birnbaum, 193 F.2d at 463 (discussing meaning of *in-connection-with* requirement).

[53] The court does cite *Fischman* but only for the legislative history therein relating to Rule 10b-5.

[54] Birnbaum, 193 F.2d at 463.

[55] Birnbaum, 193 F.2d at 463-64.

[56] The Supreme Court later rejected an expansive interpretation of 16(b) in *Blau v. Lehman,* 368 U.S. 403 (1962), over a vigorous dissent by Justice Douglas (who typically recused himself from cases arising under the federal securities laws). *See* Adam C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices,* 95 Va. L. Rev. 95 841 (2009). Incidentally, Blau appears to have been a bit of a crank who made a business out of

Birnbaum is a thoroughly modern opinion that could have been written today. Until 1975 or so, most courts that addressed Rule 10b-5 effectively assumed that it extended to any dispute involving trading in securities. In effect, the burden was on the defendant to show why the rule did not apply. *Birnbaum* stands virtually alone in rigorously analyzing how the rule fits into the statutory scheme – which may explain the lack of any citation to precedent.

On the other hand, the reasoning of *Birnbaum* depends heavily on the idea that Congress is just as careful in drafting statutes as are courts in interpreting statutes. To be sure, Congress was quite careful in the 1933 Act to distinguish between strict liability for falsehoods in a registration statement (under §11) negligence in a prospectus (under §12) and fraud writ large (under § 17). But the 1934 Act is a bit of a mishmash. Moreover, the idea that Congress is careful is largely a fiction used by the courts to justify their decisions. As a deconstructionist would note, the language of a statute (or rule) stands alone – like the cheese in the dell – and quite independent of what might have been meant by Congress. To be fair, it is difficult to predict all of the situations that might arise in the future. Nevertheless, Congress is largely powerless to control what the courts do with the language of a statute.

Notably, the same deal that gave rise to *Birnbaum* later gave rise to *Perlman v. Feldmann,* wherein the Second Circuit, supposedly applying Indiana law, ruled that Feldmann (the controlling stockholder of Newport Steel) had breached his fiduciary duty to the corporation when he cancelled the merger with Follansbee (at $15) and instead sold his shares to Wilport (at $20).[57]

Perlman has fascinated legal scholars and corporate lawyers since it was decided in 1955 because it stands in stark contrast to the general rule that a stockholder – including a controlling stockholder – is free to sell his shares at a premium reflecting their value as controlling shares.[58] The decision seems to suggest that the right to control a corporation is an asset that belongs to the corporation itself and one that

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derivative litigation arising under Section 16(b). *See* Blau v. Petteys, 385 U.S. 1006 (1967); Blau v. Lamb, 385 U.S. 1002 (1967); Blau v. Max Factor & Co., 382 U.S. 892 (1965) (all denying certiorari petitions).

[57] Perlman v. Feldmann, 219 F.2d 173 (2d Cir.1955). *See also* Jones v. H. F. Ahmanson & Co., 460 P.2d 464 (Cal. 1969) (appropriation by controlling stockholders of opportunity to set up liquid market in shares).

[58] *See* Polk v. Good, 507 A.2d 531 (Del. 1986). There are many exceptions to the general rule – even in Delaware. *See, e.g.,* Thorpe v. CERBCO, Inc., 676 A.2d 436 (Del. 1996) (director and controlling stockholder who receives offer to buy corporate asset but instead induces buyer to buy his controlling interest is liable to principal corporation for failure to convey offer even though he may use his power as controlling stockholder to block the transaction).

cannot be bought and sold by a controlling stockholder to the exclusion of other (minority) stockholders. The idea is difficult to reconcile with the active market for corporate control that emerged in the 1960s and peaked in the 1980s.[59] But *Perlman* is much easier to understand as a reaction to *Birnbaum* at a time when Rule 10b-5 offered the promise of a robust remedy for abuse of minority stockholders and when Delaware law seems to have wimped out. Although *Birnbaum* affirmed a lower court order dismissing the complaint, it appears that the court retained jurisdiction based on diversity of citizenship and bent over backward to cook up a remedy – as would any good legal realist.[60]

The Supreme Court later embraced *Birnbaum* in *Blue Chip Stamps* (1975) and again in *Dabit,* (2006).[61] But the Court had undermined the reasoning of *Birnbaum* in *Bankers Life* (1970) by noting that misappropriation (embezzlement) is a classic example of fraud and thus could be reached by Rule 10b-5, suggesting that the rule could be used to litigate pretty much any breach of fiduciary duty involving a corporation. The Court later reneged on that promise in *Santa Fe Indus., Inc. v. Green,* holding that fraud requires affirmative deception.[62]

As noted, the *Birnbaum* doctrine (as it came to be known) was eventually adopted by SCOTUS in *Blue Chip Stamps v. Manor Drug Stores* (1975).[63] But the doctrine was slightly modified in the process. *Blue Chip Stamps* involved a potential purchaser who had been offered shares (as part of an antitrust settlement) – at what turned out to be a bargain price – but had been persuaded *not* to buy the shares by unduly gloomy projections from the issuer. Rather than holding that Rule 10b-5 did not provide a cause

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[59] On the other hand, most of the developed world follows a rule of equal opportunity, requiring that minority stockholders be afforded an opportunity to participate in any change of control transaction. And many states follow such a rule in the context of closely held corporations for which there is no ready market for shares. *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass.1975); Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976). *But see* Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) (rejecting idea that special rules should be applied to closely held corporations); Toner v. Baltimore Envelope Co., 498 A.2d 642 (Md.1985) (rejecting presumption that selective repurchase is improper). *Cf.* Maffei v. Palkon, 2025 Del. LEXIS 51, 2025 WL 384054 (discussing what constitutes non pro rata benefit for controlling stockholder).

[60] *See also* Gratz v. Claughton, 187 F. 2d 46, 49 (C.A. 2, 1951) (1951) (L. Hand discussion of 16(b)). *See supra* note 11 (discussing *Chenery* cases); note 48 (discussing Blau case).

[61] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006). *See also* Cyan, Inc. v. Beaver County Employees Ret. Fund, 583 U.S. 416 (2018).

[62] Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977). *See also* Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972) (dismissing claim for injunctive relief in connection with merger).

[63] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

of action in such a case, SCOTUS ruled that a non-buyer had no *standing* to sue. This subtle distinction left open the possibility that the SEC (or DOJ) might be able to address such cases administratively (or criminally) whereas holding that Rule 10b-5 did not give rise to a cause of action might preclude such enforcement or (prosecution).[64] Nevertheless, *Blue Chip Stamps* is widely regarded as the beginning of SCOTUS efforts to limit the reach of Rule 10b-5 and federal securities laws in general. Although the Court would later confirm that the rule gives rise to a private cause of action, it would reject every other attempt to imply such rights whether based on statute or rule.

If you remember the sixties, you weren't there.

SCOTUS effectively endorsed *Kardon* in *J. I. Case Co. v. Borak* in 1964, holding that there is a private right of action for proxy fraud (so-called) under SEC Rule 14a-9.[65] But a careful reading of the *Borak* opinion reveals that the Court made no real commitment therein to a particular remedy or indeed to whether the action should be seen as direct or derivative. Indeed, the *Borak* Court suggests that the distinction is irrelevant for federal securities law purposes. Thus, *Borak* exemplifies the rather loosie-goosy why-not anything-goes approach that prevailed in the courts and would continue to do so until 1975. Still, *Borak* says what it says. And given that Rule 10b-5 uses language that is almost identical to that of Rule 14a-9, it would be almost impossible for the Court to rule against a private right of action under Rule 10b-5.[66]

As for the remedy, it might be injunctive or it might be damages. If the merger eggs have already been scrambled, perhaps because the plaintiffs did not seek an injunction or because the court denied such relief, money damages might fix things. This is a particularly thorny question in the context of proxy fraud in connection with a merger. It is easy to imagine a case in which a proxy statement contains a misstatement of a

[64] *Cf.* Aaron v. SEC, 446 U.S. 680 (1980) (holding that SEC must prove scienter in enforcement proceeding per *Hochfelder* case).

[65] J. I. Case Co. v. Borak, 377 U.S. 426 (1964). Note that Rule 14a-9 appears to be cloned from Rule 10b-5. It is first mentioned by a court in Dunn v. Decca Records, Inc., 120 F. Supp. 1, 2 (SDNY 1954). The oddity of proxy-fraud is that it involves voting rather than trading. On the other hand, a merger involves an ultimate exchange of company shares for some specified consideration, and most mergers require a stockholder vote. *See, e.g.,* Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991).

To be completely clear, *Borak* does not cite *Kardon*. On the other hand, Borak did support the idea of a private attorney general to assist in the enforcement of the federal securities laws. *See* Rosenblatt v. Northwest Airlines, 435 F.2d 1121, 1124 (2d Cir. 1970) (opinion by Friendly). But the idea was undermined by the SCOTUS decision precluding the award of plaintiff attorney fees against the defendant even in successful cases. *See* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240 (1975).

[66] *See* Shapiro, 495 F.2d at note 12 (suggesting that proxy rules and tender offer rules embody same concepts and may serve as precedent for each other).

material fact – and one that might have changed the number of votes cast in favor of the transaction but not the outcome of the vote. In such a case, it might make sense simply to determine whether the price paid was fair – especially if the merger has already occurred – which was the approach adopted by the Seventh Circuit in *Mills v. Electric Autolite Co*.[67] But the Supreme Court disagreed, holding that it is not necessary to show that the omission of a material fact actually influenced votes. Rather, it is enough to establish that the vote itself was an *essential link* in the transaction being questioned.[68]

In contrast, the looming question under Rule 10b-5 was whether a plaintiff must show some causal connection between defendant actions and plaintiff losses. Into the early 1960s, reliance and privity were required (and were seen as more or less synonymous).[69] Thus, open-market fraud – where the buyer buys in an anonymous market without any prompting by seller – was an open question until the 1961 SEC enforcement action against the broker-dealer Cady Roberts & Co., holding that Rule 10b-5 prohibited insider trading even in such situations.[70]

Two events in the late 1960s enabled the system we have today. Neither was sufficient. But both were necessary. The first such event was the amendment in 1966 of FRCP Rule 23 governing class actions. More about that later when we turn to a discussion of the first big class action case involving Rule 10b-5. The second and more dramatic of

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[67] Mills v. Electric Autolite Co., 403 F.2d 429 (7th Cir. 1968). See Richard A. Booth, *The Emerging Conflict Between Federal Securities Law and State Corporation Law,* 12 J. Corp. L. 73 (1986).

[68] Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970). The phrase *essential link* has given rise to the idea that if a vote (or indeed some item of information) cannot affect the outcome, it cannot be material. *See, e.g.,* Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977); Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991). *See also* Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 575 U.S. 175 (2015) (holding that an opinion may constitute a fact). *Cf.* Ret. Plans Comm. of IBM v. Jander, 589 U.S. 49 (2020) (to plead breach of fiduciary duty of care one must show lack of plausible excuse for action taken). No doubt *Mills* is better remembered for suggesting that a fact is material if it *might* be important to an investor in deciding how to act, giving rise to the great might-could-would debate. SCOTUS seems to have regretted setting the bar so low and held in TSC Industries v. Northway, Inc., 426 U.S. 438 (1976), it must be shown that a fact *would* be important to an investor to be found to be material and that it must change the total mix of information available to investors, thus suggesting that it must affect some investors and perhaps market price without quite saying so.

[69] *See, e.g.,* Joseph v. Farnsworth Radio & Television Corp., 99 F.Supp. 701 (S.D.N.Y.1951), *aff'd per curiam,* 198 F.2d 883 (2d Cir. 1952); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962). It seems more than likely that the evolution of what constitutes securities fraud is at least distantly related to the growth of product liability law during the same period. *See, e.g.,* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral,* 85 Harv. L. Rev. 1089 (1972).

[70] In re Cady Roberts, 40 S.E.C. 907; 1961 SEC LEXIS 385 (November 8, 1961). *See supra* note 41.

the two events was the 1968 decision by the Second Circuit Court of Appeals in *SEC v. Texas Gulf Sulphur* – *TGS* for short.[71] When it comes to matters of securities law, the Second Circuit is almost as influential as the Supreme Court – indeed maybe more so – because it sits in New York and has jurisdiction over appeals of federal law arising on Wall Street. Thus, most big cases relating to federal securities law pass through the Second Circuit on their way to the Supreme Court. And given that the Supreme Court takes relatively few cases, the Second Circuit ends up speaking the final word on most. As such, the Second Circuit quickly became specialized in federal securities law.[72]

The TGS case arose as the result of TGS's discovery (in 1963) of an extraordinary deposit of ore in Canada. When rumors of the discovery spread to Wall Street (and Bay Street), the price of TGS stock began to rise from about $17 per share in early November 1963. TGS responded (on April 12) with a gloomy press release playing down the significance of the discovery in order to quell any frenzy of speculation (and to prevent an increase in land values in the area). Stock price fell back to about $30. Meanwhile, several high level officers of the company began to buy stock. Some even bought options (never having done so before).[73] Still others were awarded (and accepted) stock options as compensation. None of the buyers (save one) was responsible for the gloomy press release. They merely took advantage of a situation created by others. And when the truth came out, they made a ton of money (so to speak). Stock price rose to about $37 on the day of the announcement (April 16). A month later (May 15) TGS stock sold for a bit over $58.

The TGS case was mostly about insider trading. But in its complaint, the SEC also sought permanently to enjoin TGS (the company) "in connection with the purchase or sale of securities *** from issuing, publishing, distributing or otherwise disseminating materially false *** or inaccurate press releases and other communications and reports" about its operations.

The legal hurdle faced here by the SEC was that as a company TGS did not clearly do anything wrong. TGS itself did not seek to buy its own shares at bargain prices. Nor did TGS seek to confer a benefit on its officers and employees who seized the opportunity

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[71] *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir.1968). *TGS* was a *cause celebre* even at the time it was decided. (I recall one Yale classmate who was quite eager to get to the discussion thereof in our class on corporations – which was called *Business Units* in 1974 – whereas I had never heard of the incident.)

[72] To be fair, other courts of appeal have played an important role. The DC Circuit hears most cases relating to SEC rules and enforcement actions simply because it is the go-to circuit for administrative agencies generally. In addition, the Seventh Circuit (which sits in Chicago) sees plenty of action as does the Ninth Circuit (which sits in San Francisco). Followed by Third, Fifth and Sixth. Nevertheless, the Second Circuit largely remains the opinion leader in cases involving federal securities law.

[73] And there was no public market for options at the time. The CBOE not would open its doors for another ten years. So it took some effort to buy options in 1963.

to supplement their income. Rather, TGS sought to calm the market and to buy some time to negotiate mineral leases. But a majority of Second Circuit judges (sitting en banc) saw things otherwise. In the words of Judge Waterman who wrote the opinion for the court:

> Congress when it used the phrase "in connection with the purchase or sale of any security" intended only that [a statement] be of a sort that would cause reasonable investors to rely thereon, and *** so *** cause them to purchase or sell a corporation's securities. There is no indication that Congress intended that the corporations or persons responsible for the issuance of a misleading statement would not violate the section unless they engaged in related securities transactions or otherwise acted with wrongful motives; indeed, the obvious purposes of the Act to protect the investing public and to secure fair dealing in the securities markets would be seriously undermined by applying such a gloss onto the legislative language. Absent a securities transaction by an insider it is almost impossible to prove that a wrongful purpose motivated the issuance of the misleading statement. The mere fact that an insider did not engage in securities transactions does not negate the possibility of wrongful purpose; perhaps the market did not react to the misleading statement as much as was anticipated or perhaps the wrongful purpose was something other than the desire to buy at a low price or sell at a high price. Of even greater relevance to the Congressional purpose of investor protection is the fact that the investing public may be injured as much by one's misleading statement containing inaccuracies caused by negligence as by a misleading statement published intentionally to further a wrongful purpose. We do not believe that Congress intended that the proscriptions of the Act would not be violated unless the makers of a misleading statement also participated in pertinent securities transactions in connection therewith, or unless it could be shown that the issuance of the statement was motivated by a plan to benefit the corporation or themselves at the expense of a duped investing public.

In short, the seemingly innocuous phrase – *in connection with* – proved to be sufficiently expansive for the Second Circuit to rule that TGS (the company) was guilty of securities fraud. Like E. F. Hutton of old, TGS should have known that when it speaks, people listen.

We should pause here to explain why this enforcement action by the SEC is relevant to the securities fraud class action as we now know it. Needless to say, the SEC is not an investor. It did not sell TGS stock (in effect) at a loss. So it did not need to prove that it relied on the press release or that it suffered a loss as a result. Moreover, the value of an injunction against TGS prohibiting it from repeating its offense is dubious at best. A violation of the law is illegal anyway. And this once-in-a-lifetime situation was unlikely to be repeated. The only substantial effect of proving its case against TGS was that plaintiffs – in one of the forty-nine private actions that were pending at the time – could piggyback on the ruling in seeking damages.[74]

This is not to suggest that the court would have been shocked shocked to discover that its ruling might lead to something like the system we have today. Quite to the contrary, Judge Henry Friendly expressed concern about such implications in a separate concurring opinion. But he did so mostly out of a worry that a corporation might be held liable for mere mistake:

> The consequences of holding that negligence in the drafting of a press release *** may impose civil liability on the corporation are frightening *** [since] any remedy imposed against the issuer itself is indirectly imposed on all holders of the common stock. [Moreover], a rule imposing civil liability in such cases would [discourage] informing security holders and the public generally with respect to important business and financial developments. If the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that a slip of the pen *** judged in the bright gleam of hindsight will lead to large judgments, payable *** by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former.

Judge Friendly seems to have had little doubt about that a violation of federal securities law (or rules) generally gives rise to a private claim for damages as held by the Supreme Court four years earlier in *J.I. Case Co. v. Borak*. But regarding the claim that acceptance of stock options could constitute insider trading, he states:

> If we were writing on a clean slate, I would have some doubt whether the framers of the Securities Exchange Act intended section 10(b) to provide a remedy for an evil that had long been effectively handled by derivative actions for waste of corporate assets under state law simply because in a particular case the waste took the form of a sale of securities.

Although Friendly did not suggest how a securities fraud claim might be recast as a derivative claim, it seems quite clear that he would have been sympathetic to the idea.[75]

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[74] *See generally* Donald C. Langevoort, *From Texas Gulf Sulphur to Chiarella: A Tale of Two Duties* (2017); Adam C. Pritchard & Robert B. Thompson, *Texas Gulf Sulphur and the Genesis of Corporate Liability under Rule 10b-5,* 71 SMU L. Rev. 927 (2018).

[75] There were (eventually) at least sixty private actions for damages against TGS filed in the SDNY alone. *See, e.g.,* Reynolds v. TGS, 309 F.Supp. 548 (D. Utah 1970), *aff'd. as modified,* 446 F.2d 90 (10th Cir. 1971), *cert. denied,* 404 U.S. 1004 (1972). *See* Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333 (S.D.N.Y. 1969). *See* 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 (1969). Apparently all of these cases settled, and it does not appear that any court ruled on privity question – that there must be counterparty gain of some sort. *See* Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976) (collecting cases).

Still, the bigger idea that the court would rule that *the company* (TGS) had violated Rule 10b-5 – and thus might be liable for the losses suffered by sellers – seems already to be assumed by the plaintiffs in the many private actions that were pending. But Judge Friendly repeatedly suggested that Rule 10b-5 and other similar anti-fraud rules might not *always* give rise to an action for damages.[76]

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TGS was decided on August 30, 1968. On December 9, 1968 the Second Circuit decided another case that was similarly important. The question in *Green v. Wolf Corporation* was whether a claim based on Rule 10b-5 could be litigated as a class action on behalf of all investors who bought shares during a specified period.[77] Again, FRCP Rule 23 had been amended in 1966 to make it more user friendly (so to speak). Among other things, the old rule had required the consent of individual class members to be included in the class. While it seems only right that an investor should be free to choose whether to join a lawsuit, the practical reality was that an individual plaintiff seeking to file a class action would need to seek out fellow buyers (or sellers) to join the action. Few small investors would be motivated by the prospect of minimal recovery to fill out the necessary paperwork to be filed with the court. Thus, an enterprising individual plaintiff would likely seek out large claims and not bother with small claims. Quite aside from leaving the latter without an effective remedy, the result in a securities fraud setting would be for small investors to foot the bill for large investors because the company pays any settlement, thus exacerbating the echo effect. Incidentally, this same problem seems to be reëmerging today with large claimants tending to opt out more and more often in order to avoid the limitations that now go with class actions.

Accordingly, Rule 23 was amended to provide for opt-out class actions. In other words, one was IN unless one opted OUT rather than the other way round. Judge Marvin

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[76] *See* TGS, 401 F.2d at 866-68. *See also* Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969) (discussing merits of injunctive relief in tender offer setting). *Cf.* J.I. Case v. Borak, 377 U.S. 426, 432 (1964) (largely dismissing relevance of distinction between direct and derivative actions for proxy fraud). Similarly, the reach of Rule 10b-5 might be greater for the SEC than for private plaintiffs. *Cf.* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 193 (1963)(noting that elements of fraud vary with nature of relief sought and that it is not necessary in action for equitable relief to establish all elements required in action for money damages). Although SCOTUS shot down that idea in Aaron v. SEC, 446 U.S. 680 (1980), Congress resurrected it in PSLRA (1995) by authorizing the SEC (but not private plaintiffs) to prosecute claims for aiding and abetting violations of Rule 10b-5.

[77] Green v. Wolf Corporation, 406 F.2d 291 (2d Cir. 1968).

Frankel described the opt out scheme as "patterned after the highly successful procedures of the Book-of-the-Month Club." [78]

In addition, *Green* seems to be the first important case in which the ultimate question is whether the issuer corporation is liable for losses suffered by buyers based solely on open-market purchases made at a time when price is inflated by misinformation disseminated by the company. To be clear, the company had not sold shares. Indeed, the plaintiff stipulated that his claim was based solely on shares he had bought on the open market. Again, as in *Raytheon,* the misinformation was contained in a prospectus for a *different* offering – one that never happened. But unlike *Raytheon,* there was no indication that insiders had sold any of the shares that the plaintiff bought. The *Green* court did not seem to notice any of these subtleties. Indeed, the question whether the company might be liable for money damages was left open by *TGS* – which was an enforcement action by the SEC – although it was noted therein that forty-nine private actions arising from the same facts were then pending in the courts. Nevertheless, *TGS* ruled only that TGS the company was liable – for something. So *Green* appears to be the first case in which the potential for an echo effect clearly emerged.

Notably, the *Green* court also addressed the question whether punitive damages could be awarded in an action based on Rule 10b-5. The plaintiff argued that an action under Rule 10b-5 was essentially a common law fraud claim for which punitive damages ordinarily may be awarded. After all, fraud is an *intentional* wrong unlike a mere accident arising from negligence. Thus, punishment is appropriate in addition to compensation. Moreover, mere compensation is no deterrent to repeat behavior (at least in a classic Brooklyn Bridge fraud scheme). If the worst that can happen to a fraudster is that the ill-gotten gain must be paid back, there is no disincentive against repeating the scam.

In the end, the *Green* court ruled that punitive damages are not available under the 1934 Act because the statute itself limits recovery to *actual* damages (unlike the 1933 Act under which punitive damages are permitted (according to the court)).[79] But the court went on to point out that the burden of punitive damages would ultimately fall on the stockholders. Indeed, the court noted that some courts have gone so far as to refuse to permit any punitive damages against corporations.[80] Although the court does

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[78] Marvin E. Frankel, *Some Preliminary Observations Concerning Civil Rule 23,* 43 F.R.D. 39, 44 (1967). Again, as a first-year law student in 1973-74 I recall Geoffrey Hazard, J. William Moore, and Ralph Winter all attempting to convey the significance of the issues raised by the relatively new class action rule as well as the federal rule relating to derivative actions adopted at the same time. I fear that few of us (if any) really appreciated what they were saying.

[79] Green v. Wolf Corporation, 406 F.2d 291, (2d Cir. 1968), *citing* Globus v. Law Research Service, Inc., 287 F. Supp. 188 (SDNY 1968).

[80] *Citing* PROSSER ON TORTS § 2 at 12 (3d ed. 1964).

not quite recognize here the potential for an echo effect, it comes mighty close. The court further noted that there is no need for punitive damages in a Rule 10b-5 action, which carries the potential for crushing liability anyway (not to mention the potential for criminal penalties). As the court stated, "class actions, derivative suits and other such procedural devices provide sufficient incentive to insure that those injured by a violation of 10b-5 will have adequate opportunity" to obtain redress. In other words, the rationale for punitive damages disappears – even in cases of fraud – if it is likely that most victims will seek and obtain compensation.[81]

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A third 1968 event may have played a subtler role in the evolution of securities litigation, namely the passage of the Williams Act subjecting **tender offers** to federal securities regulation. In essence, the act extended registration requirements to large *purchases* of shares. So one might think of it as a corollary to the 1933 Act or an expansion of Rule 10b-5. In any event, the Williams Act (named for NJ Senator Harrison Williams of Abscam fame) made it clear as a matter of statutory law that Congress was concerned about sellers as well as buyers. So if there was any doubt remaining about the fundamental thrust of Rule 10b-5, the Williams Act dispelled it.

Moreover, the Williams Act was quite clearly a management-friendly piece of legislation. It eliminated the possibility of Saturday Night Special offers – which were designed to encourage (or coerce) target stockholders into tendering – by requiring that offers remain open for at least twenty business days and establishing minimal bidding rules. The Williams Act also provided a distant early warning (DEW) system requiring bidders to identify themselves upon establishing a toe-hold position in target stock. But the point (for present purposes) is that management could hardly object to the idea that federal securities law (and the SEC) extended to fraud in connection with purchases of stock. Sauce for the goose is sauce for the gander.

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Soon after *TGS,* the Supreme Court adopted an equally expansive reading of the connection requirement in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.* (1971) – an inscrutable opinion authored by Justice Douglas, the former chairman of the SEC who curiously had recused himself from most cases involving the federal securities laws up to that time.[82] And soon after *Bankers Life,* the Court addressed the question of how a plaintiff might satisfy the thorny problem of showing reliance on an omission – the Clause (2) issue – in *Affiliated Ute Citizens v. United States,* 406 U.S. 128 (1972). The

[81] *See generally* Richard A. Booth, Back to the Future of Arbitration, 41 Regulation (Cato), No. 2, at 14 (Summer 2018) (discussing interrelationship between class actions, punitive damages, and arbitration).

[82] Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971).

answer – which presaged several decisions to come – was that reliance could be presumed where the omission involved a material fact if the non-speaker (omitter) owed a fiduciary (or similar) duty to the plaintiff.

It is often said this was the high water mark for the expansion of Rule 10-5. Thereafter, the Court embarked on an extended campaign to limit the reach of federal securities law in general and Rule 10b-5 in particular. For example, SCOTUS attempted to limit the reach of Rule 10b-5 to cases of actual fraud and to dispel the notion that schemes operating as frauds – the moral equivalent of fraud – could be actionable. In a series of cases decided from 1975 to 1977, the Court held that only buyers or sellers had standing to sue under Rule 10b-5, that the plaintiff must plead and prove that the defendant acted with scienter (some level of intent), that the fraud must involve deception, and that the defendant must have participated in the deception rather than merely facilitating it. The problem is that this solution does not quite get at the real problem – that the company pays for gains enjoyed by others. But that is also a problem with the common law of fraud – which does not require that the fraudster actually gain from the fraud.[83]

While SCOTUS could not quite find a way to put the genie back in the bottle, many legal scholars found this series of decisions to be quite discouraging. Some commentators also saw Delaware law and its courts as pandering to the interests of management and neglecting the interests of investors.[84] For them, the restrictive SCOTUS decisions of 1975 and after meant that Rule 10b-5 could not be used to litigate questions of fairness and that stockholders would be relegated to whatever protections might be available under the state law of fiduciary duty. But there is another way to tell the story. Although deep-state conspiracies are compelling stuff, it is entirely possible that courts and litigants themselves did not understand the issues as well as they do today.[85]

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[83] *See* PROSSER ON TORTS §xxx at xxx (3d ed. 1964).

[84] *See, e.g.,* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 Yale L. J. 663 (1974).

[85] *See* Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker,* 72 Yale L. J. 223, 245 (note 37) (1962), bemoaning the demise of traditional corporate law scholarship focused on the true nature of the entity and redirected to its commercial functionality, stating: "One result of this break-through is that corporation law, as a field of intellectual effort, is dead in the United States. When American law ceased to take the "corporation" seriously, the entire body of law that had been built upon that intellectual construct slowly perforated and rotted away. We have nothing left but our great empty corporation statutes – towering skyscrapers of rusted girders, internally welded together and containing nothing but wind."

In 1976, SCOTUS agreed in *Ernst & Ernst v. Hochfelder* that mere negligence is not enough to state a claim under Rule 10b-5.[86] Rather, a plaintiff must plead and prove scienter – some degree of intent. How much is difficult to say. The *Hochfelder* Court suggested in a footnote that recklessness might suffice – something like the criminal indifference of which *Seinfeld* and friends were convicted in their final episode.[87] And in *Aaron v. SEC*, SCOTUS extended this holding to enforcement actions under Rule 10b-5 – even though commenced by the SEC – despite indications to the contrary in *TGS* that it was unnecessary to show intent in an action for an injunction.[88]

It is worth noting that the Supreme Court based these rulings (and later rulings) on the traditional (ordinary) meaning of the word *fraud* – which requires both deception and some level of intent. Where I come from, it also connotes some effort to cheat someone for personal gain – or at least to confer some gain on someone else. But no such requirement seems to apply in securities fraud class actions.[89] To complicate matters further, some states (California in particular) recognize claims for negligent misrepresentation (at least when combined with proof of reliance by the victim).[90] If one drills down into the elements of this tort, it is not clear that it differs much from fraud under Rule 10b-5 (although the latter applies only to trading in securities).

SCOTUS also relied on the ordinary meaning of fraud in *Santa Fe Industries, Inc. v. Green,* a 1977 decision wherein the plaintiffs challenged the price of a cashout merger pursuant to the Delaware short-form merger statute (which permits a parent corporation to merge with a subsidiary corporation without a stockholder vote if the parent owns 90% or more the stock of the subsidiary). In effect, a cashout merger is akin to an eminent domain proceeding – a taking – in that the corporation can force stockholders to sell their shares by merging the target company out of existence. The plaintiffs argued that taking their stock at a too-low price (and without any business purpose) was equivalent to fraud – if not worse than fraud in that there was no need to deceive the victim. But the Supreme Court held that fraud *requires* deception. It is not enough that the parent simply exercises its power (in effect) to buy subsidiary stock at its option.[91]

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[86] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 and note 12 (1976) (opinion by Powell).

[87] Id., 425 U.S. at 194 note 12.

[88] Aaron v. SEC, 446 U.S. 680 (1980).

[89] *See supra* text at note xxx ff.

[90] *See* Bily v. Arthur Young & Co., 3 Cal. 4th 370 (1992).

[91] In other words, it matters not that the result is the moral equivalent of a wrong – MEOW. *Cf.* SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (holding that hacking into computer to gain access to inside information does not constitute deception and thus does not support action for insider trading).

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Although most observers point to the 1988 Supreme Court decision in *Basic, Inc. v. Levinson* as the ruling that opened the floodgates of securities fraud class actions, the barn door had been standing wide open since the 1972 decision in *Affiliated Ute Citizens v. United States* wherein the Court held that "in a case involving primarily a failure to disclose, proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision." *Basic* effectively extended this idea to cases involving misrepresentation on the theory that investors rely on market price when they trade and that the market reacts to statements emanating from publicly traded corporations. DUH. Thus, a court may presume that a buyer has relied on a misrepresentation in any case involving an actively traded stock because the price can be presumed to reflect the misrepresentation.

To be clear, *Affiliated Ute* had held that a court may presume reliance on an omission to state a material fact if the (non)speaker owes a duty of disclosure to the aggrieved investor. Practically speaking, the law could hardly be otherwise. How could an investor be required to prove that they relied on facts they did not know – or more precisely that they would have acted differently if they had known facts they did not know? In contrast, *Basic* may be seen as addressing the very real issue of reliance on an affirmative misrepresentation of a material fact. But as any first-year law student knows, the distinction between a sin of omission and sin of commission is illusory. It is easy to convert one into the other. One can always argue that a misrepresentation involves the omission of the always-material fact that the statement is false. Thus, it is unclear that *Basic* adds anything to the mix.

A Semblance of Privity

Although *TGS* had established the idea that the company itself could be held liable for a violation of Rule 10b-5 based on a misleading press release, it did so in the context of a case prosecuted by the SEC and involving insider trading by various directors, officers, employees, and agents – one of whom drafted the offending press release. Few observers would have thought that the company could be held liable in the absence of insider trading. In other words, most would have seen *TGS* as akin to a case of civil conspiracy or vicarious liability – that the company had facilitated insider trading.[92] Accordingly, almost all of securities litigation under Rule 10b-5 through the mid 1980s involved insider trading and focused on recovery by buyers (or sellers) who might have traded with insiders.

To be sure, *Green v. Wolf Corporation,* which was decided just four months after *TGS,* was a class action by an open-market purchaser solely against the company for false

[92] *See* Richard A. Booth, *The Missing Link Between Insider Trading and Securities Fraud,* 2 J. Bus. Tech. L. 185 (2007); Restatement (Third) of Agency §204 (2006) (vicarious liability).

statements in two prospectuses that were withdrawn. No one seems to have suggested that the complaint should be dismissed for lack of any trading by the company or insiders. But it may be that the prospect of an offering by the company provided a semblance of privity.[93] Still, the plaintiff argued quite explicitly that the misrepresentations in the prospectus had inflated (or maintained) issuer stock price. As such, the case was typical of a case one might see today.

In the middle 1970s, increasing volume of trading (and the rise of takeovers) exposed problems with the idea that securities litigation was about compensation for insider trading.[94] With ever greater numbers of buyers and sellers, there emerged the potential for awards of damages far out of proportion with insider gains. And plaintiff lawyers began to stretch the envelope (as they are wont to do).

One of the most extreme examples arose in *Fridrich v. Bradford,* in which the defendants had learned of an offer by US Life to buy Old Line Insurance Company at a significant premium over market price.[95] One of the individual defendants, who netted a profit of about $13,000, was found liable (jointly and severally with the other defendants) for more than $360,000 in damages to three investors who had sold Old Line stock. Moreover, the defendants as a group had already disgorged an amount exceeding their gain to contemporaneous traders pursuant to an SEC enforcement action.

Ironically, the settlement with the SEC reflected the fact that all of the stock bought by the defendants was purchased from their own inventory as market makers. Thus, *Fridrich* was a rare case in which it *was* possible to identify a limited pool of counterparty sellers who were (arguably) harmed by defendants' trading. Accordingly, the funds disgorged by the defendants were held in escrow for customers of the defendant firm. Thus, it was all the more troubling that sellers who were *known* not to have traded with defendants should be able to recover.

The Sixth Circuit reversed: "We conclude that upon the facts of this case defendants' conduct caused no injury to plaintiffs and the judgment of the district court must be reversed. It is undisputed that defendants did not purchase any shares of stock from

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[93] *See* Joseph v. Farnsworth Radio & Television Corp., 99 F.Supp. 701 (S.D.N.Y.1951), *aff'd per curiam,* 198 F.2d 883 (2d Cir. 1952). *See also* Reynolds v. TGS, 309 F.Supp. 548 (D. Utah 1970), *aff'd. as modified,* 446 F.2d 90 (10th Cir. 1971), *cert. denied,* 404 U.S. 1004 (1972).

[94] Data on volume.

[95] The defendants were partners in a brokerage firm that made a market in Old Line stock, and they held a large (possibly controlling) interest in the company as a result of which one of the defendants sat on the BOD thereof. Moreover, the director defendant was the first person to be contacted by the bidder in connection with the merger offer and was offered a finder's fee for any shares he could deliver under an exchange offer.

plaintiffs, and that defendants' acts of trading in no way affected plaintiffs' decision to sell."[96]

Fridrich was a bad case for making good law. The decision of the Tennessee trial court was so off-the-wall, that the Sixth Circuit had almost nothing of substance to critique.[97] Then again, the decision also demonstrated how confused a lower court judge could be about Rule 10b-5 and thus how important it was for SCOTUS to resolve these questions.

The Sixth Circuit was well aware that its decision ran counter to the position taken two years earlier by the Second Circuit in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* wherein Merrill Lynch had discovered – as a result of working on a bond offering for McDonnell Douglas – that the company was about to report dramatically lower than expected earnings.[98] The broker passed along this information to various institutional investor customers who sold shares accounting for about half of the trading volume in McDonnell Douglas stock during a three-day period in 1966. When the news came out, stock price fell from about 90 to about 60. The plaintiff filed a class action on behalf of buyers against Merrill Lynch and the selling investors. Defendants moved to dismiss, arguing that they did nothing to cause (induce) plaintiffs to buy. The court rejected this argument mysteriously citing the then quite recent SCOTUS decision in *Affiliated Ute* for the proposition that failure to disclose a material fact provides the requisite causal connection (or reliance).[99] In other words, the *Shapiro* court cites *Affiliated Ute* for the idea that the "requirement [of connection] is satisfied by plaintiffs' allegation that they would not have purchased [the] stock if they had known of the information withheld by defendants." [100]

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[96] Fridrich v. Bradford, 542 F.2d 307, 318 (note 21) (6th Cir. 1976). The *Fridrich* court considered but rejected the argument that *Blue Chip Stamps* required not only that plaintiffs buy or sell but also that defendants buy or sell. The *Fridrich* court also could have ruled as it did on the grounds that the defendants had rebutted a presumption of reliance.

[97] Aside from holding the defendants jointly and severally liable (and thus on the hook as group for each other's trading), the trial court defined the fraud period as ending on the date the merger was approved, even though the merger price was announced (and market price adjusted) three months earlier and just a few days after defendants had traded. In addition, the trial court found that the defendants had violated Rule 10b-6 (relating to the practice of stabilization in connection with offerings) even though the plaintiffs made no such argument and even though there was no offering of Old Line stock.

[98] Shapiro v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 495 F.2d 228 (2d Cir. 1974). *See* Fridrich, 542 F.2d at 317-18.

[99] Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

[100] Shapiro, 495 F.2d at 240. This may or may not be true. But there is no doubt that if they had bought, the price would have been lower.

To be sure, the Second Circuit had stated as early as 1968 – in dictum and without any real analysis – that a company could violate Rule 10b-5 even though the company itself did not offer or sell any stock.[101] But the privity issue remained alive until it was finally killed by *Shapiro.* The *Shapiro* court states flat out that there is no requirement of privity:

> We hold here, as we have held before, that privity between plaintiffs and defendants is not a requisite element of a Rule 10b-5 cause of action for damages. For example, we have upheld Rule 10b-5 claims for relief where there have been no direct transactions between plaintiffs and defendants. As the Tenth Circuit stated in Mitchell v. Texas Gulf Sulphur Co., "perhaps the first step is to realize that the common law requirement of privity has all but vanished from 10b-5 proceedings while the distinguishable *connection* element is retained." [102]

[101] *See* Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968). This assertion in *Heit* comes in the context of resolving a question tabled while the court awaited the *en banc* decision in *TGS*. The *Heit* court ruled that the defendant company's financial statements – which concealed that reported company income had been derived in part from overcharges on government contracts – were reasonably calculated to influence the investing public (in the words of the *TGS* court) and thus were made in connection with the purchase or sale of securities by the public. But the *Heit* court left open the question whether the defendant could be held liable for *damages* absent a showing of scienter, noting that monetary relief had not been at issue in *TGS.* In other words, the court ruled that the plaintiff had stated a claim for a naked violation of Rule 10b-5 but did not decide whether plaintiffs could recover where the fraud was aimed at the government and not at investors – and the defendants had not themselves traded. Accordingly, the statement by the *Heit* court to the effect that privity is not required must be seen as dictum for purposes of a claim seeking damages. Note also that the *Heit* court seems to see scienter as requiring some sort of intent to gain from or at least to visit harm on the particular plaintiff who asserts the claim. As scienter doctrine has evolved under Rule 10b-5, the need to show such particularized intent has largely been ignored. Rather, it is enough to show that the defendant misled *someone* and was at least reckless in doing so. Finally, *Heit* is also troubling because the alleged misrepresentation derives from overcharges on government contracts that may or may not have been part of a scheme to defraud the government. Although it seems presumable that the securities fraud action was based on some sort of culpable wrongdoing found by the government, there is no explicit statement to that effect in any of the case reports relating thereto. In addition to the opinion of the Second Circuit, see *Heit v. Weitzen,* 260 F. Supp. 598 (S.D.N.Y.1966) and *Howard v. Levine,* 262 F. Supp. 643 (S.D.N.Y.1965). Thus, it is conceivable that there was an honest difference of opinion between the government and the contractor even if the contractor was ultimately found to be in the wrong. But if so, management would likely have been protected from any liability as a matter of state law by the business judgment rule. Nevertheless, by disseminating financial statements based on their belief that their accounting was correct – but knowing that the government could always challenge their accounting would likely be seen as scienter today.

[102] Shapiro, 495 F.2d at 239 (citations omitted). *See also* id. note 17 discussing *Astor.* To be clear, the *connection* to which the court refers is necessarily different from the *in connection with* requirement that is express in the text of Rule 10b-5.

Thus, the *Shapiro* court acknowledges that there must be some connection between seller gains and buyer losses. Otherwise why should buyers have any claim against sellers? As the *Shapiro* court itself allows, absent some such connection, sellers might be liable to the world.[103]

As the *Fridrich* court notes, this is a strange interpretation of *Affiliated Ute.*[104] In *Affiliated Ute* the plaintiffs had sold shares through a broker (market maker) – with whom they had a (fiduciary) relationship of trust – at a price that the broker knew to be well below fair market value. SCOTUS ruled that it was not necessary in this situation for the plaintiff to prove reliance on the failure of a fiduciary to disclose material information. Rather, reliance could be presumed from the materiality of the information in combination with a duty of disclosure. To be sure, SCOTUS ruled that materiality provides enough connection in a case of omission but only because the relationship between the parties gave rise to a duty to disclose. Sounds a lot like privity. Nevertheless, the *Shapiro* court rejected the idea that *Affiliated Ute* should be limited to face-to-face dealing.[105]

Moreover, although there was ample precedent even in 1973 that *literal* privity was not required for liability under Rule 10b-5, the *Shapiro* court went farther out of its way than necessary to discredit any such requirement. As a result, the word *privity* was used in a strange way in the context of securities fraud well into the 1970s. Few (if any) courts seemed to mean a one-to-one relationship – let alone a face-to-face relationship as the word is used in the context of contract law. Rather, the courts seemed to use the word – more as the *Shapiro* court used the word *connection* – to refer to the fact that insiders somehow enjoyed gains while outsiders suffered losses from a given constellation of events. Indeed, the *Shapiro* court cites a long line of cases that have supposedly dispensed with the privity requirement.[106] But (if anything) these cases stand for the proposition that privity means something like connection. In this sense, the *Shapiro* case was replete with privity. Again, Merrill Lynch customers accounted for half of the volume in McDonnell Douglas stock during the fraud period.[107] Thus, the court could have said that **contemporaneous trading** was enough to provide a connection akin to privity. Indeed, the *Shapiro* court emphasized that it was the act of trading while in possession of undisclosed material information that was at the heart of the offense.

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[103] *Citing* Globus v. Law Research Service, Inc., 418 F.2d 1276, 1292 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970).

[104] Fridrich, 542 F.2d at 319.

[105] Shapiro, 495 F.2d at 240. But see Fridrich, 542 F.2d 321 and note 29.

[106] Shapiro, 495 F.2d at 238-240.

[107] To be clear, Merrill Lynch did not itself sell any stock although it did generate substantial commissions for itself. Cf. Miley v. Oppenheimer & Co. (churning). Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir.1981).

Whatever, the courts meant by *privity* or *connection,* it seems quite clear that if no one had been trading on inside information, plaintiffs would have had no claim. Indeed, *Cady Roberts* said so quite explicitly. But plaintiffs would have lost what they lost whether or not insiders had been trading. So it must be because insiders gain that plaintiffs have a claim. In other words, the losses are going to fall somewhere. Think musical chairs. Insider trading does nothing to change the loss suffered by investors in the aggregate. It follows that disgorgement should be enough. It also follows that securities litigation should not be seen a matter of compensation – which amounts to a windfall for those who happen to have a claim because they happen traded at the same time as insiders (more or less).

What was needed was some way to cabin claimants to avoid a multiplicity of actions. It is curious that the court does not seize on the idea of unjust enrichment to deal with the connection problem. The ultimate issue with insider trading is one of advantage-taking – here by sellers as against unsuspecting buyers. Indeed, insider trading depends on clueless counterparties. Thus, the *Shapiro* court is quite correct that inducement is not necessary.[108] But rather than recognize that the problem of insider trading was a problem of unjust enrichment, the courts became obsessed with developing an explanation (or rationalization) for how plaintiff losses could be tied to insider gains. In other words, the courts began to focus on causation.

The *Shapiro* court observes that causation and reliance have been used interchangeably.[109] And the court emphasizes that what is required is causation *in fact.*[110] But what really does that mean? As opposed to what alternative form of causation? Given that insider trading depends on the random trading activity of uninformed counterparties, transaction causation seems like a red herring. The *Shapiro* court would seem to be more worried about establishing a connection between buyer loss and seller gain – especially in light of the fact that the buyer is going to suffer a loss when the truth comes out whether or not insiders have been trading on the undisclosed news. By so confusing loss causation with transaction causation, the *Shapiro* court is able to assert that SCOTUS has spoken: That materiality implies causation. Again, there was no such issue in *Affiliated Ute* where the defendants effectively stole from plaintiffs or at least helped others do so (for a small fee). Loss causation hardly called for discussion.

It is odd that SCOTUS did not resolve this conflict between the circuits. But the conflict may have been more apparent than real. Both the *Shapiro* court and the *Fridrich* court

[108] Shapiro, 495 F.2d at 240. If anything, sellers (here) are induced to sell by inside information.

[109] Shapiro, 495 F.2d at 239. Thank you, Captain Obvious.

[110] Shapiro, 495 F.2d at 238.

noted that something might need to be done to limit the potential for damages in such cases.[111] And both courts seemed to recognize that the reach of Rule 10b-5 might differ depending on whether the action is one by the SEC or one by a private plaintiff.[112] Moreover, both courts recognized the possibility of a derivative action to recoup ill-gotten gains but worried that such a remedy was not uniformly available.[113]

In short, *Shapiro* cut off the debate about privity. Literally. No lawyer would dare raise the issue thereafter for fear of being sanctioned by the court. But *Fridrich* exposed the problems inherent in the lack of any such concept.

The solution came from several sources. First, the Second Circuit ultimately ruled in *Elkind v. Liggett & Myers, Inc.,* that damages should be limited to defendant gain.[114] Second, the DOJ effectively turned insider trading into a crime.[115] Third, Congress passed the Insider Trading Sanctions Act (ITSA) in 1984 and beefed it up with the Insider Trading & Securities Fraud Enforcement Act (ITSFEA) in 1988. In effect, ITSFEA codified the *Elkind* rule by providing an action on behalf of investors for contemporaneous trading.[116]

This was an odd move in many ways. Congress could have extended the reach of Section 16(b) as the Hand brothers and Justice Douglas no doubt would have argued. But no one seemed to notice that the claim for contemporaneous trading by investors conflicted with the well-settled claim that ran to the corporation itself.[117] In other words, the claim should have been made derivative. To be sure, it would have been difficult to declare that investors should no longer have a remedy. But the direct claim running to investors could be argued to preempt any state law claim running to the corporation.[118] In the end, the claim for contemporaneous trading has been little used possibly because the recovery for any individual investor is likely to be miniscule in the absence of any

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[111] *See* Fridrich, 542 F.2d at 317-18; Shapiro, 495 F.2d at 242.

[112] *See* Fridrich, 542 F.2d at 320-22 (noting also that private litigation should be compensatory while SEC or DOJ action can address deterrence and solution may be to limit damages to amount of defendant gain); Shapiro, 495 F.2d at 241 and note 18.

[113] Fridrich, 542 F.2d at 322 and note 32; Shapiro, 495 F.2d at 241 and note 18.

[114] Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980).

[115] *See infra* text at note 119 ff.

[116] *See* Exchange Act Section 20A.

[117] *See* text at note 33 ff (discussing Brophy and its progeny).

[118] *See* Pfeiffer v. Toll, 989 A.2d 683 (Del. Ch. 2010), *abrogated by* Kahn v. Kolberg Kravis Roberts & Co., L.P., 23 A.3d 831 (Del. 2011).

prospect of multiple damages.[119] In contrast, the entire pot goes to the corporation in a successful derivative action.[120]

One problem – quite well recognized at the time – was that no one could figure out how to define insider trading. Moreover, derivative actions had been hobbled by the use of the special litigation committees (SLCs) to seek voluntary dismissal.[121] In any event, plaintiffs lost interest in prosecuting actions for insider trading.[122] But the prospect of recovery for the benefit of hundreds or thousands of disappointed investors remained.

Whack-a-Mole

Although one might say that the *Elkind* rule endorsed a form of privity, it did not go so far as to *require* any showing that defendants stood to gain from an alleged fraud. Given that privity was off limits, defendant efforts to argue that some prospect of gain or benefit should be required to plead fraud were made under the guise of scienter as the *Shapiro* court itself had suggested.

Shapiro effectively eliminated any need for plaintiffs to demonstrate that their losses could be traced to the gains of others. It soon became apparent that mere disgorgement would not suffice to discourage insider trading. Again, if one might be forced to give up ill-gotten gains at worst, there is no reason not to trade on inside information. To be sure, punitive damages are a possibility. But the courts had already rejected that alternative both because federal law seemed to limit awards to actual damages and because the sheer number of actions and plaintiffs prompted by high-profile insider trading cases provided a natural multiplying effect.[123] *Shapiro* notwithstanding, *Fridrich* called into question the possibility that buyers could reliably feed at that trough. There was some state law on the subject. But that route usually required a derivative action under which recovery would go to the corporation.

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[119] *See* Lexis data. On the other hand, it might be worthwhile for an enterprising plaintiff lawyer to prosecute such a class action for the prospect of a contingent fee and then to have remaining settlement contributed to a good cause. *But see* Frank v. Gaos, 586 U.S. 485 (2019) (questioning validity of such *cy pres* only settlements).

[120] *See, e.g.,* In re Dell Techs. Class V S'holders Litig., 300 A.3d 679 (Del. Ch. 2023); Tornetta v. Musk, 326 A.3d 1203 (Del. Ch. 2024) (both addressing fee award where recovery goes to corporation).

[121] *See, e.g.,* Joy v. North, 692 F.2d 880 (2d Cir. 1982).

[122] I am reminded of Nicholas Cage as the Secret Service agent in *Guarding Tess* who reports via radio from a grocery store to which he has accompanied the former first lady that she has lost interest in peas.

[123] *See supra* text following note 70 (discussing musings of Judge Friendly). What about more run-of-the-mill low-profile cases in which a few insiders (or tippees) sell ahead of ordinary bad news (for example). Martha Stewart.

Criminal prosecution addresses this issue nicely: Jail time makes sense when money damages fail.[124] Coincidentally (or not), the Justice Department – or more precisely the US Attorney for the SDNY – undertook a vigorous campaign to prosecute insider trading criminally in the late 1970s, focusing on tippers and tippees rather than traditional insiders.[125] Sensing perhaps that it might be upstaged, the SEC followed suit.[126]

It is not clear that prosecutors were focused on the puzzle of damages in the context of private securities litigation where allegations of insider trading provide the causal connection to plaintiff losses. If anything, the problem faced by the SEC was that disgorgement was an *inadequate* remedy. Congress addressed the problem in ITSA (1984) and ITSFEA (1988) by providing the SEC with the power to assess fines equal to three times the gain (or loss avoided)

Almost gratuitously, ITSFEA included a provision permitting contemporaneous traders to recover an amount equal to insider gain (or loss avoided). One might think that investors would have been thrilled to have a statutory cause of action permitting them to recover when they are the victims of insider trading. But the effect of the statute was quite to the contrary. Consider the example cited by the *Fridrich* court. The defendant netted $13,000 while counterparties lost $360,000 and would thus stand to collect less than four cents on the dollar *before* attorney fees. Why bother? By limiting compensation to an amount equal to disgorgement, Congress effectively abolished private litigation in connection with insider trading except where the parties are in privity. Although the idea was to cement a remedy for investor victims, the statute also set a ceiling on the amount that defendants could be required to pay. As a result, the contemporaneous trading statute is seldom invoked.

I suppose you know what you're doing, but I wonder if you realize what this means.

Although federal securities law has evolved largely according to its own logic, the world to which it applies has also evolved. The 1933 Act was tailored to fit the financial world of 1933. It is based largely on the notion that investors want and need company-specific information to make intelligent investment decisions. The archetypical reasonable investor is one who does their homework and picks a few good stocks. But in the early 1950s financial economists (starting with Harry Markowitz) began to explore how risk

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[124] *See* Richard A. Booth, *What is a Business Crime?* 3 J. Bus. Tech. L. 127 (2008).

[125] Chiarella v. United States, 445 U.S. 222 (1980).

[126] Dirks v. SEC, 463 U.S. 646 (1983). Although Robert Fiske was the first US Attorney to focus on insider trading, it was Rudy Giuliani (succeeding Fiske in 1981) who enhanced the process by inventing the perp walk, often arresting suspects at work as seen in the 1987 Oliver Stone movie *Wall Street*.

could be reduced (if not eliminated) by holding a diversified portfolio of stocks. If one can eliminate risk, research is a waste of time and money. So it was inevitable that the utility of information would change.

On the other hand, the ability of investors to diversify was limited by the expense of holding many different stocks. One way to do so was to invest in a mutual fund. But mutual funds in the 1950s and 1960s charged their investors as much as 8.5% up front as an entry fee – a so-called sales load. At that rate, an investment of $1000 is immediately reduced to one of $915 and might take a year or more to grow back to $1000 and start generating real returns. Moreover, the system of fixed commission rates enforced pursuant to NYSE rules made it expensive for mutual funds themselves to manage their portfolios.

All of this changed on May 1, 1975 – May Day – when amendments to federal securities law mandating the so-called National Market System went into effect. Among other things, the legislation abolished fixed commission rates and thus permitted mutual funds to negotiate with brokers as to fees charged in connection with trading.[127] That led to a dramatic increase in the number of mutual funds, fierce competition to attract investors the birth of no-load mutual funds, and eventually exchange traded index funds that have called into serious question the logic of securities fraud class actions. So one good reason for seeking to understand how we ended up with the system we have – as this article has sought to do – is to pave the way to fixing it.

Conclusion

Although most scholars of federal securities law would likely say that securities fraud class actions – and their attendant problems – began with the endorsement of the fraud on the market theory by SCOTUS in its 1988 *Basic* decision, the die was cast twenty years earlier in the 1968 *TGS* decision by the Second Circuit *en banc*. Indeed, *Basic* said almost nothing new. It reaffirmed the definition of materiality first laid down by SCOTUS in its 1976 *TSC* decision – albeit there in a proxy fraud case. And it extended the presumption of reliance – first laid down in its 1972 *Affiliated Ute* decision – from cases of omission to state a material fact (in a face-to-face trade) to cases of commission by misrepresentation (in an open market setting), thus endorsing the fraud-on-the-market theory. To be sure, *Basic* clearly dispensed with the any semblance of privity. But that putative requirement had been laid to rest by the Second Circuit decision in *Shapiro* in 1974. *Basic* did make the presumption of reliance rebuttable. But that move – which may have been expected to mollify defendants by creating an escape from the most extreme claims – has generated even more litigation – and plenty of new work for SCOTUS – in the years that have followed.

[127] *See* Gordon v. New York Stock Exch., 422 U.S. 659 (1975).

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