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An Essay: Six Competing Currents of Rule 10b-5 Jurisprudence

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Carpenter v. United States,¹ the recent decision in which the Supreme Court failed to accept or reject the application of the "misappropriation theory"² in rule 10b-5³ cases, reportedly surprised many observers.⁴ Winans, a reporter for the Wall Street Journal and one of the authors of its "Heard on the Street" column, tipped several confidants, including two Kidder Peabody brokers, as to the contents of future columns. Winans, Carpenter (Winans' lover), the brokers and a customer of the brokers were able to earn short-swing profits from the movement of

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¹108 S. Ct. 316 (1987).

²See generally Aldave, *Misappropriation: A General Theory of Liability for Trading on Non-Public Information*, 13 HOFSTRA L. REV. 101 (1984).

³Rule 10b-5, 17 C.F.R. § 240.10b-5 (1987), was promulgated by the Securities and Exchange Commission (the "SEC") under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982). The rule states:

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.

⁴See, e.g., N.Y. Times, Nov. 17, 1987, at D10, col. 1; Wall St. J., Nov. 17, 1987, at 1, col. 6.

securities' prices following the appearance of the columns. The government brought a criminal action against Winans and several of these tippees, alleging both mail and telephone fraud and rule 10b-5 violations.

Supreme Court decisions applying rule 10b-5 to insider trading require, as necessary conditions for both civil and criminal liability, not only the purchase or sale of securities on the basis of information unknown to the marketplace, but the violation of a duty in so trading.⁵ In the case of the traditional insider—the corporate officer, director or controlling party—the duty breached is to the corporation or its shareholders whose stock the insider has bought or sold. While the nexus between the duty breached and the securities traded is problematic even in the case of the traditional insider—does, for example, the corporate insider who sells stock on the basis of inside information owe a duty before or at the time of the purchase to the purchaser (who, prior to the sale, was not a stockholder)?—at least the alleged breach of duty directly relates to the securities sold and the identity of the party on the other side of the transaction. But Winans, as an employee of the Wall Street Journal, was not an insider of the corporations whose stock was traded. The government, therefore, based its prosecution on the theory that Winans had violated a duty he owed to his employer not to disclose the contents of future columns (a term of employment of which Winans was found to have been aware). Breach of duty and the purchase or sale of a security, the conditions precedent to a possible rule 10b-5 violation, became analytically distinct; the duty breached was to one party (the employer), but the purchase was by an entirely different party (the corporation's security holder).

The Supreme Court affirmed the convictions on the communications violations, but split 4-4 on whether Winans' violation of his obligation to his newspaper employer could constitute the basis for a rule 10b-5 violation. Because the court unanimously upheld the convictions on the communications grounds, Justice White's opinion for the Court did not indicate which justices would have upheld the convictions on rule 10b-5 grounds as well, and which justices would have reversed on the same grounds. Nor, quite obviously, did the opinion indicate the content and range of views of the justices on the rule 10b-5 issue. Although the split left standing a Second Circuit decision that upheld the convictions on rule 10b-5 grounds as well,⁶ the split seemed to guarantee that the Court would face the issue again in future cases.

The surprise engendered by *Carpenter* was not unique. For example, one would have thought that on the basis of past precedent, the Supreme

⁵See *infra* text accompanying notes 111-21.

⁶*United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986).

Court would have decided differently in *Landreth Timber Co. v. Landreth*⁷ and *Bateman Eichler, Hill Richards, Inc. v. Berner*,⁸ two rule 10b-5 cases that came before the Supreme Court in 1985.⁹

Prediction has been difficult, in large part, because various strands of thought about rule 10b-5 recur and compete for dominance in Supreme Court opinions. The aim of this essay is to identify and untangle these "competing currents." They are: "idealism," "traditionalism," "economic behaviorism," "paradigm case analysis," "literalism" and "textual structuralism." The first three currents might properly be viewed as substantive positions: idealism favors the expansion of rule 10b-5 liability; traditionalism has as its goal to contain rule 10b-5 liability; and economic behaviorism, while inherently not in favor of or against rule 10b-5 liability, would determine the issue of 10b-5 liability according to the economic incentive effects of that liability on the actors concerned. Paradigm case analysis, literalism and textual structuralism are more in the nature of interpretive strategies. Paradigm case analysis calls for the issue of liability to depend upon the similarity of the facts of a given case with certain paradigm fact situations. Literalism favors the language of a statute or regulation in the interpretive process above, and sometimes instead of, all other considerations. Textual structuralism is an interpretive strategy that emphasizes harmony among various parts of a regulatory scheme when interpreting any particular part of that scheme. While certain justices have shown an affinity to both traditionalism and literalism, and other have favored both idealism and textual structuralism, these correlations—particularly that between traditionalism and literalism—have also proved to be quite weak at times.

Recognition of the competing currents can present a richer, more realistic disclosure of Supreme Court jurisprudence with respect to rule 10b-5, especially in its application to insider trading, than is possible with attempted doctrinal statements of the law.¹⁰ In particular, such

⁷471 U.S. 681 (1985). See *infra* text accompanying notes 141-48 & 159.

⁸472 U.S. 299 (1985). See *infra* text accompanying notes 39-54.

⁹The dominant current in Supreme Court decisions from 1975 through the early 1980's, "traditionalism," had as one of its aims the discouragement of the initiation of causes of action on the basis of rule 10b-5. See *infra* text accompanying notes 66-121. Yet, both *Landreth* and *Bateman Eichler* would seem to encourage the initiation of such actions.

¹⁰Doctrinal statements—for example, the common aphorism that insiders "must either disclose . . . [inside information] to the investing public, or, . . . abstain from trading" (SEC v. Texas Gulf Sulphur, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969))—frequently fail to depict accurately the degree to which the law restrains the purchase or sale of securities by those with informational advantages. Such statements both understate the degree of legal proscription, which applies to more than traditional insiders, and overstate the legal restraint because, in some sense, substantially all purchases by corporate insiders are made with an informational advantage not shared by outside investors.

recognition can facilitate our ability to predict future outcomes.¹¹ In light of the competing currents in rule 10b-5 jurisprudence, the *Carpenter* decision, while not necessarily expected in its exact form as a tie-vote, should hardly have come as a surprise.

I. THE COMPETING CURRENTS: THE PAST AND PRESENT

All justices seek to buttress their conclusions by references to textual language, legislative history,¹² behavioral considerations and other policy concerns. But identification of the competing currents demonstrates substantial differences in nuance and emphasis among the justices. And, as we shall see, how faithfully a justice is prepared to follow the textual language or what policy or incentive effect a justice chooses to emphasize, materially affects the outcome of rule 10b-5 cases.¹³

Various justices subscribe to one or several of the competing currents. Some justices vacillate among them. Sometimes a particular current dominates an opinion to which a majority of the Supreme Court nominally subscribes. Which current dominates may depend on such factors as the time period in which the case comes before the Supreme Court (*i.e.*, a pre- or post-1975 judicial decision) and the justice who is assigned to write the majority opinion (*i.e.*, to which competing current does that justice usually subscribe). True, if another justice feels strongly enough that the reasoning of the majority opinion writer does not comport with his own, he will write a concurrence or, if he disagrees with the result, a dissent,¹⁴ but often the feelings are not so strong as to provoke a separate opinion. At other times, no particular current dominates, but the decision results from an uneasy alliance of several currents pointing in favor of, or against rule 10b-5 liability in the particular case. A third

¹¹See *infra* note 198.

¹²Legislative history, in particular, has been used to support every conceivable position. Section 10(b) of the Securities Exchange Act is quite broadly worded, and thus fails to give specific guidance as to the contours of securities regulation to be promulgated under it. Rule 10b-5 is itself the product of the SEC. Finally, private implied causes of action on the basis of rule 10b-5 were judicially created. See *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). To divine legislative intent as to the elements of that cause of action when the cause of action, itself, is at most legislatively inspired, rather than specified, often seems farfetched.

¹³The literalist, for example, is far more concerned with text than are traditionalists or idealists. See *infra* text accompanying notes 153-69. In contrast, idealists and traditionalists often seem more imbued with their normative visions of federal securities laws than with analyses which derive easily from legislative history. See *infra* text accompanying notes 15-65 and 66-121.

¹⁴"Public choice" literature indicates that we should expect multiple opinions to be the norm rather than the exception. See Easterbrook, *Ways of Criticizing the Court*, 95 HARV. L. REV. 802 (1982).

result is also possible: the competing currents cancel each other out, and the Court is unable to reach a decision. This occurred in *Carpenter*.

What are the distinguishing characteristics of the various competing currents and with which justices of the Supreme Court can we associate them? Is it possible to speculate on how the justices who subscribe to one of these currents would have voted in *Carpenter*? It is to these questions that we now turn.

A. Idealism

We begin with idealism for two reasons. First, historically its heyday occurred before competing currents of thought were recognizable. But more importantly and for reasons I advance later, its influence still affects the thinking of those justices of the Supreme Court who openly espouse other currents. Hence, while idealism may not command the same support it once did on the Supreme Court, fears about its demise that have long been voiced by scholars and others have not been realized.¹⁵

What are the distinguishing characteristics of idealism? Idealism is characterized by three elements: first, a striving toward the ideal of equal information among all participants in a securities transaction (or, at least, equal access to information);¹⁶ second, the unabashed espousal of ethics as a source of law; and third, an emphasis upon the need to protect the investing public, and hence, the deterrent function of suits brought on the basis of rule 10b-5, including suits initiated by private parties for damages.¹⁷ This third characteristic implies that the defendant and his conduct rather than the plaintiff and her conduct are the primary factual foci of the justice.

The ideal of equal access to information by all investors appeared in many of the early, landmark rule 10b-5 cases such as *SEC v. Texas Gulf Sulphur Co.*,¹⁸ a 1968 decision. Although *Texas Gulf Sulphur* was

¹⁵See, e.g., Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883, 897 (1976).

¹⁶See generally Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083 (1985). For an earlier academic expression of idealism, although somewhat more limited than that expressed by Professor Seligman, see Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979) (rule 10b-5 should be interpreted to bar the exploitation of "unerodable advantages that one trader has over another").

¹⁷For an insightful critique of this emphasis upon deterrence, at least in the context of private party suits on the basis of rule 10b-5 or other implied causes of action under the securities acts, see Frankel, *Implied Rights of Action*, 67 VA. L. REV. 553 (1981). In contrast to the "idealist" emphasis upon deterrence, "traditionalist" decisions have emphasized the plaintiff's position and, in particular, the question whether the plaintiffs deserve to be compensated for their alleged loss. See *infra* text accompanying notes 76-80, 101-09.

¹⁸401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

itself the decision of the Second Circuit Court of Appeals, the Supreme Court seemed to be moving towards the same parity of information stance. In *Affiliated Ute Citizens v. United States*,¹⁹ for example, the disparity of information about the presence of another and higher market for the shares of stock sold by the seller Indians to the buyers, employees of the First Security Bank of Utah who also made a market in such stock, was an important contributor to the Court's holding that the plaintiff sellers need not allege and prove any reliance upon the buyers' omissions.²⁰

The goal of deterrence in order to protect the investing public was also highlighted in the early 10b-5 cases. The attention of the Court seemed to focus primarily upon the conduct of the defendants and the need to deter them and similarly situated parties from either misleading investors or trading on the basis of information from which others were excluded. Other than requiring that the plaintiffs, themselves, must have bought or sold securities (a requirement seen as limiting the class of plaintiffs to those who had been injured),²¹ the Court devoted little attention to the actual plaintiffs and their equities (as contrasted with those of the investing public generally). This tendency is most apparent in *J.I. Case Co. v. Borak*²² and *Mills v. Electric Auto-Lite Co.*,²³ two Supreme Court opinions that dealt with implied causes of action under rule 14a-9²⁴ (the anti-fraud provision of the proxy regulations), but nonetheless had much to say about all implied causes of action brought on the basis of misleading disclosures or omissions,²⁵ especially those

¹⁹406 U.S. 128 (1972).

²⁰This is not to say, however, that the Court fully adopted a parity of information stance. The Court emphasized that a duty of disclosure arose because the defendants had been active in making a market for Ute Development Corporation stock. *Id.*

²¹Even this requirement was the product of a Second Circuit decision, *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). In 1975, the Supreme Court explicitly adopted the *Birnbaum* doctrine. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

²²377 U.S. 426 (1964).

²³396 U.S. 375 (1970).

²⁴Rule 14a-9, 17 C.F.R. § 240 (1987), states:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

Its language, then, closely parallels that of Rule 10b-5(2). See *supra* note 3.

²⁵See *Borak*, 377 U.S. at 433-35; *Mills*, 396 U.S. at 381-85.

based upon rule 10b-5.²⁶ The Supreme Court showed scant interest in such questions as whether the actual litigating shareholders knew the omitted facts or had actually been injured, both factors in determining what the ultimate remedy would be.²⁷

The heyday of idealism occurred prior to 1975, after which traditionalism gained the upper hand.²⁸ Yet, while idealism, evidenced by the espousal of the ideal of equal access and the need to protect the public by deterring similarly situated insiders, went into a tailspin, it has remained the dominant current of thought among Justices Blackmun, Marshall and, for the most part, Brennan, although each of these Justices has, at times, adopted other modes of reasoning as well.²⁹ Their idealism has been evidenced by their dissents in *Aaron v. SEC*³⁰ and *Dirks v. SEC*,³¹ and by the dissents of Justices Blackmun and Marshall in *Chiarella v. United States*.³² In these dissents, the ethical underpinnings of idealism became much more patent than in earlier idealist opinions.

The *Dirks* case, decided in 1983, involved Equity Funding Corporation, which wrote and then sold insurance policies to reinsurers. Secrist, a former officer of Equity Funding, tipped Dirks, an insurance stock analyst and broker for an investment banking firm, that many of the insurance policies written by Equity Funding were fictitious.³³ Dirks then set out to investigate the allegation. In the course of his investigation, Dirks apparently made some effort to encourage a reporter for the Wall Street Journal to write an expose about the matter and to prompt the SEC to initiate an investigation on its own, although the extent of Dirk's efforts with respect to the Journal and the SEC was a point of some dispute. In any event, Dirks also communicated with some of his institutional clients about Secrist's allegations and the extent of his own

²⁶See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972) (the *Mills* materiality standards, see *infra* text accompanying note 107, used to support the conclusion that "positive proof of reliance is not a prerequisite to recovery"); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971) (*Borak* cited to support the statement, "[i]t is now established that a private right of action is implied under § 10(b)").

²⁷Ultimately, in *Mills*, after many years of litigation, the plaintiffs were denied a monetary remedy because the terms of the transaction involving a merger between Mergenthaler Linotype Company and Electric Auto-Lite Company, were deemed favorable to the suing shareholders. *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239 (7th Cir. 1977).

²⁸See *infra* text accompanying notes 66-121

²⁹For example, Justice Marshall was quite traditionalist in his opinion in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (see *infra* text accompanying notes 103-08), and Justice Blackmun has been the most forceful voice for the current of "textual structuralism." See *infra* text accompanying notes 170-83.

³⁰446 U.S. 680, 704 (1980).

³¹463 U.S. 646, 667 (1983).

³²445 U.S. 222, 245 (1980).

³³*Dirks*, 463 U.S. at 649.

investigation to confirm such allegations. The institutional clients were generally able to sell their stock in Equity Funding at a price substantially higher than the market price of the stock after the news of the fraud became public. The SEC censured Dirks for violating rule 10b-5.³⁴

Although a Supreme Court majority exonerated Dirks,³⁵ Justice Blackmun dissented in an opinion joined by Justices Marshall and Brennan. Justice Blackmun's dissent illustrates the idealist stance. To Justice Blackmun, the fact that Dirks' investigation helped to expose the fraud hardly justified his conduct: "Even assuming that Dirks played a substantial role in exposing the fraud, he and his clients should not profit from the information they obtained from Secrist."³⁶ Most indicative of the tenor of the idealist position was Blackmun's open espousal of ethics as a source of law: "As a citizen, Dirks had at least an ethical obligation to report the information to the proper authorities."³⁷

Having kept idealism alive in dissents such as that in *Dirks*, Justices Blackmun, Marshall and Brennan were able to collect a majority for its expression in both *Herman & MacLean v. Huddleston*³⁸ and *Bateman Eichler, Hill Richards, Inc. v. Berner*.³⁹ The former of these cases, decided in 1983, is of primary interest as a portent of things to come. The Supreme Court, per Justice Marshall, held that the purchaser of securities who asserts that a prospectus contained misrepresentations has a 10b-5 claim, despite the presence of an express remedy in the Securities Act of 1933 dealing with that context.⁴⁰ The Court further held that the allegedly defrauded purchaser need only prove his case by a preponderance of the evidence.⁴¹ *Herman & MacLean*, with its encouragement of rule 10b-5 litigation, its rejection of a state standard of proof in such litigation, and its reference to the "broad remedial purposes" of the Securities Acts,⁴² evinced that, although other currents may have eclipsed idealism for a five to seven year period, idealism as a significant

³⁴*Id.* at 651-52.

³⁵See *infra* text accompanying notes 120-21.

³⁶463 U.S. at 677.

³⁷*Id.*

³⁸459 U.S. 375 (1983).

³⁹472 U.S. 299 (1985).

⁴⁰*Herman & MacLean*, 459 U.S. at 387.

⁴¹*Id.* at 390. The Court of Appeals for the Fifth Circuit had ruled that the plaintiff must prove his case by "clear and convincing" evidence, a much harder standard to satisfy. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 545-46 (5th Cir. 1981). The "clear and convincing" evidence standard comes from the common law of fraud. Thus, the Supreme Court's decision in *Herman & MacLean* was a departure from the Court's pattern of referring to state law to determine the elements of a rule 10b-5 suit. See *infra* text accompanying notes 66-121.

⁴²459 U.S. at 386.

current had staged a substantial comeback. For present purposes, however, *Bateman Eichler*, decided in 1985, is the more interesting case.

In that case, tippees, who had received confidential information from a broker dealer regarding a gold discovery by a corporation whose stock was traded over the counter, sued the broker who touted the stock to them.⁴³ They also sued the principal of the corporation, who had advised the tippees that the broker was a "trustworthy and . . . good man." Although the stock initially skyrocketed in value, the inside information ultimately proved to be false, and the value of the stock plummeted. The tippees sued on the basis of rule 10b-5. The defendants sought to dismiss the suit on *in pari delicto* grounds: namely, that the plaintiffs, who were also guilty of violating the law, should be precluded from suing the defendant tipper.⁴⁴

If *Herman & MacLean* was an aberration confined to the question of remedy, one would have expected the defendants to prevail on their motion to dismiss.⁴⁵ Anyone but a formalist legal scholar would acknowledge the tremendous influence of facts on a case, not simply in the sense of determining whether a given legal principle is to be applied, but also in the sense of affecting the court's interpretation of the elements of that legal principle. If the plaintiffs in *Bateman Eichler* had knowingly used inside information to purchase their stock, they had been hoisted by their own petards and surely no one, including a court, should rescue them! Moreover, liberal application of such common law defenses as the *in pari delicto* defense would have much the same effect as application of such common law elements of the fraud cause of action as scienter or violation of a duty. It would serve to restrict the number of such rule 10b-5 cases that could be successful and, therefore, *ex ante* discourage their initiation. However, in an opinion by Justice Brennan, the Supreme Court held that the case should not have been dismissed.⁴⁶

Although Justice Brennan did not completely rule out the possibility of an *in pari delicto* defense⁴⁷ in private suits based upon alleged violations

⁴³*Bateman Eichler*, 472 U.S. at 301.

⁴⁴*Id.* at 305.

⁴⁵Indeed, the District Court for the Northern District of California had dismissed the suit on *in pari delicto* grounds, although the Court of Appeals for the Ninth Circuit had reversed. See *Berner v. Lazzaro*, 730 F.2d 1319 (9th Cir. 1984).

⁴⁶*Id.* at 310-11.

⁴⁷Justice Brennan, speaking for the Court, stated:

[A] private action for damages in these circumstances may be barred on the grounds of the plaintiff's own culpability only where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public.

of rule 10b-5, he quite explicitly disagreed with the notion "that an investor who engages in such [insider] trading is necessarily as blameworthy as a corporate insider or broker-dealer who discloses the information for personal gain."⁴⁸ In Justice Brennan's words, "we do not believe that the tippee properly can be characterized as being of substantially equal culpability as his tippers."⁴⁹

More important than the actual holding of *Bateman Eichler* were the idealist themes that Justice Brennan openly espoused. Quite explicitly, Justice Brennan laced his opinion with the need to protect the "public" and the deterrent nature of the rule 10b-5 suit, even when initiated by private parties. For example, citing *J.I. Case Co. v. Borak*,⁵⁰ Justice Brennan noted that "we [the Supreme Court] repeatedly have emphasized that implied private actions provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'"⁵¹ In other words, the culpability of the defendants' conduct and the conduct of those similarly situated was the focus of Brennan's opinion, rather than the plaintiffs' conduct, and the implied right of action was viewed in a very positive light, rather than the negative light in which it had been viewed in traditionalist opinions that preceded *Bateman Eichler*. To Brennan, "deterrence of insider trading most frequently will be maximized by bringing enforcement pressures to bear on the sources of such information—corporate insiders and broker-dealers."⁵²

Like Justice Blackmun in his dissent in *Dirks*, Justice Brennan did not shy away from highlighting the ethical dimension that supports the idealist view. To some, the impossibility of ever achieving complete parity of information between transacting parties conduced toward a view that insider trading should be tolerated, indeed perhaps encouraged, as the key to other benefits.⁵³ But to Brennan, speaking for the Court, the ideal remains:

Id.

In *Pinter v. Dahl*, 108 S. Ct. 2063 (1988), the Supreme Court extended the *in pari delicto* defense to actions brought under § 12(1) of the Securities Act of 1933. In so doing, it reaffirmed this test for the application of the defense which it had enunciated in *Bateman Eichler*.

⁴⁸*Bateman Eichler*, 472 U.S. at 312.

⁴⁹*Id.* at 314.

⁵⁰377 U.S. 426 (1964).

⁵¹*Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985).

⁵²*Id.* at 316 (emphasis added).

⁵³See, e.g., Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980); Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUDIES 801 (1980).

We also believe that denying the *in pari delicto* defense in such circumstances will best promote the primary objective of the federal securities laws—protection of the investing public and the national economy through the promotion of “a high standard of business ethics . . . in every facet of the securities industry.”⁵⁴

Perhaps most interesting about *Bateman Eichler* is the fact that there were no dissents to the decision. All Justices but two joined in Justice Brennan’s “idealist” expression of the law. The two were Justice Marshall, whom we know from other opinions generally shares that “idealist” view, and Chief Justice Burger, who simply concurred in the judgment without writing a separate opinion.

At times, then, idealism has been a strong current, indeed a wave in the pre-1975 period; at other times, it has been a weaker current, but one still present in the dissents of some of the Court’s members. More recently, a near unanimous majority of the Court has been willing to follow its course in selected cases. What accounts for the endurance of idealism, despite the vicissitudes in its popularity?⁵⁵ Can we speculate as to how avowed idealists voted in *Carpenter*?

The recurrence of idealism in majority opinions strongly suggests the existence of a widely-held intuition that affirmative misrepresentations and, under certain circumstances, insider trading are “wrongs.”⁵⁶ Consensus may be lacking as to what those “circumstances” are, but no sitting Supreme Court Justice is prepared to defend insider trading on moral grounds. Thus, a growing body of literature that, on economic grounds, either justifies insider trading or denigrates the ability of rule 10b-5 practicably to unify ethical and legal norms⁵⁷ has had only moderate impact on the Court. One should not expect greater impact from such analysis if it is idealism’s patent appeal to ethics as a source of law, rather than, for example, economic arguments that can also be advanced in its favor,⁵⁸ that explains its strength.

⁵⁴472 U.S. at 315.

⁵⁵For some factors that bear on the vicissitudes themselves, see *infra* text accompanying notes 96-102 (suggesting why traditionalism overtook idealism as a dominant force during the latter 1970’s) and text accompanying notes 190-98 (suggesting that personnel on the Court and popular sentiment might be moving in opposite directions).

⁵⁶As Donald Langevoort has expressed, the acceptance of rule 10b-5 liability by the courts and the SEC “seems to rest . . . on the strongly held intuition that insider trading is unfair.” Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 2 (1982).

⁵⁷See, e.g., Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Cox, *Insider Trading Regulation and the Production of Information: Theory and Evidence*, 64 WASH. U.L.Q. 475 (1986); Dooley, *supra* note 53; Haddock & Macey, *A Coasian Model of Insider Trading*, 80 NW. U.L. REV. 1449 (1986); H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Scott, *supra* note 53.

⁵⁸These arguments are summarized in R. CLARK, *CORPORATE LAW* 273-77 (1986).

In turn, this intuition seems rooted in a "truth norm" that pervades much of our legal culture, even if the law does not fully implement it. State fraud actions, consumer warranty law, creditor remedies against debtors⁵⁹ and other provisions too numerous to mention have their justification in an obligation to be truthful in one's dealings with others. The same truth norm seems implicated in the situations covered by rule 10b-5 as well. Rule 10b-5's misrepresentation cases patently involve conduct that directly violates an obligation to be truthful. But one can also argue that insider trading is untruthful as well.

Silence, like declaring something to be a fact when it is not so, can be a lie under circumstances where the other transacting party reasonably expects to be informed if the actual facts differ from his understanding of them.⁶⁰ Such expectations exist where one party is in a relationship of dependence upon another, such as a trust or certain contractual relationships. But, arguably, such expectations are also reasonably held where only one of two parties to a trade has lawful access to material information affecting the value of the security traded.⁶¹ The insider would want to be told the same information if the insider were standing in the other party's shoes; that is to say, the insider is both aware of and shares the reasonable expectations of the other party. Various ethical sources teach the imperative that one should treat others as one wishes others to treat him.⁶² Thus, at least some acts of insider trading can properly be depicted as attempts to avoid this ethical imperative of reciprocal treatment. As such, these acts are disrespectful of others; the insiders would deny to others the treatment that they would reasonably

⁵⁹See R. CLARK, *supra* note 58, at 42-45.

⁶⁰See S. BOK, *LYING: MORAL CHOICE IN PUBLIC LIFE* (1978).

⁶¹See Brudney, *supra* note 16. At least three situations require differentiation. First, if the party with the inside information has unlawfully gained access to that information, the other investor's expectations have been violated because he simply would not expect the other party's access or use of the information. Second, the party trading on the basis of inside information may have had lawful access to it, but for purposes other than gain in the trading of securities. For example, the corporate officer or director might have such information as a part of his corporate duties, or the newspaper columnist might have access to such information for purposes of writing his column. Third, the party having the inside information might have acquired it lawfully for the very purpose of capitalizing on the information acquired. The argument that one's expectations have been violated seems strongest in the first two situations, and weakest in the third. In the third situation, the second investor would probably also want and think that, if he developed information for the express purpose of investment gains, he could lawfully profit from such information. In other words, while there may be some who would claim to hold expectations of sharing even in the third situation, their expectations (if expressed) would seem to be feigned, or, at least, unreasonable.

⁶²See, e.g., I. KANT, *GROUNDWORK OF THE METAPHYSICS OF MORALS* 88 (H. Paton trans. 1964) (first formulation of the categorical imperative). See also Phillips, *The Commercial Culpability Scale*, 92 *YALE L.J.* 228, 252-53 (1982).

expect for themselves. The relationship between certain instances of insider trading, the truth norm, and a general ethical imperative that calls for mutually respectful conduct among people⁶³ probably explains best the fact that idealism, despite some setbacks, has endured in Supreme Court opinions.⁶⁴

Finally, how did such idealists as Justices Blackmun, Marshall and Brennan approach the *Carpenter* case? There is little doubt that they voted to affirm the convictions of Winans and his tippees on rule 10b-5 grounds. *Carpenter* implicated all three prongs of the idealist stance: disparity of information; unethical behavior; and the need to deter similarly situated actors. The transactions that formed the basis of the suit were characterized by an informational disparity between the traders. The idealists would especially be concerned with the lack of ethics on the part of Winans and those he directly or indirectly tipped. And because the informational disparity resulted from a misuse of information by Winans, the idealists would stress the need to deter similarly situated parties from behaving in a like manner.⁶⁵

B. Traditionalism

The distinguishing characteristics of the traditionalist current include: first, a reluctance on the part of the Supreme Court to have federal courts intrude excessively into areas traditionally reserved to state law; second, even when rule 10b-5 is held to apply to a transaction, explicit or implicit reference to state law, particularly the state law of fraud and fiduciary duties, in order to derive rule 10b-5's substantive content; and third, a tendency to view those plaintiffs who would sue on the basis of rule 10b-5 in a more negative light than the defendants whose alleged conduct necessitated initiation of the litigation. Traditionalism gained the upper hand in rule 10b-5 jurisprudence in 1975 and dominated the Supreme Court's holdings with respect to rule 10b-5 liability at least through 1980. Because it succeeded idealism as the dominant theory espoused by a majority of the Supreme Court, traditionalism is best understood as a reaction to idealism. And because traditionalism looked

⁶³See C. FRIED, *RIGHT AND WRONG* 67 (1978).

⁶⁴See Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 122-23 (1982).

⁶⁵Significantly, Justices Blackmun and Marshall would have sustained Chiarella's conviction in *Chiarella v. United States*, 445 U.S. 222, 245 (1980). Although Justice Brennan concurred, voting to overturn Chiarella's conviction, he did so because breach of a duty had not been presented to the jury. Justice Brennan nonetheless stated that "a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities." *Id.* at 239. For a discussion of *Chiarella*, see *infra* text accompanying notes 111-19.

to state common law, especially the state law of fraud, to define rule 10b-5 liability and because that body of law was restrictive in a number of respects,⁶⁶ traditionalism can properly be viewed as restrictive; it tended to restrict rather than expand the development of rule 10b-5. Although traditionalism in its reactive and restrictive guise does not now enjoy the same level of support it did some eight years ago, its basic tenet that courts are to refer to state law—such as fraud doctrine, fiduciary duties and property rights—to determine whether rule 10b-5 has been violated still represents a frequently reiterated current in Supreme Court opinions.

The Supreme Court's 1975 decision in *Cort v. Ash*,⁶⁷ a case that itself had nothing directly to do with rule 10b-5, signaled a change in the Court's attitude toward privately-initiated suits based upon implied causes of action under federal law.⁶⁸ In *Cort v. Ash*, which dealt with the attempt by shareholders to bring suit against the directors of Bethlehem Steel Corporation for violating a federal criminal statute that prohibited corporations from making contributions or expenditures in connection with presidential campaigns,⁶⁹ Justice Brennan, speaking for the Court, specified four factors that were relevant to the decision whether to imply a private cause of action under a federal statute.⁷⁰ The restrictive nature of the *Cort v. Ash* test is illustrated by one of these factors: "Is there any indication of legislative intent, explicit or implicit, either

⁶⁶The state common law of deceit has remained quite restrictive. The elements of a tort action for deceit are: a false representation, knowledge or belief that the representation is false, intent to induce the plaintiff to act or refrain from acting in reliance on the misrepresentation, justifiable reliance by the plaintiff, and damage to the plaintiff as a result of the reliance. W.P. KEETON, PROSSER AND KEETON ON TORTS 725-28 (5th ed. 1984). See also Keeton, *Fraud-Concealment and Non-Disclosure*, 15 TEX. L. REV. 1 (1936).

⁶⁷422 U.S. 66 (1975).

⁶⁸See Frankel, *supra* note 17.

⁶⁹The statute under which an implied cause of action was sought was 18 U.S.C. § 610 (repealed, 1976) which prohibited corporations "from making 'a contribution or expenditure in connection with any election at which Presidential and Vice Presidential electors . . . are to be voted for.'" 422 U.S. at 68 (footnote omitted).

⁷⁰Justice Brennan wrote:

In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant. First, is the plaintiff "one of the class for whose especial benefit the statute was enacted," —that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?

422 U.S. at 78 (citations omitted).

to create such a remedy or to deny one?"⁷¹ If Congress had intended to grant a cause of action, it would be quite likely that an explicit cause of action would exist in the statute. In other words, the most probable context to confront an attempt to imply a cause of action is in that very context where evidence of such intent is lacking. Therefore, to suggest that implied causes of action should be confined to those statutory contexts where evidence of legislative intent to grant such causes of action exists biases the issue against such actions.⁷² The application of the four factors, as well as their articulation, left no doubt that the Court had as its primary agenda the restriction, rather than the further expansion, of such implied causes of action.⁷³

While *Cort v. Ash* dealt with a statute outside the securities law context, its restrictive tenor was soon reflected in securities law cases,⁷⁴ including a variety of rule 10b-5 cases. Having already sustained an implied cause of action under rule 10b-5,⁷⁵ the Supreme Court would be unlikely to deny that one existed. But it could, and did, seek to deter the initiation of 10b-5 lawsuits.

Blue Chip Stamps v. Manor Drug Stores,⁷⁶ a 1975 case, illustrates the tendency of traditionalism to focus upon the litigating plaintiffs rather than the defendants whose conduct gave rise to the suit. In *Blue Chip Stamps*, the Supreme Court strictly interpreted a long standing Court of Appeals requirement that the plaintiff in a rule 10b-5 case must have been a purchaser or seller of securities.⁷⁷ In his opinion for the majority, Justice Rehnquist spoke of the "danger of vexatiousness [in rule 10b-5 litigation] different in degree and in kind from that which accompanies litigation in general."⁷⁸ *Ernst & Ernst v. Hochfelder*,⁷⁹ which

⁷¹*Id.*

⁷²As Professor Frankel pointed out, following *Cort v. Ash*, the Supreme Court soon "moved toward a more restrictive test whereby legislative intent came to subsume the other *Cort* factors." Frankel, *supra* note 17, at 560.

⁷³For example, another test was whether the plaintiff was among the class sought to be benefitted by the statute. There was evidence that one of the purposes underlying the criminal statute was to protect stockholders since it was their money that was being spent. But the Court did not give this factor much weight on the ground that "the protection of ordinary stockholders was at best a secondary concern." *Cort v. Ash*, 422 U.S. 66, 81 (1975).

⁷⁴*See, e.g., Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977) (the Court held that the tender offeror has no implied cause of action for damages under § 14(e) of the Securities Exchange Act of 1934).

⁷⁵*See Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Superintendent of Insurance of the State of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971).

⁷⁶421 U.S. 723 (1975).

⁷⁷*Id.* at 754-55. *See Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

⁷⁸421 U.S. at 739.

⁷⁹425 U.S. 185 (1976).

illustrates the tendency of the Supreme Court to define the elements of a rule 10b-5 claim in terms of the state law of fraud, followed in 1976. The Supreme Court held, in that case, that the plaintiff must prove that the defendant acted with scienter with respect to the words or conduct that gave rise to the action.⁸⁰ Justice Powell, speaking for the Court, was hardly crystal clear in defining scienter.⁸¹ But, he did rule out the possibility that scienter was satisfied by a mere allegation of negligence. Although Justice Powell carefully stressed the language of Section 10(b) of the Securities Exchange Act of 1934, pursuant to which the SEC promulgated rule 10b-5, and the structure of remedies in the Act, he nonetheless implicitly drew the parallel to the state law of deceit, with respect to which the defendant must have intended to defraud the plaintiff in order for the plaintiff purchaser to have established his case.⁸²

In 1977, Justice White wrote the opinion of the Court in *Sante Fe Industries, Inc. v. Green*.⁸³ This decision evinced the reluctance of a Supreme Court majority to continue to expand rule 10b-5 to areas that traditionally had been the province of state fiduciary law. Prior to this decision, some federal courts had broadly interpreted the kind of conduct that would give rise to a rule 10b-5 suit. "Fraud" was said to include not only fraudulent words or omissions, but also conduct that in everyday parlance one would think of as fraudulent.⁸⁴ Even the Supreme Court, in *Superintendent of Insurance v. Bankers Life and Casualty Co.*,⁸⁵ applied rule 10b-5 to a fraudulent series of transactions that lacked any

⁸⁰*Id.* at 193.

⁸¹Did it require intentional, knowing or only reckless conduct on the part of the defendant? See 425 U.S. at 193-94 n.12.

⁸²In note 33 of the opinion, Powell quoted with approval Justice Rehnquist's words in *Blue Chip Stamps* that "[w]hile much of the development of the law of deceit has been the elimination of artificial barriers to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good." 425 U.S. at 214 n.33, (quoting *Blue Chip Stamps*, 421 U.S. at 747-48).

⁸³430 U.S. 462 (1977).

⁸⁴*Id.* at 479. See, e.g., *Walling v. Beverly Enterprises*, 476 F.2d 393 (9th Cir. 1973) (entering into reorganization agreement without intention to perform held actionable under rule 10b-5); *Shell v. Hensley*, 430 F.2d 819, 826 (5th Cir. 1970) (rule 10b-5 cause of action stated where "[f]airly read, the complaint alleges that defendants, directly or indirectly, caused at least a majority of the Alabama National board" to engage in a securities transaction between two commonly controlled corporations); *Bryan v. Brock & Blevins Co.*, 343 F. Supp. 1062 (N.D. Ga. 1972) (proposed merger to ensure that only "active employees" as shareholders can be challenged on the basis of rule 10b-5), *aff'd on other grounds*, 490 F.2d 563, 570 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974). *But see* *Schoenbaum v. Firstbrook*, 405 F.2d 200, 210-14 (2d Cir. 1968), *cert. denied sub nom.* *Manley v. Schoenbaum*, 395 U.S. 906 (1969) (there can be no rule 10b-5 cause of action where no one is deceived).

⁸⁵404 U.S. 6 (1971).

misrepresentations or omissions of material facts directly relating to the Treasury securities being sold.⁸⁶ *Sante Fe Industries* dealt with a "going private" or "freezeout" transaction.⁸⁷ The plaintiffs claimed that they were forced to surrender their investment in Kirby Lumber Corporation, which Sante Fe Industries controlled, at only a fraction of the per share value of its net assets. Justice White held, however, that the thrust of rule 10b-5 was the accuracy of disclosure rather than unfairness. If the price, no matter how unfair it was, had been disclosed, then rule 10b-5 did not offer relief. For that, the plaintiffs had to seek relief pursuant to state law.⁸⁸

Three years later the same restrictive trend seemed soundly in place. In 1980, the Supreme Court decided two major cases interpreting rule 10b-5.⁸⁹ One of these was *Aaron v. SEC*.⁹⁰ One question that had been left open by the Supreme Court's 1976 opinion in *Ernst & Ernst v. Hochfelder*⁹¹ was whether the requirement of scienter applied not only to private causes of action founded upon rule 10b-5, but also to injunctive proceedings initiated by the SEC. The issue generated a plethora of law review commentary,⁹² and the circuit courts of appeals had split on the

⁸⁶In a complicated multi-step transaction, one Begole managed to acquire all the stock of Manhattan Casualty Co. ("Manhattan") from Bankers Life & Casualty Co. ("Bankers Life") for \$5,000,000 that was essentially paid out of the sale of nearly \$5,000,000 of Treasury bonds owned by Manhattan. Since the action was brought by the Superintendent of Insurance of New York on behalf of Manhattan's creditors, rule 10b-5 was implicated only because the Treasury securities were sold by Manhattan (Bankers Life was not complaining about its sale of Manhattan stock to Begole). As Justice Douglas admitted in his opinion for the Court, "To be sure, the full market price was paid for those bonds . . ." *Id.* at 9.

⁸⁷Although such transactions can be divided into various categories, such transactions include the element that, following the transaction, the corporation is private rather than public. The public shareholders have been "frozen out," sometimes willingly by selling their shares or concurring to a merger, but often unwillingly. See Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978).

⁸⁸Technically, this approach involved focusing upon subsection (b) rather than subsection (a) or (c) of rule 10b-5. See *supra* note 3. To the Court, rule 10b-5 concerned misrepresentation, not merely an act or practice which might, in the vernacular sense, defraud an investor. More recently, the Supreme Court, in an opinion by Chief Justice Burger, held that misrepresentation or nondisclosure is also a necessary element of a cause of action based upon §14(e) of the Securities Exchange Act. See *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985).

⁸⁹Besides *Aaron v. SEC*, 446 U.S. 680 (1980), the Supreme Court decided *Chiarella v. United States*, 445 U.S. 222 (1980). See *infra* text accompanying notes 111-19.

⁹⁰446 U.S. 680 (1980).

⁹¹425 U.S. 185 (1976).

⁹²See Berner and Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder*, 51 N.Y.U.L. REV. 769 (1976); Lowenfels, *Scienter or Negligence Required for SEC Injunctions Under Section 10(b) and Rule 10b-5: A Fascinating Paradox*, 33 BUS. LAW. 789 (1978); Note, *The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) After Ernst & Ernst v. Hochfelder*, 77 COLUM. L. REV. 419 (1977).

issue.⁹³ Justice Stewart wrote the majority opinion for the Court in *Aaron*. The Court held that the same requirement of scienter applied against the SEC even when it brought a suit for an injunction. And given the facts of the case, Justice Stewart's opinion can also fairly be read as saying something quite significant about the definition of scienter itself.⁹⁴

Aaron stood at the zenith of the Supreme Court's apparent lack of concern with deterrence of misleading statements or conduct. Even the agency charged with enforcing the 1934 Act could not seek to stop continuing securities acts violations under rule 10b-5 without alleging and proving the state law-derived element of scienter.⁹⁵ This attitude stood in sharp contrast with that which had characterized the Supreme Court's opinions of less than a decade earlier. Why had the Supreme Court turned so restrictive?

Various reasons could be, and were advanced for the trend reversal that had occurred in 1975 and still seemed in place in 1980.⁹⁶ The *Sante Fe* case suggested that the Court was concerned with federalism, and specifically, with the prospect of an open-ended doctrine such as rule 10b-5 usurping all state law respecting the governance of corporations.

⁹³Compare *SEC v. Cowen*, 581 F.2d 1020 (2d Cir. 1978) (scienter not required) with *Steadman v. SEC*, 603 F.2d 1126 (5th Cir. 1979) (scienter required).

⁹⁴With respect to a definition of scienter, the narrow holding of the Supreme Court's opinion in *Ernst & Ernst v. Hochfelder* was negative, scienter did not include negligence. Whether scienter could be satisfied not only by intentional conduct to deceive, but also by knowing or reckless conduct, was still unsettled. *Aaron*, himself, was the branch manager of a brokerage concern who was aware—i.e., knew—that salespersons in his office were promoting the sale of a security with false claims. He did little to insure that the salespersons ceased the practice. In addition to the explicit holdings, then, that the *Ernst & Ernst* requirement of scienter applied to the SEC as well as private parties, and that it applied in a suit for injunctive relief, the Supreme Court's opinion might be interpreted as implying that mere knowledge did not suffice to constitute scienter. If knowledge did not suffice, nor could mere recklessness.

⁹⁵If one takes seriously the need to protect the public, then requiring something more than negligent conduct, particularly in the circumstances present in the *Aaron* case, would seem to be counterproductive. First, the higher the state of scienter required, the more difficult the burden of proof the plaintiff must meet. Even if the defendants intentionally sought to mislead the plaintiffs, proof of intention, whether in civil or criminal law, has historically posed great obstacles. Some truly guilty parties will win simply because of the difficulty of proof. Second, either where misleading statements have been made or material facts omitted, the investing public has been injured whether the party who produced the facts or omitted them acted intentionally, recklessly, or negligently. If one concentrates upon the need to deter conduct that can harm the investing public, then, it is not clear that one would make the distinction. This is especially the case if one speaks about an action by the SEC for an injunction.

⁹⁶See Conard, *Securities Regulation in the Burger Court*, 56 U. COLO. L. REV. 193 (1985); Frankel, *supra* note 17.

Moreover, equal access to information, at least in the sense of information that is immediately usable in the investment decision, is an ideal that can hardly be realized. Consequently, one is inevitably expanding the law trying, but never being able, to achieve the goal. Similarly, unless one speaks in cost-benefit terms (a frame of analysis almost wholly lacking among those adopting the idealist stance), deterrence is a "good" of which one cannot get enough. More litigation, in other words, is axiomatically better. There is always some insider trading or unequal access to information that must be discouraged. At some point, "over-enforcement" results; some socially useful conduct is restricted, and, in any event, the costs (including the litigation costs) of deterrence exceed its benefits at the margin.⁹⁷

The general tightening of requirements for such actions, including the reaffirmation of the standing requirement in *Blue Chip Stamps*, enunciation and elaboration of the scienter requirement in the *Ernst & Ernst* and *Aaron* cases, and the tightening of the materiality standard in *TSC Industries v. Northway, Inc.*,⁹⁸ all indicated that the Supreme Court was interested not in encouraging more litigation, but in reducing the volume of suits brought on the basis of rule 10b-5.⁹⁹ To accomplish this required a philosophy other than idealism. This desire to reduce the volume of litigation, if true, would correspond to a general desire, stated repeatedly by Chief Justice Burger during those same years, to reduce the workload of the federal judiciary.¹⁰⁰ Limiting the opportunity to bring suit on the basis of rule 10b-5, then, can be seen as an integral aspect of a broader strategy implementing such a reduction.

There also seemed to be a feeling that rule 10b-5 had been misused, at least when private parties brought suit. Private suits had at first seemed quite equitable on the theory that private parties had in fact been deceived, and an implied cause of action on the basis of rule 10b-5 was the equivalent of giving that deserving private party the federal analogue of a fraud cause of action. If the plaintiffs were deserving, and if the dominant focus was on the need to protect the investing public from conduct such as that engaged in by the defendants, why not construe the elements of this new cause of action quite liberally so as to attain the maximum deterrence? However, an increasing number

⁹⁷See Frankel, *supra* note 17, at 572-78.

⁹⁸426 U.S. 438 (1976).

⁹⁹See Conard, *supra* note 96, at 216-17.

¹⁰⁰See, e.g., *Chief Justice Burger's 1977 Report to the American Bar Association*, 63 ABA JOURNAL 504 (1977) (expressing support for the elimination of diversity jurisdiction because the federal courts were overburdened); *Chief Justice's Yearend Report, 1977*, 64 ABA JOURNAL 211 (1978) (supporting elimination of the mandatory appeal jurisdiction of the Supreme Court).

of cases seemed to involve not private parties who in fact had been deceived, but sophisticated investors who had not necessarily relied on the alleged omission or false statement.¹⁰¹ These investors were using implied causes of action, such as that based upon rule 10b-5, as a strategic tool in the context of larger corporate battles.¹⁰²

*TSC Industries v. Northway, Inc.*¹⁰³ illustrates this phenomenon. Although this was not brought as a rule 10b-5 case—the allegation by the plaintiffs in *TSC Industries* concerned alleged omissions in the proxy statement of a corporation, and suit was brought on the basis of rule 14a-9—the standard of materiality articulated by the Supreme Court case was interpreted to apply to rule 10b-5 cases as well.¹⁰⁴ On the basis of *Mills v. Electric Auto-Lite Co.*,¹⁰⁵ one would have thought that a misstatement or omission was material if “it *might* have been considered important by a reasonable shareholder who was in the process of deciding how to vote.”¹⁰⁶ But the Supreme Court, in an opinion written by Justice Marshall, interpreted *Mills* to have held only that materiality substituted for proof of reliance in a rule 14a-9 case rather than to have defined materiality. Justice Marshall, who was the author of the Court’s opinion in *TSC Industries*, then carefully laid out a definition of materiality that subtly, but substantially, differed from the apparent definition found in *Mills*: “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder *would* consider it important in deciding how to vote.”¹⁰⁷ The “might” of *Mills* became the “would” of *TSC Industries*. Although the verbal change seemed slight, the consequences

¹⁰¹For example, the plaintiffs suing on the basis of rule 10b-5 have included business enterprises, professional investors and insiders under circumstances patently illustrating that the plaintiffs had not been deceived by the alleged misrepresentations or omissions. *See, e.g.*, *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88 (2d Cir. 1981) (a professional investor’s suit on the basis of rule 10b-5 dismissed where the corporate statements alleged to have been misleading were not determinative factors in his decision to purchase the stock); *Allen v. H.K. Porter Co.*, 452 F.2d 675, 679 (10th Cir. 1971) (“knowledgeable” plaintiffs, who were a security brokerage firm and its clients, brought suit when “there was ‘no semblance whatever of a lawsuit’ ”); *Harnett v. Ryan Homes, Inc.*, 360 F. Supp. 878 (W.D. Pa. 1973) (former vice-president of a corporation unsuccessfully sought to sue the corporation on the basis of rule 10b-5).

¹⁰²*See, e.g.*, *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969).

¹⁰³426 U.S. 438 (1976).

¹⁰⁴*See, e.g.*, *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 238 (6th Cir. 1985); *Basic Inc. v. Levinson*, 108 S. Ct. 978, 983 (1988).

¹⁰⁵396 U.S. 375 (1970). Significantly, Justice Harlan’s opinion in *Mills* fits the idealist mode. It is laced with references to the need to protect the public, for deterrence, and, unlike traditionalist views, dismissive of state law elements as restrictive of a federal cause of action.

¹⁰⁶*Id.* at 384 (emphasis added).

¹⁰⁷426 U.S. at 449 (emphasis added).

were not. To plaintiffs, the change in wording made the difference between being able to secure a judgment as a matter of law on the pleadings and having to spend resources at trial to prove materiality.¹⁰⁸

For our purposes the key to Justice Marshall's opinion lies in the identity of the plaintiff. The initiator of the suit was Northway, Inc., which held 2,000 shares of TSC stock. Although all the omissions from the proxy statement about which Northway complained seemed to be material even by the more restrictive definition laid down by Justice Marshall, substantially all the omitted facts must have been known to a corporate investor like Northway, presumably the recipient of sophisticated investment advice. For example, one omission was that National Industries, which was on one side of the transaction to be voted on, controlled TSC Industries, which was the other party to the transaction, and whose shareholders were asked to vote. Thus Northway was using an implied cause of action based upon inadequate disclosure not because it had been misled, but simply to buttress its case; use of the materiality doctrine (although the elements of the doctrine may have been satisfied) did not seem to square with the motivation for the suit.

Whatever the reasons and motivations for the Supreme Court's swing from idealism to traditionalism¹⁰⁹—a swing so strong as to carry with it Justice Brennan in *Cort v. Ash* and Justice Marshall in *TSC Industries*—the key respect in which traditionalism has specifically affected rule 10b-5's application to insider trading is the necessity for finding that the defendants have violated some duty owed under state law (e.g., the fiduciary duty that officers and directors owe to the corporation and its shareholders).¹¹⁰ Violation of a duty under state law as a precondition to liability under rule 10b-5 for insider trading is illustrated by Justice Powell's opinions for the majority in two key cases: *Chiarella v. United States*¹¹¹ and *Dirks v. SEC*.¹¹²

¹⁰⁸For example, in *TSC Industries, Inc. v. Northway, Inc.*, 512 F.2d 324 (7th Cir. 1974), the district court denied Northway's motion for summary judgment on the issue of liability, but the court of appeals reversed, holding the omissions material as a matter of law. The actual decision of the Supreme Court was to reverse the court of appeals and hold that Northway was not entitled to summary judgment on the issue of liability.

¹⁰⁹Another reason for containing rule 10b-5 litigation was that the problems of damages in private suits proved to be quite formidable. For example, unlike the plaintiff, the defendant in a rule 10b-5 suit need not have been a purchaser or seller. But even if he was, the defendant may have only traded a small number of shares. The damages the plaintiff alleged to have suffered might be disproportionate to the defendant's gain (if one existed). Were damages in such suits to be limited to the defendant's gain, or was the plaintiff to be allowed the full amount of his alleged loss?

¹¹⁰For an excellent exploration of this aspect of traditionalism, see Langevoort, *supra* note 56.

¹¹¹445 U.S. 222 (1980).

¹¹²463 U.S. 646 (1983).

Chiarella was an employee of Pandik Press, a financial printer that, *inter alia*, printed tender offer statements. Although the names of the tender offer targets were omitted from the various printer's proofs until the very last printing, Chiarella was able to determine certain tender offer targets on the basis of the information presented in the tender offer statement. Chiarella then purchased the stock, or call options that enabled him to purchase the stock at a set price, of the tender offer targets at a price that did not yet reflect the high probability, or even in some cases the certainty, of a tender offer being made for the shares of stock. The United States successfully brought a criminal suit against Chiarella on the basis of rule 10b-5,¹¹³ and his conviction was sustained by the Second Circuit Court of Appeals.¹¹⁴ But the Supreme Court, per Justice Powell, reversed, holding that the mere trading on the basis of information unknown to the marketplace could not constitute a violation of rule 10b-5.¹¹⁵ Justice Powell specifically rejected the "idealist" current that had dominated the Court of Appeals' opinion:

Its decision thus rested solely upon its belief that the federal securities laws have "created a system providing equal access to information necessary for reasoned and intelligent investment decisions." The use by anyone of material information not generally available is fraudulent, this theory suggests, because such information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers.¹¹⁶

Rather, what is required is "the element . . . to make silence fraudulent—a *duty* to disclose . . ."¹¹⁷ And that duty must be found in law other than rule 10b-5 itself. For example, to consider the paradigm case of conduct that would violate rule 10b-5—the corporate officer or director who profits by the use of information confidential to the corporation and known to him because of his officership or directorship—there would be a breach of his fiduciary duty as an officer or director to use the corporate property (including any information) for the benefit of the corporation and its shareholders rather than himself.¹¹⁸ But Chiarella, of course, was not an insider, that is, an officer or director, having fiduciary duties under state law. Nor did he, as in the case of many tippees, get his information from such an insider, for even the

¹¹³450 F. Supp. 95 (S.D.N.H. 1978).

¹¹⁴588 F.2d 1358 (2d Cir. 1978).

¹¹⁵445 U.S. 222 (1980).

¹¹⁶*Id.* at 232.

¹¹⁷*Id.* (emphasis added).

¹¹⁸See Phillips, *Managerial Misuse of Property: The Synthesizing Thread in Corporate Doctrine*, 32 RUTGERS L. REV. 184 (1979).

tender offeror could not be considered an “insider.” In Justice Powell’s opinion, the government failed to allege (and thus, *a fortiori*, to prove) violation of any other duty.

Chiarella thus put to rest the most expansive reading of rule 10b-5—much of it derived from the Second Circuit’s landmark decision in *SEC v. Texas Gulf Sulphur*¹¹⁹—that rule 10b-5 itself was the source of a duty to abstain from trading or to disclose the information on which one wanted to trade.

Dirks v. SEC,¹²⁰ unlike *Chiarella*, did involve a corporate insider having fiduciary duties under state law. However, the insider, Secrist, was viewed as not having violated any duties because his own motivation was to expose rather than to profit. In his opinion for the Court, Justice Powell again articulated his “duty”-dependent analysis, this time in regard to the liability of a tippee.¹²¹ There was no doubt that Dirks had both used, and profited from, the use of inside information. However, Powell held that use and profit from inside information, by themselves, could not spell liability. Rather, the tippee’s liability depended upon the breach of fiduciary duty by the corporate insider and upon the tippee’s knowledge of that breach. In this particular case, according to Justice Powell, Secrist had not breached his fiduciary duty because he had not exposed the fraud for personal gain. Quite the contrary, one could argue that Secrist had acted most properly in trying to expose the fraud.

Traditionalism, then, looks to state law. First and foremost it looks to the state law of fraud as the central focus of rule 10b-5; hence the very strong scienter requirement and the emphasis that the thrust of a complaint must allege a disclosure problem, not other conduct that is allegedly unfair or even fraudulent in a vernacular sense. But traditionalism also looks to other state law. Most importantly, with respect to rule 10b-5 regulation of insider trading, it looks to the state law of agency. In most cases, this will involve a reference to the state law of fiduciary duties. The necessity for finding a violation of a duty on grounds other than the use of information unknown to others in the marketplace puts traditionalism at odds with, and explains the characterization of it as a reaction against, idealism.

Nor is this emphasis upon violation of duties an abstract proposition. The traditionalist judge would want to see a direct nexus between the violation of the duty and the act that allows prosecution to be based, or suit to be brought, pursuant to rule 10b-5, that is, the purchase or

¹¹⁹401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

¹²⁰463 U.S. 646 (1983). For a discussion of *Dirks*, see *supra* text accompanying notes 31-37.

¹²¹Note that Dirks can be considered both a tippee—from Secrist, the insider—and a tipper—to his institutional clients who had profited by his research unknown to the marketplace.

sale of securities. Given the reluctance of state law to grant relief even in instances of insider trading where the party purchasing or selling securities on the basis of inside information is a true insider, and given the strong attraction of traditionalism for state law, it is quite inconceivable that the traditionalist judge would apply rule 10b-5 to the non-traditional context presented by *Carpenter*. To hold otherwise would undermine the authority of the *Sante Fe* case, one of the icons of traditionalist rule 10b-5 jurisprudence. Thus, we can safely speculate that those justices on the Court who have actively promoted this current of thought in their opinions, such as Chief Justice Rehnquist and Justice White, voted not to sustain the convictions in *Carpenter* on rule 10b-5 grounds.

C. *Economic Behaviorism*

Every current we have identified has a behavioral dimension. We have seen that one of the primary functions of traditionalism, placed in historical context, was to deter the initiation of litigation based on implied causes of action such as rule 10b-5. This is not to say, of course, that traditionalists have always been frank in espousing that goal. In contrast, idealists quite openly aspire to modify the behavior of actors outside the litigation context. Idealism seeks to promote the disclosure of information or, lacking fulfillment of that objective, to deter trades in which the participants lack parity of information.¹²²

Like idealism, another current—"economic behaviorism"—is directed to conduct outside litigation. Unlike idealism and traditionalism, however, this current does not view insider trading, or litigation based upon its occurrence, as necessarily positive or negative. Economic behaviorism considers the law of insider trading as bearing on the production of information.¹²³ The ability to trade on the basis of information unknown to others in the marketplace may stimulate the production of information. In that respect, insider trading should not necessarily be discouraged. On the other hand, not all use of information is desirable. If one party has property rights in certain information, its use in a trading or other context by another will be a theft of that information. Unless deterred, that trading lessens the value of the information to its owner and, indirectly, discourages its original creation. The task of the law, then, becomes drawing the line that differentiates the legal from the illegal in such a way as to encourage the creation and use of information that is socially productive. Unlike idealism and traditionalism, economic be-

¹²²See Seligman, *supra* note 16.

¹²³See Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309 (1981).

haviorism is neither inherently expansionary nor restrictive. It may lead to findings of liability in certain cases and conclusions that rule 10b-5 has not been violated in others.

To illustrate this economic behaviorist view and its differences from both idealism and traditionalism, consider three examples: first, the corporate insider who, knowing of a corporate development before the disclosure of information to the marketplace, trades on that information; second, the printing employee who determines from materials he is printing that a tender offer is to be made for a particular target and profits from that insight; and third, the security analyst who, on the basis of his research and thought-processes, determines that a particular security is overvalued and, for profit, communicates that information to his clients prior to disclosing his conclusions to the marketplace as a whole.

A strict economic behaviorist, *i.e.*, one who determines the legality of insider trading on economic behavioral considerations alone, might either condone or condemn the insider's trading in the first of these three examples. Before arriving at the ultimate question of legality, the behaviorist would want to know answers to certain questions. Is the ability to trade on the basis of inside information an incentive for the insider to have developed the information in the first place? Does the corporation indirectly get the benefit through the ability to compensate such an officer at a level lower than he would otherwise demand for his services?¹²⁴ Is any reduction in pay at least equal to the value the information would have to the corporation if the insider had not exploited the information for trading purposes? Finally, does either a rule that allows the insider to trade or one that forbids trading offer advantages in reducing the cost of transacting between the corporation and the insider? Although certain academics have advocated economic behaviorism even as applied to the insider in this example,¹²⁵ no present justice of the Supreme Court has openly equated economic behaviorism with the law that should be applied to such facts. Nonetheless, the academic literature has influenced the court, and that influence has been felt in judicial reactions to the other two examples posed.

The second example, the printer who profits on the basis of information about a tender offer target, resembles in rough outline the facts of *Chiarella v. United States*.¹²⁶ I have already alluded to the idealist dissents in *Chiarella*¹²⁷ and the traditionalism voiced by Justice Powell

¹²⁴See Cox, *supra* note 57, at 488-92; Haddock & Macey, *supra* note 57, at 1460-62.

¹²⁵See, *e.g.*, Carlton & Fischel, *supra* note 57, at 867-68.

¹²⁶445 U.S. 222 (1980).

¹²⁷*Id.* at 245-52. See also *supra* text accompanying notes 28-32.

in his majority opinion.¹²⁸ Chief Justice Burger's dissent¹²⁹ illustrates an economic behaviorist position. Unlike the idealists, Burger would neither try nor even want to rectify all informational inequalities between sellers and buyers. On this score, he agreed with Justice Powell that, "[a]s a general rule, neither party to an arm's-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation."¹³⁰ However, unlike the traditionalist who would justify the necessity for finding a violation of a duty primarily on the basis that state law incorporates such a requirement, Burger justified such a limitation of liability in terms of its incentive effects: "This rule permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting."¹³¹ Why, then, did Burger dissent? That is, why would he have upheld Chiarella's conviction?

Chief Justice Burger's economic behaviorism led him to suggest one version of the misappropriation theory.¹³² If the basis for concluding that there is no liability generally is the desire to influence the behavior of the transactor, then surely there are some situations where the securing and evaluating of relevant information are not the product of superior skill and experience and, indeed, should be discouraged:

[T]he policies that underlie the rule also should limit its scope. In particular, the rule [of no liability generally] should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.

. . . .

[The conduct of] [a]n investor who purchases securities on the basis of misappropriated nonpublic information . . . quite clearly serves no useful function except his own enrichment at the expense of others.¹³³

Chief Justice Burger thus, "would read §10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."¹³⁴

¹²⁸See *supra* text accompanying notes 111-18.

¹²⁹445 U.S. at 239-44.

¹³⁰*Id.* at 239-40.

¹³¹*Id.* at 240.

¹³²See generally Aldave, *supra* note 2, at 101.

¹³³445 U.S. at 240-41.

¹³⁴*Id.* at 240.

Chiarella did misappropriate information from his employer. Financial printers must observe the confidentiality of their clients. Without that confidentiality, news would leak to the markets, often to the prejudice of the client. Hence, the financial printer with a reputation for leaking information is hardly a printer with bright prospects. But Chief Justice Burger's articulation of the duty owed and therefore breached—particularly his use of the phrase, “an absolute duty to disclose”—implied that the printing employee owed a duty that extended well beyond the printer's employer or even the employer's client, the tender offeror. Once having failed to refrain from trading, the printer offended a duty of disclosure owed to the investing public, or at least a subset of that investing public consisting of the target corporation's shareholders who had sold their stock.¹³⁵

Consider now the third example, that of the investment analyst who investigates and concludes on the basis of his investigation that a security is either over- or undervalued by the marketplace and communicates that judgment to his clients prior to disclosing it to the public at large. While the security analyst may trade or advise others to trade on the basis of inside information, one may argue that the production of information leads to better investment decisions and promotes allocational efficiency. Because the production of information is considered a positive good, the judge approaching the question from the production of information perspective would tend to find that this use of inside information is not illegal. Without the ability to use the information, there simply would not be an incentive to produce the information.

The third example is based on the facts of *Dirks v. SEC*.¹³⁶ I have already referred to the idealist dissent in *Dirks* by Justices Blackmun, Brennan and Marshall¹³⁷ and to the traditionalist basis of Justice Powell's majority opinion that exonerated *Dirks*, the investment analyst, from liability.¹³⁸ Part of Powell's reasoning, however, seemed to have been influenced by Chief Justice Burger's earlier expressed economic behaviorism:

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognized is necessary to the preservation of a healthy market. It is com-

¹³⁵At least one prominent academic authority supports Burger's conception of the misappropriation theory. See Langevoort, *supra* note 56.

¹³⁶463 U.S. 646 (1983).

¹³⁷See *supra* text accompanying notes 31-37.

¹³⁸See *supra* text accompanying notes 120-21.

monplace for analysts to “ferret out and analyze information,” . . . and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation’s securities. The analysts’ judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation’s stockholders or the public generally.¹³⁹

Were Chief Justice Burger still on the Supreme Court, it seems clear that he would have voted to sustain the conviction of Winans and the tippees involved in the *Carpenter* case on rule 10b-5 grounds. In fact, the government’s theory in *Carpenter*, that Winans breached the duty he owed to his employer, the Wall Street Journal, is less embracing than Burger’s conception that Chiarella owed both a duty of silence towards his employer and, once having violated the duty of silence, a duty of disclosure towards investors in the marketplace. The government’s theory could only be used to justify civil or criminal enforcement actions brought by the government itself. In contrast, Burger’s theory would seem to allow private investors to initiate causes of action against the misappropriator. It seems clear, however, that no one presently sitting on the Court, with the possible exception of Justice Scalia,¹⁴⁰ whose views on this subject are presently unknown, has adopted economic behaviorism in the form espoused by Burger. Hence, despite economic behaviorism’s influence on decisions that are primarily grounded upon other currents, particularly traditionalism, I cannot conclude that economic behaviorism contributed a fourth vote in favor of the convictions in *Carpenter*.

D. *Paradigm Case Analysis*

Three additional recognizable currents represent general approaches to interpreting statutes or administrative regulations more than they reflect any substantive positions about regulating insider trading by means of rule 10b-5. In this regard, they differ from idealism and economic behaviorism, and even traditionalism, when account is taken of the latter’s bias against the expansion of federal law to matters traditionally within state law. I term the first of these modes of statutory interpretation “paradigm case analysis.”

¹³⁹463 U.S. at 658-59 (citations and footnotes omitted).

¹⁴⁰See *infra* note 198.

To analyze on the basis of paradigm cases is a particular mode of deriving the legislative or administrative intent behind a statutory provision or administrative rule. First, the approach involves conceptualizing the dominant paradigm to which the provision was directed, i.e., what factual situation did the legislators have in mind when they drafted the particular provision? The second step is to adjudge how congruent with that paradigm are the actual facts of a given case. The closer the congruence, the more the adherent of paradigm case analysis is prepared to say the provision covers the case; the greater the dissimilarity between paradigm and facts, the more one following this interpretive approach would tend to conclude that the statutory or administrative provision does not cover the situation.

To illustrate paradigm case analysis, first consider this interpretive methodology in the opinions of Justice Stephens in *Landreth Timber Co. v. Landreth*¹⁴¹ and *Gould v. Ruefenacht*,¹⁴² two rule 10b-5 cases that did not concern insider trading. Then I will speculate about the position that Justice Stevens probably took in *Carpenter*. That speculation is, to some degree, informed by his concurring opinion in *Chiarella*.¹⁴³

Landreth involved the purchase of a lumber business in the State of Washington by a Massachusetts attorney and other parties. The owner-seller was to remain as a consultant. The transaction was to be accomplished through a sale of 100 percent of the common stock of the corporation. The facts of *Gould* differ somewhat, in that only 50 percent of the corporate stock was to be sold, with the purchaser to take on some of the chores of the business while retaining his old job. But the similarities between the two cases seemingly dwarfed their differences. Although both acquisitions formally involved the sale of shares of stock, a more realistic depiction of each was that a business, or a large portion of a business, had been purchased and that the stock transfer, probably selected for tax or recording purposes, provided the means. In each situation the purchaser contended that misrepresentations had been made to him, and sued, *inter alia*, for damages pursuant to rule 10b-5.

The issue before the Court was whether these cases really involved the sale of "securities," a misrepresentation as to which would give rise to various remedies under the Securities Act of 1933 and the Securities Exchange Act of 1934, including relief under rule 10b-5. Under circumstances similar to the facts of *Landreth* and *Gould*, several Courts of Appeals had propounded a "sale of business" doctrine which would

¹⁴¹471 U.S. 681, 697 (1985) (Stevens, J., dissenting).

¹⁴²471 U.S. 701, 706 (1985) (Stevens, J., dissenting).

¹⁴³*Chiarella v. United States*, 445 U.S. 222, 237 (1980).

exclude the reach of the Securities Acts to this kind of transaction.¹⁴⁴ The theory underlying this doctrine is, quite simply, that what is really being sold is a business, not securities. The transfer of securities is simply the means by which title to the business is transferred. Indeed, the Ninth Circuit denied relief to the purchasers in *Landreth* on this basis.¹⁴⁵

The majority of the Supreme Court rejected the "sale of business" doctrine, holding that the purchasers did indeed have remedies under the federal Securities Acts. I will discuss shortly the current in which the majority's reasoning fits. Justice Stevens was the lone dissenter. In effect, he reasoned from two paradigms, two models of facts towards which the Securities Acts' remedies were directed. The first of these paradigms was "transactions in securities that are traded in a public market."¹⁴⁶ Such transactions were clearly covered by the reach of the Acts. But even if they were not, a second paradigm consisted of a transaction involving "an investor who is not in a position to negotiate appropriate contractual warranties and to insist on access to inside information before consummating the transaction."¹⁴⁷ Although Justice Stevens did not as clearly state that this paradigm was intended to be covered by the Securities Acts' reach,¹⁴⁸ he did not have to confront

¹⁴⁴See *King v. Winkler*, 673 F.2d 342, 345 (11th Cir. 1982) ("[t]he 'economic realities' of the transaction indicate not a security transaction, but rather the sale and purchase of a business using stock merely as a method of vesting the . . . [purchaser] with total ownership"); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981) (sale of 100% of the stock, and assumption of control over marina); *Chandler v. Kew, Inc.*, 691 F.2d 443 (10th Cir. 1977) (sale of liquor store by transfer of stock). *But see* *Daily v. Morgan*, 701 F.2d 496 (5th Cir. 1983) (purchase of all shares of stock and assumption of managerial control of truck dealership held to be a securities transaction); *Golden v. Garafalo*, 678 F.2d 1139 (2nd Cir. 1982) (purchase of 100% of outstanding stock of corporation engaged in ticket brokerage business); *Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979) (purchase of 50% of corporate stock and entry into corporation as executive vice-president).

¹⁴⁵*Landreth Timber Co. v. Landreth*, 731 F.2d 1348 (9th Cir. 1984).

¹⁴⁶*Landreth Lumber Co. v. Landreth*, 471 U.S. 681, 698 (1985) (Stevens, J., dissenting).

¹⁴⁷*Id.* at 699.

¹⁴⁸At one point in his dissent, Justice Stevens hints that only the first paradigm was intended to be covered by Congress:

I am not persuaded, however, that Congress intended to cover negotiated transactions involving the sale of control of a business whose securities have never been offered or sold in any public market. In the latter cases, it is only a matter of interest to the parties whether the transaction takes the form of a sale of stock or a sale of assets, and the decision usually hinges on matters that are irrelevant to the federal securities laws such as tax liabilities, the assignability of Government licenses or other intangible assets, and the allocation of the accrued or unknown liabilities of the going concern.

Id. This formulation would seem to include the first paradigm, but exclude the second. Yet,

the legitimacy of applying the Acts to the second paradigm because the facts of *Landreth* and *Gould* differed substantially from both paradigms.

How might one who argues from paradigm cases confront the cutting edge of insider trading cases, such as *Carpenter*? One would first, as Justice Stevens did in the *Landreth* and *Gould* cases, construct a paradigm or paradigms to which rule 10b-5 is directed, and, second, measure in at least a rough way the degree of similarity between such paradigms and the facts of the given case. What would such paradigms concerning insider trading appear to be? The most clear-cut would consist of the corporate insider—officer, director or other employee having a fiduciary duty not to trade on the basis of inside information—who either purchases or sells stock to the plaintiff in the case without disclosing the inside information to the other party. Another paradigm, only one step removed from the first, would consist of a tippee from an insider, knowing that the insider was breaching his duty by disclosing such inside information to him, trading with another on the basis of such information.¹⁴⁹

The facts of *Carpenter*, like those of *Chiarella*, fell within neither paradigm. Winans, the Wall Street Journal reporter, was neither an insider of the corporation whose stock was traded nor, presumably, a tippee of such insiders. *Carpenter*, a co-defendant with Winans and his lover, and Felis, another co-defendant, were tippees, but they were tippees from Winans alone.

Significantly, Justice Stevens concurred in *Chiarella*. In his concurrence, Stevens displayed unease with the extent to which the facts of *Chiarella* departed from traditional paradigms of liability. He explicitly rejected Chief Justice Burger's analysis that when *Chiarella* "bought securities in the open market, he violated . . . a duty to disclose owed to the sellers from whom he purchased target company stock."¹⁵⁰ Yet, Stevens did suggest, without himself adopting, a version of the misappropriation theory that the government later used to prosecute Winans and his tippees in *Carpenter*. He opined that "[t]he Court correctly [did] not address . . . whether the petitioner's breach of his duty of silence—a duty he unquestionably owed to his employer and to his employer's

at another point, Justice Stevens stated:

In short, I would hold that the antifraud provisions of the federal securities laws are inapplicable unless the transaction involves (i) the sale of a security that is traded in a public market; or (ii) an investor who is not in a position to negotiate appropriate contractual warranties and to insist on access to inside information before consummating the transaction.

Id. This statement of the propriety of remedial relief under the Securities Acts would include facts falling within both paradigms.

¹⁴⁹See *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228 (2nd Cir. 1974).

¹⁵⁰*Chiarella v. United States*, 445 U.S. 222, 237 (1980) (Stevens, J., concurring).

customers—could give rise to criminal liability under Rule 10b-5.”¹⁵¹ Stevens was not then prepared to adopt his own suggestion because, “inasmuch as those companies [the tender offerors] would not be able to recover damages from petitioner for violating Rule 10b-5 because they were neither purchasers nor sellers of target company securities, . . . it could also be argued that no actionable violation of Rule 10b-5 had occurred.”¹⁵²

It is unclear how Justice Stevens voted in *Carpenter*. If Stevens would have reversed the convictions under rule 10b-5, the reason would have been that the facts of *Carpenter* differed materially from those paradigms to which rule 10b-5 is applied most comfortably. If, on the other hand, Stevens did vote to uphold the convictions on rule 10b-5 grounds, that vote would mean that he managed to dispel the doubts he had raised in *Chiarella*. He would, in effect, have constructed a third paradigm of rule 10b-5 liability: the party who steals information from one party and uses it to profit against another. Facts falling within this third paradigm could give rise to criminal liability, but not civil suits on the part of the sellers or purchasers of the securities.

E. Literalism

Another current that represents a theory of statutory interpretation is “literalism.” It has had a large impact on rule 10b-5 cases generally,¹⁵³ although thus far its influence on that subset of rule 10b-5 cases dealing with insider trading has been subtle. Among the justices whose opinions have evinced literalism are Justices O’Connor, Powell and arguably White.

For example, Justice Powell wrote the majority opinion in *Landreth* to which Justice Stevens dissented. Having reviewed the facts and procedural history of the case, Powell initiated his legal discussion with the axiom “that ‘[t]he starting point in every case involving construction of a statute is the language itself.’ ”¹⁵⁴ From axiomatic statement to holding

¹⁵¹*Id.* at 238. Despite Justice Stevens’ reservations, at least one prominent scholar (*see* Aldave, *supra* note 2) and the Second Circuit Court of Appeals (*see, e.g.,* Moss v. Morgan Stanley, 719 F.2d 5 (2d Cir. 1983)) have advocated or adopted, as the case may be, Stevens’ suggested version of the misappropriation theory, which emphasizes a duty of silence owed to one’s employer rather than any purported duty of disclosure owed to others (such as had been suggested by Chief Justice Burger).

¹⁵²*Id.* One can sense Justice Stevens’ struggle by his comment in a footnote at that point: “the limitation on the right to recover pecuniary damages in a private action identified in *Blue Chip Stamp* is not necessarily coextensive with the limits of the rule itself.” *Id.*

¹⁵³*See* Conard, *supra* note 96, at 210-12.

¹⁵⁴*Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1984) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring)).

became a brief exercise: "the plain meaning of the statutory definition mandates that the stock be treated as 'securities' subject to the coverage of the Acts."¹⁵⁵ While Powell gave some consideration to statutory purpose, the reference to purpose seemed more in the nature of a rebuttal of those arguments tendered in support of "the sale of business" doctrine.

Two of Justice O'Connor's recent opinions in rule 10b-5 cases reflect the same paramountcy of language as an index of statutory intent. In *Randall v. Loftsgaarden*,¹⁵⁶ a 1986 case, the Supreme Court was confronted with the issue of whether tax benefits received by investors should be used to reduce their awards in actions to rescind the sale of limited partnership interests. The plaintiffs based their claims both on Section 12(2) of the Securities Act of 1933,¹⁵⁷ which explicitly grants a right of rescission for misleading statements or material omissions in a prospectus, and on rule 10b-5. The allegation in the case was that statements made in connection with the limited partnership interests were false,¹⁵⁸ and the project in which interests were sold in fact became bankrupt. While Section 12(2)'s right of rescission allows for recovery of "the consideration paid for such security with interest thereon," it also provides that "the amount of any income received thereon" is to be deducted from the recovery. The defendants argued that the plaintiffs had invested primarily for tax considerations, so that their out-of-pocket loss was but a miniscule percentage of the consideration they had tendered for their interests. The first part of Justice O'Connor's opinion thus concerned whether "any income received thereon" in section 12(2) should be construed to include tax benefits gained from the investment. Justice O'Connor answered this question in the negative, relying, as had Justice Powell in the *Landreth* case, almost exclusively on the "plain meaning" rule.¹⁵⁹

¹⁵⁵*Landreth* at 687.

¹⁵⁶106 S. Ct. 3143 (1986).

¹⁵⁷15 U.S.C. § 771(2) (1982).

¹⁵⁸For example, it was alleged that the availability of financing, the terms of the land lease, and the manner and extent of the compensation for services rendered were mischaracterized. 106 S. Ct. at 3147.

¹⁵⁹Justice O'Connor stated:

Here, as in other contexts, the starting point in construing a statute is the language of the statute itself. . . . Moreover, "if the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary 'to examine the additional considerations of "policy" . . . that may have influenced the lawmakers in their formulation of the statute.' " Section 12(2), we think, speaks with the clarity necessary to invoke this "plain language" canon [S]uch [tax] benefits cannot, under any reasonable definition, be termed "income."

106 S. Ct. at 3150 (citations omitted).

The rule 10b-5 claim for rescission could not be settled so easily by looking at the "plain meaning" of the language. Section 28(a) of the Securities Exchange Act, in fact, limits damages for causes of action brought under that Act to "actual damages,"¹⁶⁰ a phrase which, when taken in the vernacular, would seem to require that such matters as tax benefits be considered in any award. But with respect to the 10(b) claim, Justice O'Connor argued for the desirability of interpreting both section 12(2) and rule 10b-5 similarly with respect to rescissionary damages.¹⁶¹ Significantly, recognizing that her resolution of the two issues would grant a windfall to the suing investors, Justice O'Connor laced both her section 12(2) and section 10(b) discussions with the idealist element of deterrence:

The effect of allowing a tax benefit offset . . . [and] resulting diminution in the incentives for tax shelter promoters to comply with the federal securities laws would seriously impair the deterrent value of private rights of action, which, we have emphasized, "provides 'a most effective weapon in the enforcement' of the securities laws and are a 'necessary supplement to Commission action.'" ¹⁶²

Literalism also colored Justice O'Connor's recent majority opinion in *Shearson/American Express, Inc. v. McMahon*.¹⁶³ The case presented the issue of whether a provision in the agreement between a customer and her brokerage firm that all disputes shall be submitted to arbitration is binding even as to rule 10b-5 and RICO¹⁶⁴ claims. The customer's argument depended, in part, on the combination of sections 29(a) and 27 of the Securities Exchange Act. The former section declares void "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the Act],"¹⁶⁵ while the latter section provides that "[t]he district courts of the United States . . . shall have

¹⁶⁰15 U.S.C. § 78bb(a) (1982).

¹⁶¹This is a mode of statutory construction I term, "textual structuralism." See *infra* text accompanying notes 170-83. Justice O'Connor stated:

When section 28(a) was enacted section 12(2) stood as a conspicuous example of a rescissionary remedy, and we have found that Congress did not intend that a recovery in rescission under section 12(2) be reduced by tax benefits received. Accordingly, we think section 28(a) should not be read to compel a different result where rescissionary damages are obtained under section 10(b).

106 S. Ct. at 3153.

¹⁶²*Id.* at 3154 (quoting *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985), which in turn quoted *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964)).

¹⁶³107 S. Ct. 2332 (1987).

¹⁶⁴18 U.S.C. § 1961 *et seq.* (1982).

¹⁶⁵15 U.S.C. § 78cc(a) (1982).

exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.”¹⁶⁶ The plaintiff argued that in light of section 27, the agreement to arbitrate constituted a waiver in violation of section 29(a). But, again, Justice O’Connor made reference to “the statute’s plain language,” distinguishing a waiver of “compliance” of a substantive claim from a waiver of a right to a particular forum.¹⁶⁷ The plaintiff-customer also relied upon the idealist consideration that requiring submission of such disputes to arbitration would diminish the deterrent effect of such causes of action. In *Shearson/American Express*, unlike in *Randall*, however, Justice O’Connor seemed unmoved by this consideration.¹⁶⁸

As this brief review of the literalist mode of construing statutes indicates, it is difficult to interpret literalism as a philosophy that necessarily favors or disfavors rule 10b-5 claims. In this regard, it differs sharply from the Court’s idealism of the late sixties and early seventies and the traditionalism evinced by decisions in the later seventies, although Justice O’Connor, to support her opinion, does not aver to cite either idealist or traditionalist opinions to buttress her literalist interpretation. Nonetheless, despite this seeming “neutrality,” it is more than likely that those disposed towards literalist interpretations would not have sustained the convictions in *Carpenter* on rule 10b-5 grounds. To an avowed literalist such as Justice O’Connor, the case against application of rule 10b-5 in *Carpenter* is, quite simply, that it would be an extension beyond existing Supreme Court jurisprudence not required by the statutory language. In Justice White’s case, literalism as a judicial philosophy would have strengthened his traditionalist leanings and insured a decision not to sustain the convictions on the rule 10b-5 grounds. Furthermore, although Justice Powell no longer sits on the Court, the praise lavished upon him upon his retirement suggests that literalism has attained a legitimacy among many observers.¹⁶⁹

¹⁶⁶*Id.* § 78aa.

¹⁶⁷*Shearson/American Express*, 107 S. Ct. at 2343.

¹⁶⁸Justice O’Connor is not alone in depending upon a “literalist” interpretation. Justice White, joined by Chief Justice Burger and then Justice Rehnquist showed sympathy for the same mode of interpretation in another, recent securities law case that did not concern rule 10b-5. See *Lowe v. SEC*, 472 U.S. 181, 211 (1985) (White, J., concurring).

¹⁶⁹Such legitimacy is hardly justified. In many if not most cases the meaning of statutory language is hardly “plain”; reasonable people can and do disagree as to that meaning. See Murphy, *Old Maxims Never Die: The “Plain-Meaning Rule” and Statutory Interpretation in the “Modern” Federal Courts*, 75 COLUM. L. REV. 1299 (1975). In addition the literalist would seem to prefer to hide from the difficult policy judgments inherent in the cases coming before the Court, rather than own up to the fact that, whether overtly or covertly, the Court necessarily makes such judgments.

F. Textual Structuralism

Textual structuralism is an interpretive strategy that emphasizes the desirability of having different sections of the same statute, or related statutes and other bodies of law, be interpreted as a whole. The objective is that each provision, as interpreted, not only make sense in itself, but also logically and purposefully relate to other provisions of the relevant legal framework. As applied to rule 10b-5, this interpretive strategy calls for determining the rule's elements, contours and defenses in a way that promotes harmony rather than dissonance with other remedial sections of the Securities Act of 1933 and the Securities Exchange Act of 1934, other administrative regulations under those statutes, and the body of case law dealing with the fraudulent sale or purchase of securities.

We already have observed one example of the use of textual structuralism. In *Randall v. Loftsgaarden*,¹⁷⁰ Justice O'Connor argued, in part, that the plaintiffs' claims under rule 10b-5 should not be reduced by any tax benefits received because they were not to be so reduced under section 12(2) of the Securities Act of 1933.

Of all sitting justices, Justice Blackmun has been the strongest advocate for textual structuralism in rule 10b-5 cases. One of his most forceful pleas for textual structuralism appears in his dissent in *Aaron v. SEC*,¹⁷¹ in which the majority held that the SEC, when suing for an injunction under rule 10b-5, is bound by the same scienter requirement as are private parties in a damage suit.¹⁷² Blackmun "believe[d] [the majority's] most serious error may be a failure to appreciate the structural interrelationship among equitable remedies in the 1933 and 1934 Acts, and to accord that interrelationship proper weight in determining the substantive reach of the Commission's enforcement powers under § 17(a) and § 10(b)."¹⁷³ More specifically, Blackmun noted that the SEC is able to secure relief against the negligent representation of sellers under section 17(a) of the Securities Act of 1933, but, as a result of the majority's holding, unable to secure the same relief against negligent misrepresenting buyers under rule 10b-5. In his words, "the two statutes should operate in harmony."¹⁷⁴

Similarly, when dissenting in *Shearson/American Express, Inc. v. McMahon*,¹⁷⁵ Justice Blackmun used the existence of longstanding precedent that claims under section 12(2) of the Securities Act of 1933 are

¹⁷⁰106 S. Ct. 3143 (1986). See *supra* notes 156-62 and accompanying text.

¹⁷¹446 U.S. 680, 713 (1980) (Blackmun, J., dissenting).

¹⁷²*Id.* at 689-95. See also *supra* notes 90-95 and accompanying text.

¹⁷³446 U.S. at 713.

¹⁷⁴*Id.* at 715.

¹⁷⁵107 S. Ct. 2332, 2346 (1987) (Blackmun, J., dissenting).

not arbitrable as strong support that rule 10b-5 claims should not be either.¹⁷⁶ In both of these cases, Blackmun, whose opinions were joined by Justices Marshall and Brennan, also used idealist arguments such as the need to protect the investing public. In *Aaron*, the idealist arguments seemed to support textual structuralism; in *Shearson/American Express*, textual structuralism supported a strongly argued idealist position.

Justice Blackmun's preference for structuralism as an interpretive strategy surely would have reinforced his preference for idealism as a substantive norm in *Carpenter* as well. To support this theory, I need only refer to his dissenting opinion in *Chiarella*.¹⁷⁷ Recall that the majority, per Justice Powell, reversed Chiarella's conviction because the government had not pleaded and proved a violation by Chiarella of any affirmative duty of disclosure owed to the sellers of the securities,¹⁷⁸ but that Chief Justice Burger, in dissent, would have upheld Chiarella's conviction based, in part, on Chiarella's misappropriation of information from his employer, the printing company, and his employer's customers.¹⁷⁹ Justice Blackmun, in contrast, dissented from the whole traditionalist notion that one need allege and prove violation of a duty. To Blackmun, even if Chiarella's employer had given him permission to trade on the basis of the information about tender offers he had received by virtue of his position as a printer, Chiarella still would have violated rule 10b-5.

Justice Blackmun's analysis focused on the position of the federal securities laws in the total structure of law relating to insider trading, and the specific position of section 10(b) in the structure of the federal securities laws. If, as did the majority, one imports into section 10(b) and rule 10b-5 a state-law derived fiduciary duty requirement, one "places the federal securities laws in the rearguard of . . . [a] movement"¹⁸⁰ that would allow for a greater number of instances in which investors at an informational disadvantage could recover. Instead, the purpose of the federal securities law is to be in the foreground, that is, "to ensure the

¹⁷⁶*Id.* See also *Wilko v. Swan*, 346 U.S. 427 (1953). Speaking for the majority, Justice O'Connor placed *Wilko*'s continuing validity in substantial doubt but did not explicitly overrule the case.

¹⁷⁷*Chiarella v. United States*, 445 U.S. 222, 245 (1980) (Blackmun, J., dissenting).

¹⁷⁸See *supra* text accompanying notes 111-19.

¹⁷⁹Once having violated the duty of silence owed to his employer, Burger also intimated that Chiarella owed a duty of disclosure towards investors in the marketplace. See *supra* text accompanying notes 129-35. Other separate opinions included those of Justice Stevens (discussed *supra* notes 150-52 and accompanying text) and Justice Brennan, who agreed with Chief Justice Burger's theory that violation of a duty to Chiarella's employer would suffice but concurred with the majority because Burger's theory was not the one presented to the jury. 445 U.S. at 239 (Brennan, J., concurring).

¹⁸⁰*Id.* at 248 (Blackmun, J., dissenting).

fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate.”¹⁸¹ Within the structure of the federal securities laws, section 10(b) was designed to be “an intentionally elastic ‘catchall’ provision.”¹⁸² Imposition of a fiduciary duty requirement undermines the ability of the section to fulfill that role within the structure of the securities laws. Hence, Justice Blackmun, dispensing with breach of a fiduciary duty as a precondition to rule 10b-5 liability, would have held “that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities.”¹⁸³ Winans and his co-defendants engaged in a scheme to exploit the informational advantage Winans enjoyed as an author of the “Heard on the Street” column in the Wall Street Journal. The fact that Winans was not a traditional insider would hardly have mattered to Justice Blackmun. After all, rule 10b-5 as a “catch-all” provision within the remedial or enforcement structure of the securities acts may play its most important role precisely when the facts do not fit more traditional paradigms.

II. THE COMPETING CURRENTS: THE FUTURE

Certain metaphors, the linear and the cyclical, that are commonly used to describe events¹⁸⁴ do not aptly convey the use and force of the strands of thought that characterize the Supreme Court’s rule 10b-5 jurisprudence. For example, the case law clearly does not evince a linear movement from point X to point Y. Even during the latter 1970’s when traditionalism was strongest, some justices expressed an attachment to idealism. In the mid-1980’s, idealism, traditionalism and literalism have all recurred in majority opinions. Nor should a cyclical metaphor be adopted, for we have not come full circle. Expressions of idealism in the latter 1980’s do not go unchallenged as frequently as they did in the early 1970’s. Idealism has recurred in majority opinions, but it has no monopoly on them.

Rather, a wave-like metaphor seems most appropriate—hence, the term, “competing currents.” The currents come, recede and come again, not alone, but in competition with other currents. Sometimes, like ide-

¹⁸¹*Id.*

¹⁸²*Id.* at 246.

¹⁸³*Id.* at 251. It is interesting to note that Blackmun is as disturbed by “structural” anomalies on a substantive level as with respect to statutory text. In both contexts, Blackmun seems to be asking the question, does the particular make sense in terms of the whole?

¹⁸⁴See, e.g., S. GOULD, *TIME’S ARROW, TIME’S CYCLE* (1987).

alism in the early seventies, traditionalism in the latter seventies and arguably literalism in today's opinions, they dominate or tend to dominate but do not exclude the appearance of other currents. At times a particular current first appears in a minority opinion—for example, economic behaviorism in Chief Justice Burger's dissenting opinion in *Chiarella*—only to resurface in the majority's opinion several years later. As I noted, at least some of Justice Powell's discussion in *Dirks* can be traced to Burger's discussion in *Chiarella*.¹⁸⁵

Two of the factors that correlate positively with the appearance or even dominance of a current in the Court's opinions are the identity of that opinion's author and the time frame in which the case comes before the Court. True, the importance of these factors can be inflated. Justice Brennan, for example, most often appropriately characterized as an idealist,¹⁸⁶ has not been averse to espousing traditionalist views.¹⁸⁷ Justice O'Connor, a literalist, has buttressed her opinions with both idealism¹⁸⁸ and textual structuralism.¹⁸⁹ With the caveat, then, that the correlation between these factors and the strength of competing currents is frequently a weak one, what if anything can be said about the future course of the Supreme Court's jurisprudence in this area?

A number of personnel changes have occurred recently: Chief Justice Burger and Justice Powell have retired; Justice Rehnquist has been elevated to Chief Justice; and Justices Antonin Scalia and Anthony Kennedy have replaced Rehnquist and Powell as Associate Justices. In truth, very little is known about either Scalia's or Kennedy's views with respect to rule 10b-5 and insider trading.¹⁹⁰ Nonetheless, we can speculate that, collectively, these changes and others that may soon come will strengthen traditionalism and literalism and weaken idealism and textual structuralism. Chief Justice Rehnquist is one of the foremost traditionalists on the Court. His ability to lead the Court by, among other things, assigning cases to particular justices could influence case law development over time. Scalia's writings show a closer affinity to traditionalism or economic behaviorism than to any form of idealism.¹⁹¹

¹⁸⁵See *supra* text accompanying note 139.

¹⁸⁶For example, if Justice Brennan is assigned to write the Court's opinion, as he was in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985), we are likely to see an idealist expression of rule 10b-5, even if most justices join in that opinion.

¹⁸⁷*Cort v. Ash*, 422 U.S. 66 (1975). See *supra* text accompanying notes 67-73.

¹⁸⁸*Randall v. Loftsgaarden*, 478 U.S. 647 (1986). See *supra* notes 156-62 and accompanying text.

¹⁸⁹See *supra* notes 163-68 and accompanying text.

¹⁹⁰Kennedy has shown some sympathy towards implied causes of action. See, e.g., *Texas Partners v. Conrock Co.*, 685 F.2d 1116 (9th Cir. 1982) (reversing the district court's grant of summary judgment for defendants in an alleged proxy violation case).

¹⁹¹See Scalia, *Morality, Pragmatism and the Legal Order*, 9 HARV. J.L. & PUB. POL'Y

All three of the idealist Justices—Blackmun, Brennan and Marshall—reportedly have suffered physical setbacks in recent years that may induce the retirement of one or all of them. If Blackmun retires, textual structuralism will also lose its foremost enunciator. In contrast, at least one outspoken literalist, Justice O'Connor, seems likely to remain on the Court for some time.

At the same time, it is at least conceivable that current trends outside the Court will induce some movement in the direction of idealism, somewhat neutralizing the personnel changes. Justices are politicians of a kind, even though they are not elected. The Court's legitimacy ultimately depends upon the acceptance of its opinions not only as legal documents, but also as symbols of what is correct and incorrect. It may be that the traditionalism of the Court in the latter 1970's presaged the political conservatism that was demonstrated at the polls only several years later. But, in contrast to the latter seventies, political opinion today seems different.

Reports of certain recent insider trading cases reached a wide audience, and prosecution of such trading seems very popular.¹⁹² Certain program trading activities, such as index arbitrage and portfolio insurance, practiced by a relatively small number of sophisticated institutional traders, generally are considered to have accelerated the decline in the stock market that resulted in its collapse in October, 1987.¹⁹³ The strong trend towards the passage of state anti-takeover legislation¹⁹⁴ is consistent with a popular discontent with financial manipulations that seem to make money for a few at the expense of others,¹⁹⁵ regardless of the validity of that popular perception when applied to corporate takeovers and restructurings. Significantly, the Supreme Court encouraged the trend by sustaining the present generation of such legislation,¹⁹⁶ in contrast to

123 (1986). Scalia, without referring to rule 10b-5, seems to reject the necessary fusion of law and morality which underlies at least some of the idealist expressions.

¹⁹²See, e.g., Wall St. J., Feb. 13, 1987, at 1, col. 6 (details of arrests of Richard Wigton of Kidder Peabody and Robert Freeman of Goldman Sachs for swapping information about impending takeovers).

¹⁹³See, e.g., N.Y. Times, Feb. 3, 1988, at D4, col. 1 (excerpts from S.E.C. Report on Factors in October Stock Market Plunge); N.Y. Times, Jan. 11, 1988, at D8, col. 1 (analysis of Brady Commission report on stock market plunge).

¹⁹⁴The latest evidence of the trend is the enactment by Delaware of HB 396. See 20 Sec. Reg. & L. Rep. (BNA), 209 (Feb. 5, 1988). Delaware had previously resisted the trend.

¹⁹⁵This is not to say that such anti-takeover legislation results from such popular discontent. Rather, evidence suggests that lawmakers are reacting to demands from particular constituents such as corporations incorporated and/or operating within the borders of their states. See Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 135-36 (1987). But the popular perception might indicate why there is little if any opposition to such legislation on the part of others.

¹⁹⁶See *CTS Corp. v. Dynamics Corp. of America*, 107 S. Ct. 1637 (1987).

its earlier decision about state legislation that also sought to limit takeovers.¹⁹⁷ With respect to rule 10b-5 jurisprudence, therefore, we can suspect that the Court will not totally shun idealism, with its nexus between law and ethics, until and unless the public mood again shifts.

With personnel moving in one direction and the popular mood in another, the currents we have identified will continue to compete against each other. For the foreseeable future, none is likely to dominate the Supreme Court's rule 10b-5 jurisprudence, although the majority opinion in any particular case will reflect the predilection of the opinion's author for one of the currents. In light of the eight member Court sitting at the time of the decision, the four-four split in *Carpenter* was not a surprise. Nor will be the split decisions, whether five to four or six to three,¹⁹⁸ that are likely to follow.

¹⁹⁷See *Edgar v. MITE Corp.*, 457 U.S. 624 (1982).

¹⁹⁸For example, the Supreme Court recently split 4-2 in *Basic Inc. v. Levinson*, 108 S. Ct. 978 (1988), in which it faced, *inter alia*, the issue of whether to accept the "fraud on the market" theory in rule 10b-5 cases. That theory would allow plaintiffs who are sellers or buyers of stock traded in market transactions to recover regardless of whether they can prove their own particular reliance on a misleading statement or omission. The presumption (which, depending upon one's version of the theory, might be rebuttable) is that the misleading statement has affected the market as a whole, and hence the plaintiffs can be presumed to have relied whether or not they actually read or heard of the statement or omission. In *Basic Inc.*, the corporation issued three press releases over a fourteen month period denying any merger negotiations at a time when such negotiations were proceeding, although no deal had then been struck. The plaintiff brought a class action against the corporation and its directors. The class was defined as those who had sold the corporation's securities during the fourteen month period. Justice Blackmun wrote the opinion for the majority, in which Justices Brennan, Marshall and Stevens joined. Justice White wrote an opinion, concurring in part and dissenting in part, joined by Justice O'Connor. White dissented from the majority's acceptance of the fraud on the market theory. Chief Justice Rehnquist and Justices Scalia and Kennedy took no part in the consideration of the case.

The split in *Basic Inc. v. Levinson* was quite predictable, although the absence of three justices might have skewed the vote somewhat. Justices Blackmun, Brennan and Marshall were pursuing their idealist goal, and Justice Stevens joined because the facts of *Basic Inc.* fell within his dominant paradigm for the application of rule 10b-5. Justice White dissented on traditionalist grounds, and the literalism of Justice O'Connor, a current that Justice White also shares, dictated an alliance with traditionalism rather than idealism in the circumstances of the case.

To Justice Blackmun, one if not the main reason for adopting the fraud on the market theory was that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones." *Id.* at 989. That resolution would discourage the initiation of such rule 10b-5 litigation. Instead, Justice Blackmun was quite open in the fact that his goal was to "facilitat[e] . . . Rule 10b-5 litigation." *Id.* at 990. As an idealist, Justice Blackmun was undaunted by the fact that the state law of fraud or deceit included a reliance element: "Actions under Rule 10b-5 are distinct from common-law deceit and misrepresentations claims, . . . and are in part designed

to add to the protection provided investors by the common law, . . ." *Id.* at 990 n.22. Significantly, Justice Blackmun laced his opinion with references to such idealist icons as *Affiliated Ute Citizens v. United States* and *Mills v. Electric Auto-Lite Co.* See, e.g., *id.* at 989-90.

Justice Blackmun also added language to his opinion that would appeal to Justice Stevens' emphasis upon paradigm cases. Recall that Justice Stevens dissented in *Landreth Timber Co. v. Landreth* and *Gould v. Ruefenacht* primarily on the ground that the facts of those cases differed too substantially from the prime paradigm case to which the Securities Acts were directed: the trading of securities in market transactions. For the benefit of Justice Stevens (and obviously because it also fit with Justice Blackmun's idealist agenda), Justice Blackmun made reference to Justice Stevens' paradigm: "The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences." *Id.*

Justice Blackmun also supported his decision by reference to economic theory supporting the "premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." *Id.* at 991. Justice Blackmun's use of economic theory demonstrates that while economic behaviorism does not dominate the thinking of any present sitting justice, with the possible exception of Scalia, this current has had some influence on other justices. See *supra* text accompanying notes 122-40.

To a traditionalist like Justice White, at least two aspects of Justice Blackmun's opinion were quite objectionable. First and most importantly, it was anathema to White to develop rule 10b-5 along lines that departed substantially from state law elements of fraud. In Justice White's own words, "In general, the case law developed in this Court with respect to § 10(b) and Rule 10b-5 has been based on doctrines with which we, as judges, are familiar: common-law doctrines of fraud and deceit." 108 S. Ct. at 994. In addition, Justice White, unlike Justice Blackmun, voiced the concern of traditionalists with the equities, or more accurately, the lack thereof, of the suing plaintiffs: "I suspect that all too often the majority's rule will 'lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.' . . . This Court and others have previously recognized that 'inexorably broadening . . . the class of plaintiff[s] who may sue in this area of the law will ultimately result in more harm than good.'" *Id.* Justice White cited his own traditionalist opinion in *Sante Fe Industries, Inc. v. Green* for the development of rule 10b-5 along the lines of the state law of fraud, *id.*, and such other traditionalist touchstones as *Blue Chip Stamps v. Manor Drug Stores* and *Ernst & Ernst v. Hochfelder* to support his suggestion that too much litigation would be produced by the majority's decision. *Id.* at 999.

Justice O'Connor's attachment to literalism led her to support Justice White's traditionalism. Nothing in the statutory language supported the majority's adoption of the fraud on the market theory.

The absence of Chief Justice Rehnquist and Justices Scalia and Kennedy obviously changed the numbers in the majority and the dissent, but probably did not change the result. Justice Rehnquist would probably have dissented on traditionalist grounds, and it is unknown whether Justice Kennedy would have sided with idealism or traditionalism on the issue raised. But Justice Scalia would have added a fifth vote for the majority's decision, not because of any agreement with Justice Blackmun's idealism, but because of the majority's adoption of a theory grounded in economic behaviorism. In at least one prominent case outside the securities law context, Justice Scalia has explicitly pledged his allegiance to economic theory as the determinant of rights under federal law. See *Boyle v. United Technologies Corp.*, 108

S. Ct. 2510 (1988) (manufacturer of helicopter that crashed held not susceptible to suit by father of deceased Marine pilot because, *inter alia*, “[t]he imposition of liability on Government contractors will directly affect the terms of the Government contracts: either the contractor will decline to manufacture the design specified by the Government, or it will raise its price”). *Id.* at 2515. The only question about whether Justice Scalia would have concurred with the idealist majority in *Basics Inc. v. Levinson* is whether his espousal of economic behaviorism will carry over to contexts where the plaintiff rather than the defendant is aided by the application of economic theory.

