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# The Supreme Court and the Shareholder Litigant: *Basic, Inc. v. Levinson* in Context

Jayne W. Barnard\*

Twenty-five years ago, in *J.I. Case Co. v. Borak*,<sup>1</sup> the United States Supreme Court unanimously held that, in order to effectively supplement the often-overwhelmed enforcement efforts of the Securities and Exchange Commission (SEC), it would recognize an implied right of action, enabling private investors to seek damages and other relief under section 14(a) of the Securities Exchange Act of 1934.<sup>2</sup> Six years later, the Court enhanced the incentives for private enforcement by providing for the award of plaintiffs' attorneys' fees in Exchange Act cases.<sup>3</sup>

Then, in 1971, in a case brought under rule 10b-5 of the Exchange Act,<sup>4</sup> the Court opened the courthouse doors to litigants claiming fraud in any way "touching" the purchase or sale of securities.<sup>5</sup> These invitations quickly bore fruit, and in the early 1970's, federal securities litigation blossomed. Both private plaintiffs and the Securities and Exchange Commission increasingly sought federal court resolution of disputes related to securities transactions. In the course of five years, the federal courts' inventory of securities-related suits doubled.

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1. 377 U.S. 426 (1964).

2. 15 U.S.C. § 78n(a) (1982).

3. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

4. 17 C.F.R. § 240.10b-5 (1988).

5. *Superintendent of Ins. of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971).

Fiscal Year	Lawsuits commenced in federal courts <sup>6</sup>	Lawsuits commenced by the SEC <sup>7</sup>
1970	1211	111
1971	1962	140
1972	1919	119
1973	1999	178
1974	2378	148
1975	2408	174

Throughout this period, however, Chief Justice Burger and others increasingly decried the weight of the federal court caseload.<sup>8</sup> The Chief Justice in particular lamented that, while many decisions in the late 1960s and early 1970s had added "new burdens" to the federal docket,<sup>9</sup> "no decision of the courts ha[d] subtracted any significant burden from the avalanche which ha[d] fallen upon the Federal Courts."<sup>10</sup>

Chief Justice Burger's words were prophetic in that, in a cluster of decisions issued between 1975 and 1979,<sup>11</sup> the Supreme Court did precisely what he had been hoping for—it sharply circumscribed the ability of the federal courts to hear securities-related disputes, particularly those initiated by private shareholders as class actions. While these decisions were consistent with the Court's contemporaneous attempts to limit federal court access generally, for example by redefining concepts of federalism and abstention,<sup>12</sup> standing,<sup>13</sup> implied private rights of action<sup>14</sup> and class actions,<sup>15</sup> the rhetoric of the secur-

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6. REPORTS, JUDICIAL CONFERENCE AND ADMINISTRATIVE OFFICE, U.S. COURTS, Table 2C (1970-1988).

7. SECURITIES AND EXCHANGE COMMISSION ANNUAL REPORTS (1970-1988).

8. *E.g.*, Burger, *Has the Time Come?*, 55 F.R.D. 119 (1972) (noting expansion in federal district court filings from over 88,000 in fiscal year 1959 to over 140,000 in fiscal year 1972); A. BICKEL, *THE CASELOAD OF THE SUPREME COURT—AND WHAT IF ANYTHING TO DO ABOUT IT* (1973) (reporting on the recommendations of a court-appointed study group reviewing problems of court administration, including elimination of statutory three-judge courts, establishment of an administrative body to hear prisoner complaints, improvement of court secretarial services and the establishment of a National Court of Appeals).

9. Burger, *supra* note 8, at 120.

10. *Id.*

11. *See infra* notes 93-156 and accompanying text.

12. *E.g.*, *Younger v. Harris*, 401 U.S. 37 (1971).

13. *E.g.*, *Warth v. Seldin*, 422 U.S. 490 (1975); *Schlesinger v. Reservists Comm. to Stop the War*, 418 U.S. 208 (1974); *United States v. Richardson*, 418 U.S. 166 (1974).

14. *E.g.*, *Cort v. Ash*, 422 U.S. 66 (1975); *National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers*, 414 U.S. 453 (1974).

15. *E.g.*, *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974) (imposing on the plaintiff class representative in rule 23(b)(3) cases costs of notifying class members of their right to opt-out); *Zahn v. International Paper Co.*, 414 U.S. 291 (1973) (restricting use of the class action form in diversity cases). *See generally* Morrison, *Rights Without Remedies: The Burger Court Takes the Federal Courts Out of the Business of Protecting Federal Rights*, 30 RUTGERS L. REV. 841 (1977) (reviewing the Court's use of "devices used to deny access to federal courts"); Zeigler, *Rights Require Remedies: A New Approach to the Enforcement of Rights in the Federal Courts*, 38 HASTINGS L.J. 665 (1987) (tracing the actions of the Burger Court in impeding the enforcement of rights

ities law cases focused specifically on problems associated with corporate governance. The Court made it clear that shareholders and their "strike suits" against corporate managers, like prisoners suing their wardens<sup>16</sup> or soldiers suing their commanding officers,<sup>17</sup> were disfavored in the federal forum.<sup>18</sup>

The Court's decisions in this period can be viewed as serving two complementary purposes. By presenting a hostile face to shareholder litigation, the Court sought to limit the filing of cases which, although comprising only a small percentage of the federal docket,<sup>19</sup> occupy a vastly disproportionate amount of judicial time and attention due to their complexity.<sup>20</sup> The Court also found a ready vehicle by which to give expression to the "pro-business" philosophy of an increasingly conservative Court.<sup>21</sup>

Not surprisingly, court filings under the Securities Act and Securities Exchange Act (particularly those brought by private plaintiffs) precipitously declined.<sup>22</sup>

<u>Fiscal Year</u>	<u>Lawsuits commenced in federal courts</u>	<u>Lawsuits commenced by the SEC</u>
1976	2230	158
1977	1960	166
1978	1703	135
1979	1508	108

Despite the Court's limiting decisions, however, the activity attendant to the "economic recovery" of the early 1980s and the takeover frenzy which accompanied it (marking the emergence of new takeover defenses of contested legitimacy) generated renewed invocation of the federal securities laws. The federal court securities caseload

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by construction of "procedural barriers that leave victims without a practical remedy").

16. *Cf. Pell v. Procunier*, 417 U.S. 817 (1974).

17. *Cf. Feres v. United States*, 340 U.S. 135 (1950).

18. See *infra* notes 93-156 and accompanying text. Judicial hostility to shareholder suits has a long history. See *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541 (1949) (recounting the origins of the derivative action, and noting that it was frequently abused by "small and irresponsible . . . stockholders").

19. Cases filed under the federal securities and commodities laws during fiscal year 1988 totalled 2649. The total number of cases of all categories filed during the year was 240,821.

20. Securities cases frequently involve multiple defendants. They are frequently document-intensive, technically complicated and, because of the economic resources (including insurance) of the defendants, vigorously defended.

21. *Cf. Cohen & Milstein, The Burger Court and Business*, in *THE BURGER COURT: RIGHTS AND WRONGS IN THE SUPREME COURT 1969-1986* (Schwartz ed. 1987) (focusing on the pro-business orientation of the Court's anti-trust cases during this period).

22. See *supra* notes 6 & 7.

again doubled in a five-year period:<sup>23</sup>

<u>Fiscal Year</u>	<u>Lawsuits commenced in federal courts</u>	<u>Lawsuits commenced by the SEC</u>
1980	1694	103
1981	1768	115
1982	2376	136
1983	2915	151
1984	3142	179
1985	3266	143

The Chief Justice's complaints about the federal court caseload and attendant discovery abuses had not abated, however,<sup>24</sup> and an increasingly conservative Court still had available to it new mechanisms by which to exclude shareholders from the federal system. Most notably in its decisions enforcing the use of brokerage firm arbitration agreements,<sup>25</sup> the Court continued in its efforts to curtail use of the federal courts for the resolution of claims brought by shareholders. Curiously, the Court's ruling in *Landreth Timber Co. v. Landreth*,<sup>26</sup> which rejected the "sale of business" doctrine, had just the opposite result of encouraging resort to federal courts where previously disputes had been consigned to non-federal venues.

By the late-1980s, even as publicity about securities law violations was becoming a staple of the popular press, the Supreme Court's actions and, perhaps, the decline in the size of the shareholder pool,<sup>27</sup> led to a new decline in federal court lawsuits seeking enforcement of the securities laws.<sup>28</sup>

<u>Fiscal Year</u>	<u>Lawsuits commenced in federal courts</u>	<u>Lawsuits commenced by the SEC</u>
1986	3059	163
1987	3020	142
1988	2649	n/a

Then, following hard on the heels of the November 1987 "market break," the Supreme Court issued its decision in *Basic, Inc. v. Levinson*,<sup>29</sup> sanctioning entirely new avenues of shareholder redress under the federal securities laws. By rejecting a "bright line" test for determining the materiality of communications to shareholders,<sup>30</sup> the Court virtually assured that corporate disclosure decisions would

23. See *supra* notes 6 & 7.

24. See Burger, *The Time is Now for the Intercircuit Panel—The State of the Judiciary Address*, 71 A.B.A. J. 86, 87 (Apr. 1985) (noting 5100 cases on the Supreme Court docket in the 1984 term compared to 1463 in 1953).

25. See *infra* note 158.

26. 471 U.S. 681 (1985).

27. By 1986, institutional investors held 42.7% of the total market value of American equity investments. COLUMBIA CENTER FOR LAW AND ECONOMIC STUDIES, INSTITUTIONAL INVESTOR PROJECT (Nov. 1988).

28. See *supra* notes 6 & 7.

29. 108 S. Ct. 978 (1988).

30. See *infra* notes 209-11 and accompanying text.

more frequently be challenged by disgruntled shareholders. And, even more significantly, by embracing the "fraud-on-the-market" theory,<sup>31</sup> the Court in *Basic* seemed yet again, and at a crucial time,<sup>32</sup> to be opening the door to increased shareholder enforcement of the federal securities laws.

However, this reading of *Basic* may be misleading. The *Basic* decision is the result of an unrepresentative panel and the work of an unlikely author.<sup>33</sup> Three of the most conservative members of the Court—Justices Rehnquist, Scalia and Kennedy—did not participate in the *Basic* decision. Justices White and O'Connor, who did, joined only in the materiality portion of the decision, but dissented from the adoption of the fraud-on-the-market theory.<sup>34</sup>

Moreover, *Basic* must be read in light of its history. This article explores that history, and its implications for the shareholder litigant in the future. Part I traces the Court's securities law decisions from *Borak* forward, focusing on the shifting balance from a liberal Court which favored multiple methods of securities law enforcement to a conservative Court bent on limiting shareholders' remedies, particularly in the class action context.<sup>35</sup> This article will examine especially the developing views of those Justices who now comprise the plurality in *Basic*—Justices Blackmun, Brennan, Marshall and Stevens. Part II explores *Basic* itself and its upside potential for future types of shareholder litigation. It notes the ironic situation in which the non-plurality Justices now find themselves—on the one hand favoring strict docket control and corporate freedom from shareholder "harassment," while on the other embracing economic theories which favor shareholder litigants heretofore excluded from federal courts.

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31. See *infra* notes 212-36 and accompanying text.

32. Smart & Zigas, *Watchdog Woes: Up Against it at the SEC*, BUS. WK., Oct. 10, 1988, at 120 (detailing the serious lack of resources available to Commission for use in enforcement).

33. See *infra* notes 223-28 and accompanying text.

34. See *infra* notes 237-38 and accompanying text.

35. A number of articles have focused on the Court's dramatic shift of emphasis in securities cases as between the Warren Court and the Burger Court through the 1970s. See, e.g., Allen, *Rule 10b-5 and the Burger Court—Time to Reexamine the Elements for a 10b-5 Action*, 82 COM. L.J. 118 (1977); Freeman, *A Study in Contrasts: The Warren and Burger Courts Approach to the Securities Laws*, 83 DICK. L. REV. 183 (1978); Hazen, *Symposium Introduction—The Supreme Court and the Securities Laws: Has the Pendulum Slowed?*, 30 EMORY L.J. 5 (1981); Whitaker & Rotch, *The Supreme Court and the Counter-Revolution in Securities Regulation*, 30 ALA. L. REV. 335 (1979); Note, *The Supreme Court's Trimming of the Section 10(b) Tree: The Cultivation of a New Securities Law Perspective*, 3 J. CORP. L. 112, 129-37 (1977).

## I. PRIVATE ENFORCEMENT OF THE SECURITIES LAWS: 1964-1989

### A. 1964-1969: *The Warren Court and the Borak Case—Recognizing the Need for Private Enforcement*

In the Fall of 1956, J.I. Case Co., a midwestern farm-machinery concern, and American Tractor Corporation proposed to merge. Carl H. Borak, a Case shareholder, sought to enjoin the merger on the grounds, *inter alia*, that its terms were unfair to Case shareholders. When the injunction was denied and the merger went forward, Borak amended his complaint to seek rescission and damages, relying on the anti-fraud provisions of section 14(a) of the Exchange Act. Case and its managers argued that investors had no private rights under the proxy provisions of the Exchange Act—and indeed none were expressly set forth—but the Supreme Court held otherwise, asserting that “[p]rivate enforcement of the proxy rules provides a necessary supplement to [SEC] action.”<sup>36</sup> Noting the thousands of proxy statements submitted to the SEC each year, the Court recognized that deputization of shareholders would serve “as a most effective weapon in the enforcement of the proxy requirements.”<sup>37</sup> Moreover, the Court expressly noted the “hurdles . . . (such as separate suits, security for expenses statutes, bringing in all parties necessary for complete relief, etc.)” confronting shareholders who seek relief in state courts.<sup>38</sup> The Court’s clear preference was that shareholders should be afforded the benefits of simplified federal procedure, even in contexts not expressly anticipated by Congress.

Over the next five years, the Court continued to express this expansive view of the securities laws, providing in *Tcherepnin v. Knight*<sup>39</sup> for a widely inclusive reading of the term “security” for purposes of protection under the anti-fraud provisions of the Exchange Act<sup>40</sup> and in *SEC v. National Securities*<sup>41</sup> for the primacy of the federal securities law over state insurance regulation in the context of a merger between publicly held insurance companies.

These cases may have reflected the strong influence on the Court, particularly in the area of securities regulation, of Justice William O. Douglas, whose years as the aggressive Chairman of the Securities and Exchange Commission had given him a strong enforcement bias, and Justice Hugo L. Black, a loyal New Dealer and former plaintiffs’

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36. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

37. *Id.*

38. *Id.* at 435 (citations omitted).

39. 389 U.S. 332 (1967).

40. At issue was whether withdrawable capital shares in a state-chartered savings and loan association were securities under federal law, or whether investors in such shares would be limited to state law remedies when alleging fraud in connection with the sale of the instruments. *Id.* at 332.

41. 393 U.S. 453 (1969).

lawyer who looked out for the "little investors" and was wise to the ways of corporate managers.<sup>42</sup> They may also have reflected the view of Chief Justice Earl Warren, who had made his life in law enforcement<sup>43</sup> and recognized the value of deputization.<sup>44</sup> Soon to come, however, was Chief Justice Warren Burger, who had campaigned for his position on a "law and order" platform but whose credentials as a law enforcement officer were negligible.<sup>45</sup> Moreover, his commitment to law enforcement was at least equalled by his commitment to other "Republican values," including "free enterprise" and the elimination of governmental interference with business.

*B. 1969-1972: Mills, Bankers' Life and Affiliated Ute—The Early Burger Court Widens the Welcome*

After the ascendancy of Warren Burger to the position of Chief Justice and the arrival of Justice Harry Blackmun,<sup>46</sup> the Court, under the continuing influence of its "securities expert," Justice Douglas, at first continued to express an expansive view of shareholders' private rights of action, and specifically encouraged shareholders' class actions. This willingness to facilitate federal court redress of investor grievances was most vividly displayed during Chief Justice Burger's first term in the decision in *Mills v. Electric Auto-Lite Co.*,<sup>47</sup> a case which was conceived in the same "strike-suit" law offices that had handled the seminal *Borak* case.

*Mills*, like *Borak*, involved a shareholder challenge to a corporate merger. Plaintiffs, shareholders in the Electric Auto-Lite Co., ob-

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42. See, e.g., *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966) (noting the important role of shareholder derivative suits in "protecting shareholders of corporations from the designing schemes and wiles of insiders who are willing to betray their company's interests in order to enrich themselves").

43. Following his Army service, Warren joined the staff of the Oakland city attorney in 1919. He then joined the office of the Alameda County prosecutor in 1920, where he served until 1938, when he was elected California Attorney General. C. BARNES, *MEN OF THE SUPREME COURT* 153 (1978).

44. Prior to the chairmanship of William Cary beginning in 1961, the notion of "deputization" would have been regarded as curious, given that the SEC's own enforcement efforts were so tepid. But "[d]uring the three years of Cary's chairmanship, the [SEC] initiated approximately as many cases as it had in the previous twenty-six years." J. SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 361 (1982). Under Chairman Manuel Cohen, who succeeded Cary, the Commission further expanded its enforcement activities. *Id.* at 361-63.

45. Burger served two years as Assistant Attorney General in charge of the Civil Division of the Justice Department. C. BARNES, *supra* note 43, at 47.

46. Warren Burger became Chief Justice on June 23, 1969. Justice Blackmun joined the Court on June 9, 1970.

47. 396 U.S. 375 (1970).



jected that the proxy solicitation they had received had misrepresented the facts concerning the recommendation by the Auto-Lite Board that the merger be approved.<sup>48</sup> Because over fifty percent of Auto-Lite's stock was controlled by the proposed merger partner and the merger had been approved by a majority of shareholders far exceeding the necessary two-thirds vote, the defendants urged that, unless plaintiffs could prove that the terms of the merger had been "unfair," their complaint should be dismissed.<sup>49</sup> The Court, in an opinion particularly solicitous of the problems of "small shareholders" seeking to enforce the securities laws,<sup>50</sup> held that no such showing would be required. All that was required was that plaintiffs show that the proxy solicitation sent to them had been "materially misleading."<sup>51</sup>

The Court went on to provide that shareholders able to demonstrate a material misstatement or omission in a proxy statement would be entitled to an award of attorneys' fees for having "vindicated the statutory policy" and "render[ing] a substantial service to the corporation and its shareholders."<sup>52</sup> This would be so even if plaintiffs could never prove monetary damages.<sup>53</sup> Thus, plaintiffs' attorneys had a strong incentive to seek out, organize and prosecute actions on behalf of aggrieved shareholders, even where defendants' violations of the securities laws might be characterized as "technical." The Court, at this point, was not only tolerant of the possible abuses which would result from shareholder vigilantism, but was willing to encourage such conduct as a means of more effectively enforcing the securities laws.

The Burger Court's receptivity to the notion of private enforcement of the federal securities laws was again obvious in the 1971 decision *Superintendent of Insurance v. Bankers Life & Casualty Co.*<sup>54</sup> By the time of this decision, Justice Black had died and would soon be replaced by Justice Lewis F. Powell, Jr., a long-time corporate defense lawyer.<sup>55</sup> Justice Harlan, who authored the *Auto-Lite* decision, had retired and his place remained vacant pending the arrival of his replacement, William Rehnquist. Notwithstanding these developments, which would soon dramatically alter the Court's approach to securities cases, the Court's temporarily diminished commitment to

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48. *Id.* at 377-78, 380.

49. *See id.* at 380-83.

50. *See id.* at 382.

51. *Id.* at 382-86.

52. *Id.* at 387-94.

53. *Id.* at 394.

54. 404 U.S. 6 (1971).

55. Powell served on several corporate boards, and had served as President of the American Bar Association, the American Bar Foundation and the American College of Trial Lawyers. C. BARNES, *supra* note 43, at 119.

citizen enforcement of the securities laws remained strong. The decision of the seven member court in *Bankers Life* favorable to the plaintiff was unanimous.

The facts in *Bankers Life* have been described as "incredibly complicated,"<sup>56</sup> but, when stripped of their diversionary details, were rather simple: Manhattan Casualty Co. had been acquired from its parent by an investor, Begole, whose intent was "to pay for [the Manhattan] stock, not out of [his] own funds, but with Manhattan's assets."<sup>57</sup> In the course of a day's hectic dealing, Manhattan's new management sold \$4.8 million of the company's United States Treasury bonds, and then applied the proceeds to pay off the loan with which Begole had purchased Manhattan's shares. Begole's slight of hand, which traditionally would have been regarded as simply managerial misappropriation subject to state court oversight, was said by the plaintiff, Manhattan's receiver, also to represent a "manipulative or deceptive device or contrivance" "in connection with" Manhattan's sale of the government bonds, thus requiring the matter to be heard in federal court under section 10(b) of the Securities Exchange Act of 1934.<sup>58</sup> The receiver's complaint, however, had been dismissed by both the district court and a divided panel of the court of appeals, on the ground that the receiver had "not made out a claim cognizable under the federal Securities Acts,"<sup>59</sup> and thus could only seek redress in the state courts. Certiorari was granted to consider whether rule 10b-5 encompassed transactions such as Begole's and whether the misappropriation of the proceeds of the sale of a security could be held to have occurred "in connection with" that sale.

The *Bankers Life* decision comprised less than eight pages. It was written by the most ardent of the regulatory justices, William O. Douglas. In Justice Douglas's characteristically exuberant prose,<sup>60</sup>

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56. L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 903 (1983).

57. *Bankers Life*, 404 U.S. at 7. The notion that there is something amiss in this goal is curious in an era of leveraged buyouts.

58. *Id.* at 9. Section 10(b) provides:

It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(6) (1982).

59. *Superintendent of Ins. of New York v. Bankers Life & Casualty Co.*, 430 F.2d 355, 360-61 (2d Cir. 1980).

60. "Douglas always claimed that the work of the Court never took more than three or four days a week; he read petitions rapidly, rarely agonized over decisions, could get to the heart of an issue instantly, and wrote his opinions quickly." THE

the Court first observed that corporate investors such as Manhattan, as well as individual investors, were protected by section 10(b).<sup>61</sup> Moreover, such investors were protected whether they traded on an organized securities exchange, through the over-the-counter market, or otherwise.<sup>62</sup> The absence of an express private right of action in section 10(b) was not a disability for investors who had been injured by another's misconduct.<sup>63</sup> In addition, such investors were protected under federal law from schemes which "deprived [them] of any compensation for the sale of [a] valuable block of securities."<sup>64</sup> This was so even where the schemers responsible for this deprivation were the corporation's own executives.<sup>65</sup> The Court concluded its sweeping exegesis of rule 10b-5 by admonishing: "Section 10(b) must be read flexibly, not technically and restrictively. Since there was a 'sale' of a security and since fraud was used in 'connection' with it, there is redress under § 10(b), whatever might be available as a remedy under state law."<sup>66</sup>

Litigants and their counsel were quick to respond to this encouraging vision of rule 10b-5 and its uncompromising message to the lower courts that shareholder-initiated claims under the securities laws were to be read liberally, and with a rebuttable presumption in favor of federal court resolution.<sup>67</sup>

The Burger Court sent a comparable message just a few months later in *Affiliated Ute Citizens of Utah v. United States*.<sup>68</sup> This case, like *Bankers Life*, focused on an individual, rather than a class claim, arising out of a fact situation not involving the typical "small shareholder" in the trading markets. At issue was the conduct of tribal advisers in connection with the transfer to white buyers of shares which had been restricted to ownership by members of the Ute Indian tribe. But *Affiliated Ute*, like *Bankers Life*, was important beyond its idiosyncratic facts.

The specific question before the Court was whether a Ute seller of securities could maintain a cause of action against a white buyer (or his agent) who acquired the seller's shares at \$300 per share knowing

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DOUGLAS LETTERS—SELECTIONS FROM THE PRIVATE PAPERS OF JUSTICE WILLIAM O. DOUGLAS xvii (Urofsky ed. 1987). Some said his decisions were "slapdash." *Id.* at x. By the time he joined the Court in 1965, Douglas's friend Abe Fortas concluded that, after 25 years on the Court, Douglas had become bored with his judicial work and had gotten "sloppy in writing his opinions." B.A. MURPHY, *FORTAS: THE RISE AND RUIN OF A SUPREME COURT JUSTICE* 214 (1988).

61. *Bankers Life*, 404 U.S. at 10.

62. *Id.*

63. *Id.* at 13 n.9.

64. *Id.* at 10.

65. *Id.*

66. *Id.* at 12.

67. See *supra* note 6 and accompanying text.

68. 406 U.S. 128 (1972).

their market value in the white community was in excess of \$500 per share. The significant question was whether the buyers could defend on the ground that they had made no affirmative misstatements of fact to the sellers at any time during their dealings.

In an opinion written by Justice Blackmun—his first in the field of federal securities law since coming on the bench in 1970—the Court held that where a buyer of stock fails to disclose to the seller in a face-to-face transaction material information (such as the prevailing market price of the stock), he has failed to fulfill a duty to disclose<sup>69</sup> and positive proof of reliance is not a prerequisite to the seller's recovery under rule 10b-5. "All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of [an investment] decision."<sup>70</sup> As will be seen, *Affiliated Ute* had a strong influence on later cases well beyond those involving face-to-face transactions,<sup>71</sup> and was a direct antecedent of the *Basic* decision.<sup>72</sup>

Just as *Bankers Life* was understood to minimize plaintiffs' burden in satisfying the "in connection with" requirement of rule 10b-5, *Affiliated Ute* was understood to minimize the reliance/causation element of claims brought under the rule. However, perhaps energized by the arrival of Justices Rehnquist and Powell (who did not participate in either decision), the Court soon began to reconsider the implications of *Bankers Life* and *Affiliated Ute*.

This process of reevaluation involved five separate, although intertwining, considerations:

- (1) Concern about and hostility to the increase in federal court filings vs. the need to encourage private enforcement of the federal securities laws in order to compensate for the inadequate resources of the SEC.
- (2) Hostility to plaintiff class actions generally, especially those which could be characterized as lawyer-motivated "strike suits" vs. approval of the class action device as the only feasible way for plaintiffs with a small stake in the enterprise to protect themselves against improper conduct which results in large damages spread among thousands of people.
- (3) Hostility to "overregulation" and "harassment" of businesses and their managers vs. the need to protect shareholders (and others who deal with business) from overreaching.
- (4) Resistance to the "federalization" of corporate law and the parallel desire to leave to the state courts disputes traditionally resolved there vs. defer-

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69. The decision does not specifically articulate the source of this "duty," an issue which only later became significant in *Chiarella v. United States*, 445 U.S. 222 (1980). See *id.* at 231-32.

70. *Affiliated Ute*, 406 U.S. at 153-54.

71. See *infra* note 217 and accompanying text.

72. See *infra* notes 228-32 and accompanying text.

ence to the regulatory expertise of the SEC and federal courts in resolving disputes under federal law.

(5) A commitment to strict statutory construction vs. a desire to effectuate the intended goals of the statute writers.

For clarity, throughout the balance of this paper, I have designated these considerations respectively "caseload," "class action access," "managerial prerogative," "federalism," and "statutory integrity."

The need to balance and resolve the competing values embodied in these considerations, essentially invisible in the Warren era decisions, came more and more to dominate the Burger Court's decisions in cases involving the securities laws.

### C. 1972-1975—*The Slow Beginning of a Long Retreat*

Two cases decided during the period 1972-1975, which seemed totally unrelated to the rule 10b-5 issues examined in *Bankers Life* and *Affiliated Ute*, set the tone for that which was to come. Both cases limited the scope of section 16(b) of the Exchange Act,<sup>73</sup> which had been enacted to permit shareholders to require disgorgement to the corporate treasury of "short-swing" trading profits gained by corporate executives and persons who were ten percent shareholders at the time of both the purchase and the sale. In *Reliance Electric Co. v. Emerson Electric Co.*,<sup>74</sup> the Court held that a speculator which had acquired 13.2% ownership of a company through a tender offer and within six months had sold off its shares in sequential sales representing 3.24% and then 9.96%, would be liable only for the profits on its first sale, inasmuch as, at the time of the second sale, the speculator was no longer a 10% shareholder of the target so was not governed by section 16(b).<sup>75</sup> This sell-off scheme, which had been devised by the speculator's general counsel, had as its clear intent the evasion of section 16(b)'s coverage; but the Court in a 4-3 decision written by Justice Stewart<sup>76</sup> chose, quite contrary to the spirit of *Bankers Life*, to read the statute "technically and restrictively," and immunized from shareholder recovery any profits not strictly within section 16(b)'s purview. Justice Douglas, joined by Justices White and Brennan, predictably dissented, arguing that the majority's position "undermine[d]" the purposes of the statute,<sup>77</sup> and was "plainly at variance with the policy of the legislation as a whole."<sup>78</sup>

In this decision we can see the first stirrings of what I have designated as the "statutory integrity" issue of the debate which was to

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73. 15 U.S.C. § 78 (1982).

74. 404 U.S. 418 (1972).

75. *Id.* at 422-27.

76. Justices Powell and Rehnquist did not participate in this case.

77. *Reliance*, 404 U.S. at 431 (Douglas, J., dissenting).

78. *Id.* (quoting *U.S. v. American Trucking Ass'n*, 310 U.S. 534-43 (1939)).

mature over the next decade, with the conservative justices generally favoring a narrow "plain language" approach and the more liberal justices favoring a broader and more instrumental approach to statutory interpretation.

The following year, the Court again narrowed the scope of section 16(b). In *Kern County Land Co. v. Occidental Petroleum Corp.*,<sup>79</sup> Occidental had, by means of a public tender offer, acquired more than ten percent of the shares of Kern County Land Co. ("Old Kern"). Old Kern had aggressively resisted Occidental's takeover attempt, and entered into a defensive merger with Tenneco, Inc. Recognizing that, following the Old Kern-Tenneco merger, Occidental would end up owning a significant minority position in Tenneco (which it did not wish to own), Occidental entered into an option agreement by which Tenneco could re-purchase Occidental's Tenneco stock six months and one day after the expiration of Occidental's tender offer. Tenneco made a down payment of \$8.8 million for the option against the full \$84.2 million purchase price while the six-month waiting period was still running. The question before the Court was whether either the merger itself (by which Occidental traded its Old Kern for Tenneco shares) or the execution of the buy-back option agreement with Tenneco, constituted a "sale" subject to regulation under section 16(b).

This time the Court (now joined by Justices Powell and Rehnquist), in an opinion by Justice White, applied a "pragmatic" rather than a strict constructionist approach, holding that neither transaction was a "sale,"<sup>80</sup> and that section 16(b) ought not to apply because at no time during the running of the six-month period did Occidental have access to inside information or the opportunity to engage in "speculative abuse."<sup>81</sup> Justice Douglas (this time joined by Justices Brennan and Stewart) again dissented on the ground that the Court's manipulation of section 16(b) undermined Congress's intent to discourage insider trading.<sup>82</sup> Ironically, now it was the liberals who were urging the more literal reading of the statute and the conservatives who professed to be serving Congress's "real" goals. However, the focus of the analysis had shifted in *Kern County* from one merely of statutory intent to one of business realities. Justice White's opinion in *Kern County* was comprised almost entirely of a detailed "real

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79. 411 U.S. 582 (1973).

80. *Id.* at 603-04.

81. *Id.* at 599.

82. *Id.* at 605 (Douglas, J., dissenting).

world" analysis of how business information was acquired by (or concealed from) Occidental and how corporate decisions are made.<sup>83</sup> Thus, another thread of the debate—that relating to managerial prerogatives—began to emerge, in which the conservative members of the Court demonstrated an acute appreciation of the problems faced by corporate managers and a willingness to resolve substantive law questions so as to relieve them of liability when their wrongdoing was not manifest.

The combined consequence of the *Reliance* and *Kern County* cases was to deprive shareholders of the corporations, in whose stock profitable short-swing trading had occurred, of millions of dollars in damages and a fair assessment of attorneys' fees. Other decisions during this period also reflected an increasingly restrictive view of the sorts of securities-related claims which should be heard in the federal courts,<sup>84</sup> or the sorts of plaintiffs who ought to be able to advance federal court claims.<sup>85</sup> The vote was routinely 5-4, with Justices Douglas and Brennan always in the minority and Justices Marshall, Blackmun, and White variously making up the remaining twosome.<sup>86</sup> But the clearest sign of the Court's antipathy to investors and their use of federal courts to resolve differences with corporate managers would come in the provocative language of *Blue Chip Stamps v. Manor Drug Stores*,<sup>87</sup> issued at the close of the term in 1975.

Less than four years had passed since the unanimous decision in *Bankers Life*. Only three had passed since *Affiliated Ute*. However, the atmosphere of the Court had changed substantially in the interim. Justice Douglas, the champion of the shareholder, had become incapacitated and would soon resign to be replaced by a corporate

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83. *Id.* at 598-99.

84. *E.g.*, *Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R.*, 417 U.S. 703 (1974) (corporation cannot recover from its former 98.3% owner for alleged violations of federal securities laws and related state laws during the term of ownership) (Justices Marshall, Douglas, Brennan, and White dissented); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974) (corporation asserting violations of rule 10b-5 is bound by agreement previously executed with defendant to arbitrate any dispute arising out of the agreement in the International Chamber of Commerce in Paris, France) (Justices Douglas, Brennan, White, and Marshall dissented).

85. *E.g.*, *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975) (brokerage customers have no implied private right of action under the Securities Investor Protection Act of 1970); *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972) (trustee in reorganization lacks standing to assert claims on behalf of a corporation's bondholders alleging breach of fiduciary duty by the corporation's indenture trustee) (Justices Douglas, Brennan, White, and Blackmun dissented). *See also* *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974). *Eisen* was a case of enormous significance, holding that a representative plaintiff in a rule 23(c)(2) class action was required to send individual opt-out notices to all class members—estimated to number over two million "odd-lot" traders in securities—and to bear the cost of doing so or else see the case dismissed. (Justices Douglas, Brennan, and Marshall dissented).

86. *See supra* notes 84-85.

87. 421 U.S. 723 (1975).

lawyer with predictably different sympathies.<sup>88</sup> Not only was Justice Douglas no longer an influential voice on the Court, his views were now cancelled out by the far more management-protective instincts of Justices Powell and Rehnquist. Moreover, Justice Rehnquist had by now assumed his role as adjutant in Chief Justice Burger's campaign to reduce federal court caseloads.<sup>89</sup> The Court was beginning to systematically eliminate whole portions of the federal court docket,<sup>90</sup> especially targeting class action plaintiffs<sup>91</sup> and plaintiffs asserting implied private rights of action.<sup>92</sup> The "new" Burger Court was at last prepared to voice its new view of securities law enforcement. That voice was heard in *Blue Chip*.

#### *D. 1975-1979: The Court Condemns "Strike-Suiters"*

Plaintiffs in *Blue Chip* were retail store owners, who had for years participated in the Blue Chip trading stamp program. Under the terms of an antitrust consent decree, plaintiffs became entitled to purchase common stock and debentures in a newly-organized corporation known as Blue Chip Stamps. Upon review of the Blue Chip prospectus, which they later alleged to have been "materially misleading in its overly pessimistic appraisal of Blue Chip's status and future prospects,"<sup>93</sup> plaintiffs elected not to purchase the offered securities. When the value of the shares later rose, plaintiffs, suing on behalf of a class of non-purchasers, sought \$21.4 million for lost opportunity.

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88. Justice Douglas suffered a stroke in December 1974. Although he returned to the Court in late March 1975, he was by then physically wasted and in constant pain. He finally and reluctantly submitted his resignation from the Court in November 1975 and was replaced by Justice John Paul Stevens in December 1975. That Justice Stevens later did not meet some conservatives' expectations is one of the recurring quirks of Supreme Court history. *But see* L. Tribe, *The Myth of the Surprised President*, in *GOD SAVE THIS HONORABLE COURT* (1985).

89. *E.g.*, Rehnquist, *Whither the Courts*, 60 A.B.A. J. 787 (July 1974). Justice Rehnquist commented,

I am frequently asked whether the Supreme Court is overworked. My answer is that it is indeed overworked and that the nine members of the Court are expected to do more than nine normally capable and diligent judges can be expected to do and do in a professionally competent way.

*Compare* W. DOUGLAS, *THE AUTOBIOGRAPHY OF WILLIAM O. DOUGLAS: THE COURT YEARS 385* (1980) (notion that the Court was overworked "was insane").

90. *See, e.g.*, *Preiser v. Rodriguez*, 411 U.S. 475 (1973) (state prison inmates may not proceed under federal civil rights laws in challenging denial of "good time" but are limited to seeking habeas corpus, which requires exhaustion of state remedies).

91. *See supra* note 15.

92. *See supra* notes 14 and 85 (discussing *Barbour*).

93. *Blue Chip*, 421 U.S. at 726.



It would have been no surprise if the Court had merely upheld as matter of statutory construction the long-honored "*Birnbaum* rule," limiting standing in rule 10b-5 cases to actual purchasers and sellers of securities.<sup>94</sup> In fact, the Court did just that and ordered plaintiffs' complaint dismissed.<sup>95</sup> However, part III of the Court's opinion, which was written by Justice Rehnquist, proceeded much further into the "policy considerations" favoring a restrictive interpretation of rule 10b-5.<sup>96</sup> Describing the rule contemptuously as "a judicial oak which has grown from little more than a legislative acorn,"<sup>97</sup> Justice Rehnquist went on to cast aspersions on shareholder litigants generally. "There has been widespread recognition," he began, "that litigation under rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."<sup>98</sup> This perception was based on the notion that, because of the huge damage awards and liberal use of federal discovery rules which were possible in actions brought under rule 10b-5, many such suits—particularly those brought as class actions and characterized in any event as "nuisance" or "strike" suits<sup>99</sup>—were commonly brought solely for their settlement potential.<sup>100</sup> "The prospect of extensive deposition of the defendant's officers and associates and the concomitant opportunity for extensive discovery of business documents, is a common occurrence in this and similar types of litigation,"<sup>101</sup> noted Justice Rehnquist (without citation) in a candid expression of his concern for the prerogatives of corporate managers. He expressed particular concern that corporations be spared "disruption of [their] normal business activities"<sup>102</sup> due to shareholders' actions.

Moreover, he noted that expanding the class of plaintiffs entitled to pursue relief under rule 10b-5, to those who had foreborne from purchasing (or selling) shares, would encourage hindsight-aided testimony by the risk averse who had failed to trade.<sup>103</sup> What the opinion left unstated was that litigating shareholders, presumably guided by their "strike suit" lawyers, are prone to falsify their testimony. This represented yet another thread of the Supreme Court debate, focusing on the conservative mistrust of class activists.

One obvious reading of the *Blue Chip* decision is that its intention

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94. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952).

95. *Blue Chip*, 421 U.S. at 731.

96. *Id.* at 737-49.

97. *Id.* at 737.

98. *Id.* at 739-40.

99. *Id.* at 740.

100. *Id.* at 741.

101. *Id.*

102. *Id.* at 742-43.

103. *Id.* at 746-47.

was not only to facilitate the quick dismissal of securities-related lawsuits brought by non-buyers or sellers, but also to signal the district courts to hear with more caution the more traditional suits which remained. Justice Rehnquist did nothing to dispel such a conclusion when he ended his comments with the gratuitous observation that "we are not the first court to express concern that the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good."<sup>104</sup>

Enter Justice Harry Blackmun, who at the time of *Blue Chip* was about to inherit the mantle of Justice Douglas as the Court's most outspoken protector of the "little investor." Justice Blackmun, in a vigorous dissent joined by Justices Douglas and Brennan, felt that the "harm" which Justice Rehnquist sought to protect against was nothing more than the discomfort of corporate executives and the possibility of intensive federal court scrutiny of their manipulative behavior. "[T]he Court exhibits a preternatural solicitousness for corporate well-being," he scolded, "and a seeming callousness toward the investing public quite out of keeping it seems to me, with our own traditions and the intent of the securities laws."<sup>105</sup> This was not the first time Justice Blackmun had stood up for the small investor seeking relief in the federal court.<sup>106</sup> And it would not be the last time he challenged the Court's new paternalism toward corporate managers.<sup>107</sup>

The conservative majority's disdain for federal court shareholder claims, particularly those brought as class actions, continued to emerge in Supreme Court decisions, arising next in *Ernst & Ernst v. Hochfelder*.<sup>108</sup> This case considered the question of whether "scienter" or a specific "intent to deceive, manipulate, or defraud"<sup>109</sup> was an essential element of private claims brought by shareholders under rule 10b-5. Though the Securities and Exchange Commission argued that it was not,<sup>110</sup> the Court in an opinion written by Justice Powell held to the contrary.<sup>111</sup> The focus of the majority was on strict statu-

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104. *Id.* at 747-48.

105. *Id.* at 762 (Blackmun, J., dissenting) (citing *inter alia Bankers Life*, 404 U.S. at 12).

106. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 128; *supra* notes 65-69 and accompanying text.

107. See *infra* notes 117, 210-11 and accompanying text.

108. 425 U.S. 185 (1976).

109. *Id.* at 187-88.

110. *Id.* at 197-98.

111. *Id.* at 214.

tory construction, with ready reference to dictionary definitions to reach the plain meaning of the statute.<sup>112</sup>

One point in support of the Court's conclusion that scienter was required in rule 10b-5 actions was the observation that if plaintiffs were excused from proving scienter in claims brought under rule 10b-5, then no one would ever utilize the express but more limited shareholder recovery provisions of the 1933 Act.<sup>113</sup> These provisions—which did not require proof of scienter—were subject to various procedural restrictions not applicable to rule 10b-5, which had been imposed by Congress, Justice Powell observed, in part “to deter actions brought solely for their potential settlement value.”<sup>114</sup>

The implicit message was that to freely permit rule 10b-5 claims without requiring plaintiffs to show scienter on the part of the defendant would encourage precisely the sort of shareholder “strike suits” which *Blue Chip* had attempted to discourage. This implication was buttressed by the Court's specific recognition that rule 10b-5 claims in the absence of scienter “would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts.”<sup>115</sup> As had clearly been seen in the *Blue Chip* decision, where the Court refused to expand the class of rule 10b-5 plaintiffs empowered to sue primary violators, this was not a result to be sanctioned by the Burger Court. The articulation of this desire to keep to a minimum acceptable categories of rule 10b-5 plaintiffs was a direct manifestation not only of the Court's antipathy to “strike suits” but also of the more general “caseload” concerns of the conservative majority. Justice Blackmun once again authored the dissent,<sup>116</sup> emphasizing the majority's disregard of the needs of shareholders victimized by managerial misconduct.<sup>117</sup>

Other cases during this period reinforced the exclusionary message of *Blue Chip* and *Hochfelder*. In particular, in *TSC Industries, Inc. v. Northway, Inc.*,<sup>118</sup> the Court escalated the standard of materiality which must be proven by a shareholder in an action brought under the federal proxy solicitation rules.<sup>119</sup> In *Piper v. Chris-Craft Indus-*

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112. *Id.* at 199 n.20-21.

113. *Id.* at 210-11.

114. *Id.* at 210-11 n.30.

115. *Id.* at 214 n.33.

116. *Id.* at 215. Only Justice Brennan joined in this dissent. It should be noted that Justice Douglas had already resigned when this decision was rendered.

117. “Once again . . . the Court interprets § 10(b) of the Securities Exchange Act . . . restrictively and narrowly and thereby stultifies recovery for the victim.” *Id.* at 215-16 (Blackmun, J., dissenting).

118. 426 U.S. 438 (1976).

119. *Id.* at 449.

*tries, Inc.*,<sup>120</sup> the Court held that a tender offeror, even one holding over 500,000 shares in the target company, lacks standing to seek damages for violations by a competing offeror of the disclosure provisions of the federal tender offer rules, notwithstanding that the former may be the best situated plaintiff (in terms of incentive and financial resources) to pursue such claims.<sup>121</sup> The decisions in *TSC* and *Piper*, like those in *Blue Chip* and *Hochfelder*, were contrary to the expressed views of the SEC, which argued in *Piper* that a more receptive attitude toward private rights of action was necessary to ensure optimal enforcement of the federal securities laws.<sup>122</sup> Presumably, that was no longer an objective of a majority of this Court.

Another major case in the Court's exclusionary campaign was *Santa Fe Industries, Inc. v. Green*,<sup>123</sup> which considered the application of rule 10b-5 to "short-form" or "squeeze-out" mergers authorized under Delaware law. The Second Circuit had held that when such transactions represented a breach of fiduciary duty by a majority against minority shareholders, they were governed by the "artifice to defraud" provisions of rule 10b-5, even where there had been no material misstatements or omissions in any shareholder communications.<sup>124</sup> The Supreme Court reversed, relying on the strict constructionist approach of *Hochfelder*, and held that rule 10b-5 does not apply to "instances of corporate mismanagement such as this, in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary."<sup>125</sup> Rather, actions under rule 10b-5 should be restricted to conduct involving manipulation or deception.<sup>126</sup>

The opinion was written this time by Justice White, and rang a familiar note in light of the cases which had gone before. The Court focused on the "plain meaning" of the statute's language.<sup>127</sup> There was also a reprise of the Court's apprehensions about interference with managerial prerogatives. The Court noted that to permit plaintiff's complaint to proceed would pose a "danger of vexatious litigation which could result from a widely expanded class of plaintiffs

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120. 430 U.S. 1 (1977). (Justice Blackmun wrote a separate opinion concurring in the judgment; Justices Brennan and Stevens dissented.).

121. *Id.* at 45-46.

122. *Id.* at 64 (Stevens, J., dissenting).

123. 430 U.S. 462 (1977).

124. *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1287 (1976).

125. *Santa Fe Indus.*, 430 U.S. at 477.

126. *Id.* at 473-74.

127. *Id.* at 472.

under Rule 10b-5.”<sup>128</sup>

The Court also noted that hearing complaints such as Green’s would interfere with the traditional state regulation of matters relating to corporate governance.<sup>129</sup> Thus was raised the final item on the Court’s agenda of considerations, the federalism issue. Quite contrary to the expressed preference in *Bankers Life* for federal court resolution of claims “whatever might be available as a remedy under state law,”<sup>130</sup> the Court’s preference had now shifted to state court resolution of shareholder disputes wherever possible.

Although Justices Blackmun and Stevens concurred in the judgment in *Santa Fe*, they declined to adopt the rhetoric of part IV of the Court’s opinion which related to the “[policy] considerations that weigh heavily against permitting a cause of action under rule 10b-5 for the breach of corporate fiduciary duty.”<sup>131</sup> Instead, Justice Blackmun referred to his dissents in *Blue Chip* and *Hochfelder* and Justice Stevens referred to his dissent in *Piper*, in which they both cautioned against the emasculation of the federal securities laws.<sup>132</sup> Justice Brennan dissented from the judgment in *Santa Fe*.<sup>133</sup>

Taken together, by 1977, *Blue Chip*, *Hochfelder*, and *Santa Fe* had resolved all five of the Court’s agenda items—caseload, class action access, managerial prerogative, federalism and statutory integrity—in favor of the conservative view. While the Court had not overruled the fundamental principle that an implied private right of action exists to enforce rule 10b-5,<sup>134</sup> it had clearly signalled that such actions were no longer favored, and that continuing efforts to expand the scope of rule 10b-5 were unlikely to succeed.

For the remainder of the period 1975-1979, the “new majority” of the Burger Court repeatedly conveyed the message that the era of solicitude toward shareholders was over;<sup>135</sup> so too was any thought

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128. *Id.* at 478-79 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975)).

129. *Id.* at 478.

130. *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 604 U.S. 6, 12 (1971).

131. *Santa Fe Indus.*, 430 U.S. at 477.

132. *Id.* at 480-81.

133. *Id.* at 480 (Brennan, J., dissenting).

134. *Ernst & Ernst v. Hochfelder*, 425 U.S. at 196.

135. See *Burks v. Lasker*, 441 U.S. 471 (1979) (“disinterested” directors of an investment company may terminate a “non-frivolous” shareholders’ derivative suit brought against other directors under the Investment Company Act); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979) (limiting the definition of “security” under both the Securities Act and the Securities Exchange Act); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) (brokerage firm’s clients have no implied private right of action under section 17(a) of the 1934 Act against firm’s accountants for facilitating the filing of false reports with the SEC) (Justice Marshall dissented); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) (shareholders have no implied private right of action to seek damages under the Investment Advisers Act of 1940, although they do have standing to seek rescission of an advisor’s contract) (Justices

that the views of the SEC necessarily had persuasive authority before the Court.<sup>136</sup> The SEC had advanced on its own behalf, or as *amicus curiae*, unsuccessful arguments in *Blue Chip*,<sup>137</sup> *Hochfelder*,<sup>138</sup> *Santa Fe*,<sup>139</sup> *Northway*,<sup>140</sup> *Piper*,<sup>141</sup> *Forman*,<sup>142</sup> *Cort*,<sup>143</sup> *United States v.*

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White, Brennan, Marshall, and Stevens dissented); *Coopers & Lybrand v. Livesay*, 437 U.S. 463 (1978) (denial of class certification in an action brought by securities purchasers was not an appealable order); *Oppenheimer Fund, Inc. v. Sanders*, 437 U.S. 340 (1978) (investors in an action challenging conduct of an open-end diversified investment fund must bear total cost of assembling from defendant's records a mailing list of class members); *SEC v. Sloan*, 436 U.S. 103 (1978) (SEC has no authority to suspend indefinitely trading in exchange traded shares); *Foremost-McKesson v. Provident Securities Co.*, 422 U.S. 232 (1976) (limiting coverage of section 16(b) "short-swing" provision); *Radzanower v. Touche Ross & Co.*, 426 U.S. 148 (1976) (national bank sued for violation of federal securities laws is subject only to the limited venue provision of the National Bank Act and not the more inclusive provision of the Securities Exchange Act) (Stevens dissented); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975) (requiring corporate plaintiff to make traditional showing of irreparable harm to support request for injunctive relief against purchaser in "technical default" of schedule 13D filing requirement) (Justices Brennan, Douglas, and Marshall dissented); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (excluding non-"traditional" shares of stock from coverage under the federal securities laws) (Justices Brennan, Douglas, and White dissented); see also *Leroy v. Great Western United Corp.*, 443 U.S. 173 (1979) (constitutional challenge to state anti-takeover law may be heard only in the state in which law has been enacted) (Justices White, Brennan, and Marshall dissented); *Will v. Calvert Fire Ins. Co.*, 437 U.S. 655 (1978) (federal court may stay claim under securities law—over which it has exclusive jurisdiction—where related state action is pending) (Justices Burger, Brennan, Marshall, and Powell dissented); *Cort v. Ash*, 422 U.S. 66 (1975) (shareholders have no implied private right of action under criminal statute prohibiting corporate contributions to presidential candidates); *Gordon v. New York Stock Exch., Inc.*, 422 U.S. 659 (1975) (shareholders' challenge to fixed commission rates of Exchange member firms dismissed on grounds of antitrust immunity); *United States v. National Ass'n of Sec. Dealers*, 422 U.S. 694 (1975) (SEC-regulated marketing practices of open-end mutual funds immune from coverage of federal antitrust laws) (White, Douglas, Brennan and Marshall dissented).

But see *Parklane Hosiery Co. v. Shore*, 439 U.S. 322 (1979) (defendants in a shareholders' class action are collaterally estopped from relitigating questions of liability previously decided adversely to them in non-jury trial arising out of an SEC enforcement action, and this application does not violate the seventh amendment right to jury trial); *Boston Stock Exch. v. State Tax Comm.*, 429 U.S. 318 (1977) (state cannot tax stock transfers which occur out-of-state at a higher rate than those which occur in state).

136. One commentator has observed that, during this same period in antitrust cases, the Court's rule of thumb had changed from "the government always wins" to "the government always loses." R. GALLOWAY, *THE RICH AND THE POOR IN SUPREME COURT HISTORY* 174-75 (1982).

137. 421 U.S. 723 (1975).

138. 425 U.S. 185 (1976).

139. 430 U.S. 462 (1977).

140. 426 U.S. 438 (1976).

141. 430 U.S. 1 (1977).

142. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975).

143. *Cort v. Ash*, 422 U.S. 66 (1975).

NASD,<sup>144</sup> Gordon,<sup>145</sup> Radzanower,<sup>146</sup> Sloan,<sup>147</sup> Daniel,<sup>148</sup> Burks,<sup>149</sup> Leroy,<sup>150</sup> and Transamerica Mortgage Advisors.<sup>151</sup> And the worst was yet to come with the advent of the new decade and the Court's dismemberment of the SEC's insider trading theories.<sup>152</sup>

Though federal court solicitude toward shareholder grievances had declined, the opportunity for abuse of shareholders in the financial markets had not. Instead this opportunity for abuse actually increased. Initial public offerings increased in number and value throughout the 1980's.<sup>153</sup> Trading volume increased as well,<sup>154</sup> as did takeover activity,<sup>155</sup> attendant price volatility,<sup>156</sup> and sales of new financial "products," all of which presented opportunities for fraudulent activity in connection with the purchase or sale of securities. With this increased economic activity came new pressures on the federal courts to hear and resolve shareholder grievances.

#### *E. 1980-1987: A New Reception for a Limited Class of Shareholders*

During the 1980's, the Court continued to transmit subtle and not-so-subtle messages designed to chill the litigating ardor of shareholders.<sup>157</sup> This was especially evident in the Court's decisions compelling the enforcement of arbitration agreements where customers filed complaints against their brokers.<sup>158</sup> These decisions reflected

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144. *United States v. National Ass'n of Sec. Dealers*, 422 U.S. 694 (1975).

145. *Gordon v. New York Stock Exch., Inc.*, 422 U.S. 659 (1975).

146. *Radzanower v. Touche Ross & Co.*, 426 U.S. 103 (1978).

147. *SEC v. Sloan*, 436 U.S. 103 (1978).

148. *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979).

149. *Burks v. Lasker*, 441 U.S. 471 (1979).

150. *Leroy v. Great Western United Corp.*, 443 U.S. 173 (1979).

151. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979).

152. *See Carpenter v. United States*, 484 U.S. 19 (1987) (conviction of insider trader based upon the "misappropriation" theory upheld by a bare 4-4 vote); *Dirks v. SEC*, 463 U.S. 646 (1983) (SEC censure of investment analyst who passed along tips to customers reversed where analyst had merely received information from a corporate insider and the tipper had violated no duty of non-disclosure) (Justices Blackmun, Brennan, and Marshall dissented); *Chiarella v. United States*, 445 U.S. 222 (1980) (criminal conviction of defendant who traded on the basis of material non-public information is reversed because he owed no duty of disclosure to the trading public) (Justices Burger, Blackmun, and Marshall dissented).

153. SECURITIES AND EXCHANGE COMMISSION ANNUAL REPORT, Table 25 (1987) The number of registration statements grew from 3402 in fiscal year 1980 to 5925 in fiscal year 1986 while the value of public offerings grew from \$110,583,000,000 to \$484,383,000,000 during that same period.

154. *Id.* at Table 18 (showing exchange-traded share volume in fiscal year 1980 of 15,586,986,000 shares and in fiscal year 1986 of 48,580,524,000 shares).

155. Completed mergers increased in value from \$32.9 billion in 1980 to \$190.5 billion in 1986. MERGERS & ACQUISITIONS ALMANAC (1987).

156. *See Big Board Votes to Curb Some Program Trades*, WALL ST. J., Feb. 5, 1988, at 1, col. 1. The Dow Jones Industrial Average moved more than 50 points in a day 26 times between January 1986 and January 1988. *Id.*

157. *See infra* notes 188-94 and accompanying text.

158. *See, e.g., Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987)

the conservative majority's continuing view that the grievances of small shareholders, whether against their financial advisors or against corporate managers, are better heard elsewhere than in a federal forum.<sup>159</sup>

At the same time, there was a small boomlet of decisions which seemed to liberalize the scope of the federal securities laws, enhance their utility for private plaintiffs, and create new opportunities for shareholder recovery.<sup>160</sup> For example, the Court in 1981 gave a broad interpretation to the statutory term "offer or sale."<sup>161</sup> The following year, the Court held that investors in futures contracts could maintain an implied private action for damages under the Commodity Exchange Act,<sup>162</sup> and that a paradigm ("first-generation") state anti-takeover statute, the clear purpose of which was to impede cash tender offers reflecting substantial profit for shareholders, was unconstitutional, at least in limited respects.<sup>163</sup>

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(brokerage customers who have signed predispute arbitration agreements may be compelled to arbitrate their Exchange Act claims as well as RICO claims) (Justices Blackmun, Brennan, Marshall, and Stevens dissented in part); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985) (shareholder alleging violations of the Exchange Act together with pendent state claims may be compelled to arbitrate the state-law claims, notwithstanding their similarity to federal claims and the resultant inefficiency of multiple hearings) (unanimous decision); *see also* *Zosky v. Boyer*, 109 S. Ct. 868 (1989) (denying *certiorari* on question whether a district court order compelling arbitration in a securities fraud case is an appealable final order).

159. Justice Blackmun predicted that the decisions compelling the enforcement of predispute arbitration agreements, "no doubt animated by [the Court's] desire to rid the federal courts of these [shareholder] suits," actually may *increase* federal court litigation. *Shearson/American Express*, 482 U.S. 220, 268 (1987) (Blackmun, J., dissenting).

160. The Court also (and contrary to its posture in the insider trading cases) strengthened the power of the SEC in ruling that the agency had no obligation to notify targets of nonpublic investigations prior to issuing third party subpoenas. *SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735 (1984). The Court also ruled that adjudicatory findings by the Commission were subject only to a preponderance-of-the-evidence standard of proof. *Steadman v. SEC*, 450 U.S. 91 (1981). However, in *Aaron v. SEC*, 446 U.S. 680 (1980), the Court held that the SEC, like a private litigant, must show scienter in order to prevail in a claim under section 10(b) of the Exchange Act and section 17(a)(1) of the Securities Act. *Id.* at 695, 697 (Justices Blackmun, Brennan, and Marshall dissented in part).

161. *Rubin v. United States*, 449 U.S. 424 (1981) (pledge of stock to bank as collateral for loan held to be offer or sale). Application of this term to a pledge of stock was not surprising, nor did it have anything to do with the rights of shareholders. The case involved criminal charges against a corporate official who had participated in the submission of false financial statements to an institutional lender. *Id.* at 426-27.

162. *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353 (1982) (Justices Powell, Burger, Rehnquist, and O'Connor dissented).

163. *Edgar v. MITE Corp.*, 457 U.S. 624 (1982). Much of *MITE's* influence was undone by the Court's later decision in *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69



In a particularly receptive 1983 decision, *Herman & MacLean v. Huddleston*,<sup>164</sup> the Court ruled that plaintiffs may pursue implied claims under section 10(b) of the Exchange Act, notwithstanding overlapping express provisions of the Securities Act.<sup>165</sup> Moreover, section 10(b) claims need only be proven by a preponderance of the evidence, rather than to the clear-and-convincing standard applied by many jurisdictions in common law fraud cases.<sup>166</sup>

Two decisions issued in 1985, and both appeared to further expand the private use of rule 10b-5 beyond its previous boundaries. In *Bateman Eichler, Hill Richards, Inc. v. Berner*,<sup>167</sup> a unanimous opinion authored by Justice Brennan, the Court ruled that an investor who alleges he has been deluded by a "tipper" into believing that he is trading on the basis of inside information when he is not, may maintain a cause of action against the tipper under rule 10b-5; he is not automatically subject to dismissal under the doctrine of *in pari delicto*.<sup>168</sup> The rationale for this decision was that "denying the *in pari delicto* defense . . . will best promote the primary objective of the federal securities laws—protection of the investing public and the national economy. . . ."<sup>169</sup> The Court took particular note of the need to facilitate private enforcement of the securities laws in light of the inadequacy of the SEC's resources,<sup>170</sup> a position last considered favorably by the Court in *Borak*,<sup>171</sup> and one which in the interim had received a cold response in *Piper*.<sup>172</sup>

The decision in *Bateman, Eichler* was not likely to have a significant impact on federal court dockets, given that few investors would be inclined to pursue claims where there was a substantial likelihood that their own violations of the law would be exposed. Moreover, the decision provided little, if any, practical value to shareholders suing in the class action context. A more important decision was *Landreth*

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(1987), which upheld as constitutional a "second-generation" anti-takeover statute. See *infra* note 189 and accompanying text.

164. 459 U.S. 375 (1983).

165. *Id.* at 387.

166. *Id.* at 390.

167. 472 U.S. 299 (1985).

168. *Id.* at 312.

169. *Id.* at 315.

170. *Id.*

171. 377 U.S. 426, 432-33 (1964).

172. 430 U.S. 1, 42-43 (1976). The notion that routine use of the *in pari delicto* defense would thwart an important means of law enforcement was reenforced in the Court's decision in *Pinter v. Dahl*, 108 S. Ct. 2063 (1988). There, Justice Blackmun, writing for the Court, noted that the defense should only be available where its use would not "significantly interfere with the effective enforcement of the securities laws and protection of the investing public." *Id.* at 2071 (quoting *Bateman Eichler*, 472 U.S. at 310-11). He specifically noted that "in many instances a private suit is the only effective means of detecting and deterring a seller's [violation of the securities laws]." *Id.* at 2074.

*Timber Co. v. Landreth*,<sup>173</sup> in which the Court abolished the "sale-of-business" defense to rule 10b-5 actions, and held, contrary to the view shared by many commentators and courts of appeals,<sup>174</sup> that an investor who buys 100% of a closely-held business, by acquiring its shares, is entitled to the protection of the federal securities laws and may pursue claims of fraud in federal court in connection with the purchase.<sup>175</sup> The same holds true for the investor who acquires less than 100% of a closely-held business, with the intention of actively participating in its management.<sup>176</sup> It would not have been surprising had the Burger Court, having added an additional conservative member,<sup>177</sup> chosen to narrowly read rule 10b-5 to exclude such transactions from the coverage of federal law, on the ground that the problems presented in sale-of-business cases had traditionally been relegated to state court resolution.<sup>178</sup> For conservatives on the Court, *Landreth* created an additional dilemma between its desire to limit the scope of private actions under the securities laws and its reluctance to interpret a statute inconsistent with its "plain language." Surprisingly, statutory construction won the day.<sup>179</sup> In an opinion written by Justice Powell, the Court construed the statutory term "security," and its subsidiary definition "stock," to encompass sales of businesses effectuated by the transfer of "stock." "Although we recognize that Congress did not intend to provide a comprehensive federal remedy for all fraud," Justice Powell wrote, "we think it would improperly narrow Congress' [sic] broad definition of 'security' to hold that the traditional stock at issue here falls outside the Acts' coverage."<sup>180</sup>

The defendants in *Landreth* tried to appeal to the conservative majority's instincts. For example, they unsuccessfully urged the Court

173. 471 U.S. 681 (1985).

174. See *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1351-52 & nn.2-10 (9th Cir. 1984).

175. *Landreth Timber*, 471 U.S. at 696-97.

176. *Gould v. Ruefenacht*, 471 U.S. 701 (1985) (Stevens dissented).

177. Justice Sandra Day O'Connor joined the Court on September 25, 1981, replacing Justice Stewart.

178. See *supra* notes 123-30 and accompanying text.

179. A similar dilemma faced the Court at about the same time in the civil RICO cases, with the same result. *Sedima S.P.R.L. v. Imrex Co.*, 473 U.S. 503 (1985) (Justices Marshall, Brennan, Blackmun, and Powell dissented).

180. *Landreth Timber*, 471 U.S. at 687-88. Justice Stevens dissented, arguing that section 10(b) should be limited to transactions involving "(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.* at 699 (Stevens, J., dissenting).

to consider the "economic reality" of the transaction, suggesting that the plaintiff "was not a passive investor of the kind Congress intended the Acts to protect, but an active entrepreneur."<sup>181</sup> The Court declined to engage in economic analysis, even though it had done so in other cases,<sup>182</sup> because the plaintiff had acquired "stock" rather than some more amorphous form of interest.<sup>183</sup> By now, the Court was rooted in the language of the statute, notwithstanding what Congress may have had in mind.

The defendants also argued that abandoning the sale-of-business doctrine would "increase the workload of the federal courts."<sup>184</sup> Unpersuaded, the Court noted that application of the doctrine often required a fact-finding process (involving whether or not the acquirer had transferred "control") which would be unnecessary under its ruling.<sup>185</sup> Moreover, the Court implied that, by eliminating *ex ante* uncertainty in business transactions with respect to the "control" issue, its decision would facilitate such transactions and reduce their costs.<sup>186</sup>

*Landreth*, unlike *Bateman Eichler*, had the potential for substantial impact on the federal courts. Thousands of businesses change hands each year, often later spurring buyer's remorse. With the federal securities laws now deemed to cover many such transactions, it was fair to assume that many corporate acquirers would soon resort to the federal courts for resolution of their claims. But *Landreth* hardly represented a reversion to the expansive view of rule 10b-5 characteristic of the late 1960s and early 1970s. The interests of a corporate acquirer in recovering from its seller are quite different from the interests of thousands of small shareholders in recovering from a corporation in which they have invested. Certainly the logistical demands on the court are less. More important to the Burger Court, *Landreth*-type actions pose no risk of extracting from the defendant a large settlement, often expressed principally in attorneys' fees, paid primarily to avoid the costs and disruption attendant to defending the case, and frequently disproportionate to the true merits of the plaintiff's complaint. These settlements do little to interfere with the defendant's ongoing business operations (those operations having been sold to the plaintiff).

In short, with the exception of *Huddleston* and possibly *Randall v.*

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181. 471 U.S. at 687-88.

182. See, e.g., *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (looking at the economic reality, rather than the form, of a transaction determines whether an "investment contract" is involved).

183. *Landreth*, 471 U.S. at 690-91.

184. *Id.* at 696.

185. *Id.* at 696-97.

186. *Id.*

*Loftsgaarden*,<sup>187</sup> the "pro-plaintiff" decisions of the 1980's were not "pro-shareholder" decisions, insofar as that term contemplates the "typical" small investor acting as a class representative. Moreover, in addition to the arbitration cases,<sup>188</sup> there was another group of decisions during this period decidedly adverse to the needs of the private investor. The Court accepted in 1987 a "second-generation" state anti-takeover statute,<sup>189</sup> which, like all such statutes, was decidedly pro-management in orientation and arguably adverse to shareholder interests.<sup>190</sup> There was also the Court's exclusionary treatment of federally-protected tender offerees when a tender offer is terminated.<sup>191</sup> With strong implications for individual shareholders (who are the "victims" of insider trading but whose interests were not at issue in the cases before the Court), the Court very narrowly interpreted the scope of rule 10b-5 in the context of insider trading.<sup>192</sup> The Burger Court revived its tradition of strictly construing the jurisdictional term "security."<sup>193</sup> The Rehnquist Court perpetuated this tradition by narrowly construing the statutory definition of a "seller."<sup>194</sup>

The composition of the Court in these "anti-shareholder" decisions is especially telling, but hardly surprising. The 1970s had already seen Justices Blackmun and Brennan taking up the cause of the small shareholder and dissenting regularly in securities cases.<sup>195</sup>

187. 478 U.S. 647 (1986) (plaintiffs entitled to rescission not offset by any tax benefits enjoyed by them during the period of ownership in actions brought under section 12(2) of the Securities Act).

188. See *supra* note 158.

189. CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987) (Justices White, Blackmun, and Stevens dissented).

190. *Id.* at 1654 (White, Blackmun, and Stevens, JJ., dissenting) (The Indiana Control Shares Acquisition Chapter, in some circumstances, prevents minority shareholders from "acting in their own best interests by selling their stock.").

191. Schreiber v. Burlington N., Inc., 472 U.S. 1 (1985) ("arguable breach of contract" by tender offeror who rescinds its offer after it has been fully subscribed does not violate section 14(e) of the Exchange Act inasmuch as rescission does not constitute a "manipulative act" nor does it involve any misrepresentation or nondisclosure).

192. See *supra* note 153.

193. Marine Bank v. Weaver, 455 U.S. 551 (1982) (certificate of deposit is not a security); cf. International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979); United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975).

194. Pinter v. Dahl, 108 S. Ct. 2063 (1988). One might argue that the Court was "liberal" in its interpretation of the term "seller" in this case, in that it did not limit the term's application to those who pass title. *Id.* at 2076. However, the Court in defining the scope of the term "seller" rejected a number of far broader interpretations which had been adopted by the circuit courts. *Id.* at 2080 n.25.

195. *E.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

They were frequently joined that period by Justices Stevens and Marshall.<sup>196</sup> Justices Blackmun and Brennan continued their steadfast support of shareholder protection in the 1980s<sup>197</sup> while Justices Stevens and Marshall became increasingly vocal in matters relating to shareholder rights.<sup>198</sup> When Justice Scalia joined the Court in 1986, he fell predictably into the conservative camp in securities cases.<sup>199</sup>

By the time Justice Kennedy joined the Court in February of 1988, the philosophical camps on the Court were firmly set. On a continuum embracing the considerations previously discussed—caseload, class action access, managerial prerogative, federalism and statutory integrity—with only occasional aberrations, the ideological lines were clearly drawn:

Rehnquist	Blackmun
White	Brennan
O'Connor	Marshall
Scalia	Stevens
Kennedy? <sup>200</sup>	

It was in this context that *Basic, Inc. v. Levinson*<sup>201</sup> came before the Court.

## II. *BASIC, INC. V. LEVINSON*

*Basic*, a spiritual descendant of the *Borak-Mills* era, involved the complaint of a small shareholder suing on behalf of other shareholders similarly situated. Max Levinson's complaint, like those of the plaintiffs in *Borak* and *Mills*, was that he and other class members had been defrauded when *Basic, Inc.*, in which they had invested,

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196. *E.g.*, *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979). It has been said that Justice Marshall was essentially "indifferent, even demonstrably bored" by such cases. H. ABRAHAM, *JUSTICES AND PRESIDENTS* 291 (1985); *see, e.g.*, cases cited *supra* notes 84-85.

197. *E.g.*, *Dirks v. SEC*, 453 U.S. 646 (1983).

198. *E.g.*, *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987) (White, Blackmun and Stevens, JJ., dissenting); *Shearson/American Express, Inc. v. McMahon*, 422 U.S. 220 (1975) (Blackmun, Brennan, and Marshall, JJ., concurring in part and dissenting in part; Stevens, J., concurring in part and dissenting in part); *Dirks v. SEC*, 453 U.S. 646 (1983) (Blackmun, Brennan, and Marshall, JJ., dissenting); *Chiarella v. United States*, 445 U.S. 222 (1980) (Stevens, J., concurring; Brennan, J., concurring; Blackmun and Marshall, JJ., dissenting).

199. *E.g.*, *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987) (Scalia, J., concurring in part and concurring in the judgment); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

200. Justice Kennedy, while sitting on the Court of Appeals for the Ninth Circuit, had only two occasions to write in the field of securities laws, and they provide us with scant guidance. In *Texas Partners v. Conrock Co.*, 685 F.2d 1116 (9th Cir. 1982), he wrote to reverse the premature grant of summary judgment in a non-class case brought under rule 14(a). In *SEC v. Wencke*, 622 F.2d 1363 (9th Cir. 1980), the issue was the propriety of enjoining non-parties from taking action against entities in SEC receivership.

201. 108 S. Ct. 978 (1988).

withheld material information from them. Unlike *Borak* and *Mills*, no proxy solicitation was involved; therefore, Levinson's claim fell under rule 10b-5.

Basic, Inc. had begun exploratory talks in September 1976 with Combustion Engineering, Inc., aimed at a possible merger.<sup>202</sup> These talks were sporadic, with long periods of inactivity. Twice during 1977 and 1978, Basic's management had deflected inquiries from reporters and from the New York Stock Exchange concerning unusual market activity in Basic's stock, once specifically denying that any pre-merger negotiations were underway.<sup>203</sup> In November 1978, Basic issued a report to its shareholders, again disavowing knowledge of "any present or pending developments which would account for the high volume of trading and price fluctuations in recent months."<sup>204</sup> One month later, Basic publicly announced the impending merger at \$46 per Basic share.

Max Levinson had sold his Basic stock during the course of the Basic-Combustion Engineering discussions, and thereby lost the substantial premium paid in connection with the merger. Levinson sued on behalf of a class of those who had sold Basic stock between October 21, 1977 (the date of the first "denial" of merger negotiations) and the day of the merger announcement, alleging that Basic and its executives had violated rule 10b-5. The district court dismissed the complaint on defendants' motion for summary judgment, holding that Basic's public statements during the course of its pre-merger discussions had not been materially misleading.<sup>205</sup>

The United States Court of Appeals for the Sixth Circuit reversed the summary judgment, holding that, while Basic had been under no general duty to disclose its discussions with Combustion, it had assumed that duty when it denied discussions had, in fact, occurred. Further, the court reasoned, "once a statement is made denying the existence of any discussions, even discussions that might not have been material in the absence of the denial are material. . . ."<sup>206</sup> Basic, Inc. sought certiorari and two issues made their way to the Court.

The first issue involved whether preliminary merger-directed discussions, which had not yet jelled on matters of "price and structure," could ever be sufficiently "material" to require disclosure to

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202. *Id.* at 981.

203. *Id.* at 981 n.4.

204. *Id.*

205. *Id.* at 982.

206. *Id.*

shareholders in the event of inquiry. A court wishing to interdict shareholders from seeking relief in the federal courts could easily have answered this question in the negative, as the Third Circuit<sup>207</sup> and others had done.<sup>208</sup> Instead, however, all six members of the Court hearing this case ruled that the question of materiality does not lend itself to such a "rigid formula";<sup>209</sup> hence, a determination of whether pre-merger negotiations have reached a material stage must be made by a finder of fact on a case-by-case basis. The defendants argued that such an approach would result in *ex ante* uncertainty as to when disclosure should be made. However, Justice Blackmun, writing for the Court, dispatched this point observing that it "seem[ed] to be directed solely at the comfort of corporate managers"<sup>210</sup> and therefore presumably could be disregarded. Justice Blackmun chided, "[a] bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' [sic] policy decisions."<sup>211</sup>

The second issue before the Court involved whether the fraud-on-the-market theory could serve to satisfy the reliance requirements of rule 10b-5.<sup>212</sup> The district court had certified a class comprised of Basic shareholders who had sold their shares after the date of Basic's first allegedly-misleading public statement.<sup>213</sup> In order to find that common questions of fact or law predominated over questions applicable to individual plaintiffs, the district court had adopted a reputable presumption that all putative class members had relied on the integrity of Basic's market price on the date of the sale, and that this market price necessarily reflected the allegedly misleading public statements made by the company.<sup>214</sup> Thus, by relying on a market price which had been "defrauded" by false statements, the plaintiffs could be said to have relied on those statements, even though they may never have heard or read them. In short, the court utilized the

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207. *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 756 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985).

208. *Basic*, 108 S. Ct. at 984 n.10.

209. *Id.* at 986-87.

210. *Id.* at 985.

211. *Id.* Justice Blackmun's treatment of corporate managers' not unreasonable wishes for certainty in their transactional negotiations is reminiscent of his tone ("preternatural solicitousness") in the *Blue Chip* dissent. See *supra* note 105 and accompanying text.

The materiality portion of the Court's decision in *Basic* has been discussed elsewhere. See, e.g., Classen, *Basic, Inc. v. Levinson: Is Silence Really Golden?*, 23 WAKE FOREST L. REV. 607 (1988); Matheson, *Corporate Disclosure Obligations and the Parameters of Rule 10b-5: Basic Inc. v. Levinson and Beyond*, 14 J. CORP. L. 1 (1988).

212. *Basic*, 108 S. Ct. at 988-89.

213. *Id.* at 981-82 & n.5.

214. *Id.*

fraud-on-the market theory, which had been adopted by "nearly every court that has considered the proposition."<sup>215</sup>

In reviewing the fraud-on-the-market theory, the Court addressed an issue which had the greatest potential to impact the number of shareholder class actions since it upheld the "purchase or sale" requirement in *Blue Chip*.<sup>216</sup> Adoption by the circuit courts of fraud-on-the-market as a basis for solving the "reliance problem" had opened a whole new arena for scrutiny by plaintiffs' class action lawyers. Previously most courts had held that actions under rule 10b-5 for allegedly material misstatements or omissions could be maintained on behalf of a class only when the corporate defendant had issued a document, such as a prospectus or annual report, which a court could reasonably assume had been sent to, and therefore presumably relied upon by all members of the proposed class.<sup>217</sup> Fraud-on-the-market provided a basis for class treatment in a host of other circumstances, such as the press releases involved in *Basic*, in which no document had been sent directly to shareholders. Moreover, under a fraud-on-the-market theory, shareholders who had purchased *after* a misleading document was issued could join in such actions.<sup>218</sup> In either case, the classes of shareholders entitled to sue under rule 10b-5 were suddenly much broader than before.

Since the fraud-on-the-market theory first emerged in the mid-1970s and spread among the circuits, many classic "strike suits" brought on a contingent basis by lawyers acting for a small shareholder seeking to represent a large class of similarly situated shareholders have been pursued.<sup>219</sup> Thus the potential impact of the

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215. *Id.* at 991 & n.25. Fraud-on-the-market prior to *Basic* has been discussed in Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. REV. 435 (1984); see also Rapp, *Rule 10b-5 and "Fraud-on-the-Market"—Heavy Seas Meet Tranquil Shores*, 39 WASH. & LEE L. REV. 861 (1982); Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 GEO. WASH. L. REV. 627 (1982); Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982); Note, *The Fraud on the Market Theory: Efficient Markets and the Defenses to an Implied 10b-5 Action*, 70 IOWA L. REV. 975 (1985).

216. See *supra* notes 93-104 and accompanying text.

217. *E.g.*, *Livesay v. Punta Gorda Isles, Inc.*, 379 F. Supp. 386, 387 (E.D. Mo. 1974) (individual reliance need not be shown where class members were sent registration statement and prospectus), *rev'd on other grounds*, 550 F.2d 1106 (8th Cir. 1977), *rev'd sub nom. Coopers & Lybrand v. Livesay*, 437 U.S. 463 (1978).

218. *E.g.*, *Harris v. Union Elec. Co.*, 787 F.2d 355, 367 n.9 (8th Cir. 1986) (bondholders who may never have received offering prospectus but purchased in aftermarket need not show reliance).

219. *E.g.*, *In re Texas Int'l Sec. Litig.*, 114 F.R.D. 33 (W.D. Okla. 1987) (lawyers in fraud-in-the-market class action from famed Pomerantz strike suit firm in New York).



Court's view of the fraud-on-the-market theory in *Basic* was clear. If the Court rejected the fraud-on-the-market theory, the tide of such cases would be stemmed. If the Court accepted the theory, such cases would not only continue, but in the wake of Supreme Court acceptance, probably increase.

But the potential impact on "caseload" was only one of the considerations which the Court had to take into account in deciding whether to hear, and ultimately how to resolve, the fraud-on-the-market issue. Other recurring issues on the conservatives' agenda were presented as well.<sup>220</sup> Fraud-on-the-market raised fundamental issues relating to the conservative majority's concern about lawyer-generated class actions. The sole purpose for the fraud-on-the-market rule was to facilitate shareholder class actions,<sup>221</sup> and advocacy for its adoption came exclusively from strike suit lawyers. In addition, fraud-on-the-market defendants are stock issuers and ongoing corporate enterprises. Therefore, to the extent that the theory is bound up with questions concerning when a corporation has a duty to disclose business information,<sup>222</sup> fraud-on-the-market also presented the potential for decisions gravely intrusive to managerial discretion.

Under these circumstances, when the Court granted certiorari in *Basic*, an observer who had followed the pattern of decisions described above might have predicted with some confidence that fraud-on-the-market as a substitute for proof of reliance was unlikely to succeed.<sup>223</sup> That confidence would have been well-founded until the observer learned that three of the Court's most conservative members, including Chief Justice Rehnquist, would not be participating in the decision.<sup>224</sup>

As a result of the unexplained failure of Chief Justice Rehnquist and Justice Scalia to participate in the case and the delay in confirm-

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220. Unlike *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), there was no apparent conflict between the desire of the Court's conservatives to limit the scope of federal securities litigation and their obligation to give effect to the plain language of the statute. Fraud-on-the-market is a judge-made concept based on economic theory, not something which flows inevitably from the language of rule 10b-5, nor were any federalism issues presented. Fraud-on-the-market is a construct inherently rooted in federally imposed disclosure obligations and does not raise issues traditionally relegated to resolution in the state courts.

221. Black, *supra* note 215, at 459; Rapp, *supra* note 215, at 893.

222. See generally Gabaldon, *The Disclosure of Preliminary Merger Negotiations as an Imperfect Paradigm of Rule 10b-5 Analysis*, 62 N.Y.U. L. REV. 1218 (1987) (discussing an issuer's "affirmative duty to disclose"); *In re General Motors Class E Stock Buyout Sec. Litig.*, 694 F. Supp. 1119, 1129 (D. Del. 1988) ("Absent a specific statutory or regulatory duty, insider trading, a fiduciary duty or rumors attributable to the company, a corporation and its officers have no affirmative duty of disclosure.").

223. One commentator suggested in 1982 that fraud-on-the-market was "outrightly aberrant" in light of the prevailing Supreme Court decisions of the day. Rapp, *supra* note 215, at 865.

224. *Basic*, 108 S. Ct. at 980, 993.

ing a replacement for Justice Powell,<sup>225</sup> the Justices who had in recent years most often supported shareholders' rights generally,<sup>226</sup> and class action litigants in particular,<sup>227</sup>—Justices Blackmun, Brennan, Marshall and Stevens—found themselves in the majority of the six-Justice panel. That majority upheld fraud-on-the-market for the precise purpose of advancing the ability of injured shareholders to sue as a class.

Justice Blackmun wrote the opinion of the Court, the first time he had done so in a securities case since *Affiliated Ute*.<sup>228</sup> Extrapolating from the *Affiliated Ute* decision, in which reliance was held to be presumed where a buyer had withheld material information from the seller in a face-to-face transaction,<sup>229</sup> the Court in *Basic* held that reliance could also be presumed in the impersonal trading markets.<sup>230</sup> The use of a rebuttable presumption in such circumstances would avoid placing an "unnecessarily unrealistic evidentiary burden"<sup>231</sup> on plaintiff litigants and would "facilitat[e] Rule 10b-5 litigation."<sup>232</sup>

The Court scarcely discussed the theoretical underpinnings of fraud-on-the-market—the efficient capital market hypothesis.<sup>233</sup> Rather, the Court relied on "common sense and probability"<sup>234</sup> and held that "[a]n investor who buys or sells stock at the price set by the

225. Justice Kennedy joined the Court on February 18, 1988, several weeks after *Basic* had been argued and assigned for decision. The decision was handed down on March 7, 1988. *Id.* at 978.

226. See *supra* notes 105-07, 117, 133 and accompanying text.

227. See *supra* note 15 and accompanying text; see also *United States v. Parole Comm'n v. Geraghty*, 445 U.S. 388 (1980) (plaintiff allowed to pursue issue of whether he was proper class representative even though personal claim had expired; Justices Powell, Burger, Stewart, and Rehnquist dissented).

228. See *supra* notes 66-70 and accompanying text.

229. See *supra* notes 66-70 and accompanying text.

230. *Basic*, 108 S. Ct. at 991-93.

231. *Id.* at 990.

232. *Id.* The practical problem presented by plaintiff's theory was that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented [plaintiffs] from proceeding with a class action." *Id.* at 989.

233. Justice Blackmun quoted from *Peil v. Speiser*, 806 F. 2d 1154, 1160 (3d Cir. 1986) to describe the relationship between the ECMH and fraud-on-the-market:

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.

*Basic*, 108 S. Ct. at 988-89. He also cited recent finance literature, but discounted the need to adopt the ECMH in order to support the fraud-on-the-market presumption. *Id.* at 991 n.24.

234. *Id.* at 991.

market does so in reliance on the integrity of that price.”<sup>235</sup> The Court mentioned only briefly the manner by which *Basic* could rebut the presumption of reliance.<sup>236</sup>

Not surprisingly, the plurality’s emphasis on facilitating class action enforcement of the securities law did not sit well with the participating Justices who over the previous decade had generally favored a restrictive view of private actions under the securities laws. Justices White and O’Connor dissented from the use of the fraud-on-the-market theory, in part on the ground that it would encourage “speculators and their lawyers”<sup>237</sup> to bring other such suits. Recalling the concerns expressed in *Blue Chip* and *Hochfelder* concerning the “harm” attendant to shareholder lawsuits, the dissenters regarded this possibility as the “bitter harvest likely to be reaped from the seeds sown by [the majority’s] decision.”<sup>238</sup> There is evidence the dissenters were correct.

Since the decision in *Basic*, the lower courts have utilized the fraud-on-the market theory in the contexts of the over-the-counter<sup>239</sup> and options markets.<sup>240</sup> Even more ambitious uses of the fraud-on-the-market notion can be foreseen. For example, the SEC has argued that even where there is no active trading market, as in the case of an initial public offering, plaintiffs ought to be entitled to a presumption of reliance on the integrity of the market not to support the sale of unmarketable securities.<sup>241</sup>

The question now arises, will the decision in *Basic* inevitably lead to a new flood of shareholder class actions? The answer is “not necessarily.” One possibility is that approval of fraud-on-the-market as a basis for satisfying the commonality requirement in class actions will fail to survive prompt reconsideration by the full Court in a subsequent case.<sup>242</sup>

Ironically, however, the fraud-on-the-market theory, based as it is

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235. *Id.* at 991-92.

236. *Id.* at 992.

237. *Id.* at 999 (White, J., concurring in part and dissenting in part) (quoting *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (en banc) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969)).

238. *Id.*

239. *Harman v. Lyphomed, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 94,138 (N.D. Ill. 1988). *But see* *Epstein v. American Reserve*, No. 79-C-4767 (N.D. Ill. Apr. 21, 1988) (LEXIS, Genfed library, Dist file) (over-the-counter market is not an efficient market).

240. *Tolan v. Computervision Corp.*, 696 F. Supp. 771 (D. Mass. 1988).

241. In Bank Brief of the Securities and Exchange Commission, Amicus Curiae, *Ross v. Rice*, No. 86-7790 (Aug. 1988).

242. The approval by a plurality of the court of a principle of law does not necessarily ensure its approval by a subsequent, more “complete” panel. *CTS Corp. v. Dynamics Corp. of Am.*, 107 S. Ct. 1637, 1645 (1987). Given that only a minority of the Court adopted the theory in the first instance, there is likely to be less reluctance to overrule that decision than is the case where a change of the majority view is the result of a change in Court personnel.

in the economic theory of efficient capital markets, may not be received by the non-participating Justices with the same trepidation expressed by Justice White.<sup>243</sup> While it is beyond the scope of this article to discuss in detail the emergence of economic theory as a basis for decisions in business-related cases, it would seem that Justice Scalia in particular is unlikely to agree with Justice White's assertion that economic theory is beyond the expertise and understanding of federal courts. Nor is Justice Scalia likely to be hostile to an economic analysis which is so closely identified with the "Chicago School" from which he emerged. Indeed, as Justice White concedes, Justice Scalia's former colleague at Chicago, Judge Richard Posner of the United States Court of Appeals for the Seventh Circuit, has expressly opined that fraud-on-the-market "produces the 'economically correct result.'"<sup>244</sup>

It may not be necessary for the non-participants in the *Basic* decision to reject economic theorizing or to dispute the validity of the fraud-on-the-market theory in order to overrule or at least severely limit the decision in *Basic*. One way out, as Justice White pointedly observed,<sup>245</sup> may be suggested by the same treatise in which Judge Posner affirmed the theoretical validity of fraud-on-the-market. Damages under the theory are "difficult to quantify," Posner warns,<sup>246</sup> which may indicate why the plurality in *Basic* specifically declined to address the measure of damages question.<sup>247</sup> Specifically,

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243. In dissenting, Justice White expressed the concern that, in embracing fraud-on-the-market, the plurality was venturing "beyond its expertise." *Basic*, 108 S. Ct. at 995 (White, J., concurring in part and dissenting in part). "[W]ith no staff economists, no experts schooled in the 'efficient-capital market hypothesis,' no ability to test the validity of empirical market studies, we are not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory." *Id.* at 994.

Congress, with its superior resources and expertise, is far better equipped than the federal courts for the task of determining how modern economic theory and global financial markets require that established legal notions of fraud be modified. In choosing to make these decisions itself, the Court, I fear, embarks on a course that it does not genuinely understand, giving rise to consequences it cannot foresee.

*Id.* at 995. (White, J., concurring in part and dissenting in part).

244. *Id.* at 995 n.5 (White, J., concurring in part and dissenting in part) (quoting R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 15.8, at 423-24 (3d ed. 1986)). Of course, just as "bad economics" may nevertheless make "good law," (see *CTS Corp. v. Dynamics Corp. of Am.*, 107 S. Ct. 1637, 1653 (1987) (Scalia, J., concurring in part and concurring in the judgment)) so may "good economics" make "bad law."

245. *Basic*, 108 S. Ct. at 995 n.5 (White, J., concurring in part and dissenting in part).

246. *Id.* (quoting R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 15.8, at 423-24 (3d ed. 1986)).

247. *Id.* at 992 n.28.

the determination of damages in a fraud-on-the-market case ought to take into account "social costs" which may be speculative and difficult to quantify.<sup>248</sup> If damages are too speculative, there can be no recovery.<sup>249</sup>

Alternatively, damage determination may require a more conventional, though individualized, inquiry—for example, whether a seller of shares in a rising market had also *purchased* during the period in which the market had been defrauded,<sup>250</sup> or whether the market on any given date was skewed by factors other than the defendant's misrepresentation. If the task of determining damages for individual class members were impossible to determine except through separate trials, class treatment would be "unmanageable," and therefore, inappropriate under rule 23(b)(3).<sup>251</sup> By adopting either the view that damages in cases based on fraud-on-the-market are speculative, or that they are too individualized for class treatment, the non-participating Justices would not be forced to retreat from the economic concepts underlying the *Basic* decision while still undermining the decision's utility for shareholders.

Another way of short-circuiting the application of the fraud-on-the-market theory in shareholder class actions may be to broadly define the ways in which the presumption of reliance can be rebutted. All six Justices agreed that the presumption of reliance "must be capable of being rebutted by a showing that a plaintiff did not 'rely' on the market price."<sup>252</sup> Justice White gave three examples of situations in which a plaintiff could not state a valid claim: (1) "a plaintiff who decides, months in advance of an alleged misrepresentation, to purchase [the] stock";<sup>253</sup> (2) "one who buys or sells a stock for reasons unrelated to its price";<sup>254</sup> and (3) "one who actually sells a stock

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248. R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 16.8, at 424 (3d ed. 1986).

249. *Cf. Associated Gen. Contractors, Inc. v. Carpenters*, 459 U.S. 519, 543 (1983) (plaintiff fails to state claim under section 4 of the Clayton Act where damages claimed are "nothing but speculation").

250. *Cf. Basic*, 108 S. Ct. at 998-99 (White, J., concurring in part and dissenting in part).

251. *Cf. Fischer v. Dallas Fed. Sav. & Loan Ass'n*, 106 F.R.D. 465, 470 (N.D. Tex. 1985) (court will not certify class comprised of all persons who had been denied loans because of alleged "redlining," because there would have to be a separate and time consuming class hearing to determine each class member's damages); *Wilcox Dev. v. First Interstate Bank*, 97 F.R.D. 440, 444 (D. Or. 1983) (court will not certify class comprised of all "prime rate" borrowers, where damage determination does not lend itself to a simple formula, but will require a borrower-by-borrower hearings). *Contra Bogosian v. Gulf Oil Corp.*, 561 F.2d 434, 456 (3d Cir. 1977) (necessity of individual damage calculations need not preclude class treatment if common issues predominate); *Black*, *supra* note 212, at 441.

252. *Basic*, 108 S. Ct. at 993-94 (White, J., concurring in part and dissenting in part).

253. *Id.* at 994.

254. *Id.* at 994.

'short' before the misrepresentation is made."<sup>255</sup>

In one sense, this may seem academic when resourceful class action attorneys, usually through reciprocal information-sharing agreements with local stockbrokers, are able to find more "acceptable" class representatives.<sup>256</sup> But in a deeper sense, the issue of how the presumption of reliance on a "defrauded market" can be rebutted presents the most likely way in which fraud-on-the-market cases can be defeated.

*Basic* found only that the fraud-on-the-market presumption would suffice to satisfy the commonality element of rule 23(a); it did not consider the separate typicality or manageability requirements of rule 23(b)(3)(D). If the grounds upon which a defendant may rebut the presumption of reliance on the market are drawn broadly enough, as Justice White suggests, and the process of determining which plaintiffs' claims are rebuttable is sufficiently complicated, class action treatment will be inappropriate.<sup>257</sup>

For example, Justice White asserted that a shareholder "who buys or sells a stock for reasons unrelated to its price" should not be included within the plaintiff class in a fraud-on-the-market case.<sup>258</sup> How could such a determination be made? Presumably, it would require discovery into the investment goals and mental processes of each putative class member, the sources of information consulted prior to the purchase or sale and his understanding of market economics. It seems that even in *Basic*, on remand, the precise mechanics of rebutting the reliance presumption are yet to be understood.<sup>259</sup>

255. *Id.* The examples which the majority gives of ways in which the presumption of reliance could be rebutted are much narrower and all involve situations in which the market itself or the individual class member knew or believed the truth despite the defendants' misstatement or omission. *Id.* at 992.

256. *Cf. Carpenter v. Stephen F. Austin State Univ.*, 706 F.2d 608 (5th Cir. 1983) (where class representative is found to be inappropriate, the solution is not decertification, but the appointment of a new representative); *Harris v. Pan Am. World Airways, Inc.*, 74 F.R.D. 24, 39 (N.D. Cal. 1977) (action does not become moot merely because class representative loses his interest in it").

257. *Cf. Abernathy v. Bausch & Lomb Inc.*, 97 F.R.D. 470, 475 (N.D. Tex. 1983) (court will not certify class comprised of all optometrists, ophthalmologists and dispensing opticians in the United States who were subjected to price discrimination because establishing entitlement will require very individualized trials.).

258. *Basic*, 108 S. Ct. at 994 (White, J., concurring in part and dissenting in part).

259. See Note, *Rule 10b-5: An Old Test of Materiality with a New Presumption of Reliance*, 34 LOY. L. REV. 593, 607 n.110 (1988) (noting the unresolved issues still facing the parties in *Basic*, including "how the rebuttal will work in practice," the standard of proof applicable to a rebuttal showing and whether the presumption must be defeated "as to all plaintiffs or to a percentage.").

Courts which have considered the questions of how and when defendants may rebut the presumption of reliance have reached inconsistent outcomes.<sup>260</sup>

In the end, it may be true, as Justice White fears, that it will be virtually impossible for defendants to rebut the presumption of reliance.<sup>261</sup> Nevertheless, the issue is there to be explored, and *Basic* has failed to provide the lower courts with any guidance in this area. Eventually, this may be the issue on which the non-participating Justices can turn the *Basic* tide.

#### CONCLUSION

From 1964, when the Supreme Court first declared the existence of an implied right of action under the securities laws, until the mid-1970s, a majority of the Court led by Justice William O. Douglas consistently expanded the circumstances under which shareholders' suits could be maintained. Thereafter, as the Court came to be dominated by a more conservative, business-oriented, and docket-conscious majority, this trend was halted. Further expansion in the lower courts was expressly discouraged, especially in cases brought as shareholder class actions.

Then, in *Basic, Inc. v. Levinson*, the most liberal members of the Court formed a majority of a six-Justice panel and, by approving the fraud-on-the-market theory as a means of satisfying the reliance requirement of actions under rule 10b-5, opened the door to a whole new generation of shareholder class actions. Whether that door will remain open, and how far, remains to be seen. But the questions left unanswered in *Basic* promise to occupy the lower courts for some time, and future Supreme Court consideration of the fraud-on-the-market theory and its application is inevitable. At the point of reconsideration, the three conservative Justices who did not participate in *Basic* will face a problematic choice: whether to embrace the fraud-on-the-market theory and encourage the class action activity that will inevitably follow or to reject fraud-on-the-market in its entirety, as

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260. Compare *In re Data Access Sys. Sec. Litig.*, 103 F.R.D. 130 (D.N.J. 1984) (the defense of non-reliance "goes to the merits of the case and cannot be considered by the court on a certification motion"), *rev'd on other grounds*, 843 F.2d 1537 (3d Cir. 1988); with *Epstein v. American Reserve Corp.*, No. 79-C-47-67 (N.D. Ill. Apr. 21, 1988) (LEXIS, Genfed library, dist. file) (class certification denied where proposed class representatives were subject to "unique lack-of-reliance defenses" atypical of other class members); and *Zlotnick v. TIE Communications*, 123 F.R.D. 189 (E.D. Pa. 1988) (class certification denied where complex questions of reliance would require extensive individualized proof). See generally Comment, *Class Actions, Typicality, and Rule 10b-5: Will the Typical Representative Please Stand Up*, 36 EMORY L.J. 649 (1987); Black, *supra* note 215, at 449-50.

261. *Basic*, 108 S. Ct. at 996 n.7 (White, J., concurring in part and dissenting in part).

Justice White suggests. On the other hand, the Court may, as it did in the 1970s, simply chip away at the theory until all the strike suit lawyers have gone home.



