Central Bank of Denver v. First Interstate Bank of Denver: Rethinking Established Section 10(b) Doctrines

John Kalmbach
Central Bank of Denver v. First Interstate Bank of Denver: Rethinking Established Section 10(b) Doctrines

I. INTRODUCTION

Judicial interpretation of the federal securities laws has undergone a fundamental shift in the past two decades. Prior to 1976, the courts expansively interpreted the securities laws, regularly implying extrastatutory causes of actions to effectuate broad-based remedial purposes. In 1976 with the seminal case, Ernst & Ernst v. Hochfelder, the United States Supreme Court began a new era of restrictive interpretation of the federal securities laws. Central Bank of Denver v. First Interstate Bank of Denver represents a continuation of this trend and suggests future judicial retrenchment of the securities laws is likely.

In Central Bank, the Supreme Court held a private plaintiff may not maintain an aiding and abetting action under Section 10(b) of the Securities Exchange Act of 1934 (hereinafter "the 1934 Act" or "the Act") and Securities

1. See Daniel R. Fischel, Secondary Liability Under Section 10(b) of the Securities Act of 1934, 69 Calif. L. Rev. 80, 82 (1981) for a discussion of the "wholesale incorporation of... common law doctrines into the federal securities laws."
4. Aiding and abetting is a tenet of the criminal law. Traditionally, an aider and abettor is "[o]ne who assists another in the accomplishment of a common design or purpose; he must be aware of, and consent to, such design or purpose." Black’s Law Dictionary 68 (6th ed. 1990). In the context of securities laws, aiding and abetting is a nebulous term, describing a person who lends some degree of aid to one who himself, directly or indirectly, engages in a proscribed conduct. Private aiding and abetting liability was first recognized under the general antifraud provision, Section 10(b), of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1988), in Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 676 (1966). See infra part III.A.2.
5. Prior to Central Bank, a significant percentage of all cases prosecuted under Section 10(b) were brought against lawyers, banks, accountants, trustees, directors, and other secondary parties on the theory of aiding and abetting. Fischel, supra note 1, at 82. Such parties were considered aiders and abettors, rather than primary violators, because their involvement in the proscribed conduct was only peripheral; i.e. they did not themselves engage in each of the elements necessary to show a primary violation. Central Bank expressly rejects civil aiding and abetting liability under Section 10(b).
6. Section 10(b) is the general antifraud provision of the Securities Exchange Act of 1934 and reads in pertinent part:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities Exchange] Commission may prescribe...
15 U.S.C. § 78j (1988). Although Section 10(b) provides no civil remedies, a private Section 10(b) action has been implied by the courts and is now well established. See infra part III.A.1.
and Exchange Commission (hereinafter "the SEC" or "the Commission") Rule 10b-5. This decision resolved an issue expressly reserved by the Court on two prior occasions, concerning the proscriptive scope of the judicially implied private Section 10(b) cause of action. Prior to Central Bank, eleven federal courts of appeals recognized an extrastatutory private action for aiding and abetting under Section 10(b). Emphasizing the primacy of the statute, the Court in Central Bank concluded "nothing in the text or history of [Section] 10(b) even implies that aiding and abetting was covered by the statutory prohibition on manipulative and deceptive conduct."

Since 1976, the Supreme Court has consistently acted to narrow the scope of the implied Section 10(b) private action. The Court's holding in Central Bank follows this trend. The Court's reasoning in these decisions, however, has been inconsistent. In one line of cases, the Court has espoused a preference for strict and control of the securities markets and to insue the maintenance of fair and honest markets in such transactions. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 728, 95 S. Ct. 1917, 1921-22 (1975).

7. Rule 10b-5, the operative regulation enacted by the SEC in 1942 pursuant to Section 10(b) of the 1934 Act, reads in pertinent part:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
   in connection with the purchase or sale of any security.


8. In Ernst & Ernst v. Hochfelder, 425 U.S. 185, 96 S. Ct. 1375 (1976), the Court expressly reserved the issue of Section 10(b) aiding and abetting liability:
   In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10(b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the Rule, nor the elements necessary to establish such a cause of action.

adherence to the statutory language in interpreting Section 10(b). In another line of cases (concerning insider trading), the Court has turned to common-law doctrines to resolve Section 10(b) issues. Central Bank represents the Court's reassertion of strict statutory construction as the preferred means of interpreting Section 10(b). Despite overwhelming appellate and district court precedent to the contrary, the Supreme Court in Central Bank rejected Section 10(b) aiding and abetting liability. In light of the "potential far-reaching effects of Central Bank," many extrastatutory Section 10(b) doctrines are now subject to attack.

II. THE CENTRAL BANK DECISION

The Supreme Court's decision in Central Bank has been called "a watershed in the development of the federal securities laws." The Court held a private plaintiff may not maintain an aiding and abetting action under Section 10(b) of the 1934 Act. In reaching this conclusion, the Court analyzed the language of Section 10(b), the statutory framework of the 1934 Act, and the relevant legislative history. This Part will consider the case history, the rationale underlying the Court's decision, and the likely effect the decision will have on subsequent interpretations of the securities laws.

A. The Case History

Petitioner, Central Bank of Denver, N.A. ("Central Bank"), served as indenture trustee for bonds issued in 1986 and 1988 by the Colorado Springs-Stetson Hills Public Building Authority ("the Authority"). The bonds were issued to finance a planned residential and commercial development in Colorado Springs and were secured by landowner assessment liens covering 500 acres of the proposed development. The bond covenants required AmWest Development ("AmWest"), the developer of the Stetson Hills project, to submit to Central Bank an annual appraisal of the lands securing the bonds. The covenants further

12. See infra note 139.
16. In business financing, bonds and debentures are issued under indentures—written agreements "setting forth form of bond, maturity date, amount of issue, description of pledged assets, interest rate, and other terms," entered into between the issuing corporation and an indenture trustee. An indenture trustee is a "person or institution," typically a commercial bank, who is charged with carrying out the terms of the indenture and, in the cases of bonds, with holding legal title to corporate property serving as security for the issue. Black's Law Dictionary 770 (6th ed. 1990).
stipulated that the land subject to the liens must be worth at least 160% of the bonds' outstanding value ("the 160% test").

Pursuant to the bond covenant, AmWest provided Central Bank with an appraisal of the land in January of 1988. Despite a significant downturn in property values, the appraisal indicated the land's value was essentially unchanged from the previous appraisals. Soon thereafter, Central Bank was contacted by the senior underwriter of the 1986 bond issue, who expressed concern that the 160% test was not being met. Central Bank consulted its in-house appraiser who agreed the appraisal was optimistic and recommended the bank retain an outside consultant to review it. For unexplained reasons, Central Bank decided to delay independent review of the appraisal until the end of the year—more than six months after the planned closing for the 1988 bond issue. Before the independent appraisal was conducted and after the closing of the 1988 bond issue, the Authority defaulted on the 1988 bonds.17

Respondents, First Interstate Bank of Denver, N.A. and Jack Naber, purchasers of $2.1 million worth of the 1988 bonds, sued the Authority, the 1988 underwriter, a director of AmWest, and Central Bank alleging violations of Section 10(b). The complaint alleged that the Authority, the underwriter, and the director had made fraudulent misrepresentations in the official statement for the 1988 bond issue concerning the accuracy of the appraisal. The complaint further alleged that Central Bank was "secondarily liable under [Section] 10(b) for its conduct in aiding and abetting the fraud."18

The United States District Court for the District of Colorado granted Central Bank's motion for summary judgment (decisions not reported). The respondents appealed to the United States Court of Appeals for the Tenth Circuit. Reversing, the court identified the following to be the elements of the Section 10(b) aiding and abetting action: (1) a primary violation of Section 10(b); (2) knowledge or recklessness by the aider-and-abettor as to the existence of the primary violation; and (3) substantial assistance given to the primary violator by the aider-and-abettor.19 The court found both that Central Bank knew the appraisal was inaccurate and that the respondents had relied upon the inaccurate appraisal in purchasing the 1988 bonds. This supported a finding of "extreme departure from the standards of ordinary care"20 on the part of Central Bank. Thus, the court concluded the respondents had established genuine issues of material fact concerning the "recklessness" and "substantial assistance" elements. Central Bank petitioned the United States Supreme Court for certiorari raising two issues:

(1) whether an indenture trustee in a bond financing could be held liable as an aider and abettor of a Rule 10b-5 violation when it had not breached any of its indenture duties; and (2) whether recklessness

18. Id.
20. Id. at 904.
satisfies the scienter requirement for § 10(b) aiding and abetting even when there is no breach of a duty to disclose or act.22

The Court granted certiorari on question two only and, on its own motion, directed the parties to address the additional question of "[w]hether there is an implied private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934."23 The Court's sua sponte action, concerning what had theretofore been considered a settled issue, was met with "surprise" by many of the securities bar.24

Held: A private plaintiff may not maintain an aiding and abetting action under Section 10(b) of the 1934 Act. In a five to four decision25 the Court characterized its "uncontroversial conclusion"26 as a matter of simple statutory interpretation. Using settled interpretive methods, the Court concluded "[b]ecause the text of [Section] 10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under [Section] 10(b)."27 By so holding, the Court rejected the lower court's importation of common-law doctrines into the securities law as a basis for secondary liability.28

B. The Court's Rationale

The Court's decision included: (1) a comparison of Section 10(b)'s "directly and indirectly" language with similar language in other provisions of the 1934 Act, (2) a consideration of the 73rd Congress' intent in enacting Section 10(b), (3) a review of the origins of aiding and abetting liability and of its present role in federal law, and (4) a rejection of the argument that Congress has tacitly acquiesced to civil aiding and abetting liability.

---

21. In Ernst & Ernst v. Hochfelder, 425 U.S. 185, 96 S. Ct. 1375 (1976), the Court held scienter is a prerequisite for a violation of Section 10(b). See infra part III.B.1 and note 100.
22. Olson et al., supra note 14, at 21.
24. Olson et al., supra note 14, at 22.
25. The majority opinion was written by Justice Kennedy, joined by Justices Rehnquist, O'Connor, Scalia, and Thomas. Justice Stevens filed a dissenting opinion in which Justices Blackmun, Souter, and Ginsburg joined.
27. Id. at 1455.
28. In the context of Section 10(b), "secondary liability" has a distinct meaning. The term encompasses judicially implied liability that has been imposed on defendants who do not themselves engage in any of the proscribed "manipulative or deceptive" conduct, but rather bear some relationship to those who do. Recognized Section 10(b) secondary liability causes of action include aiding and abetting (see, e.g., Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966)), conspiracy (see, e.g., Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946)), and respondeat superior (see, e.g., Kerbs v. Fall River Indus., Inc., 502 F.2d 731 (10th Cir. 1974)). Money lenders, accountants, lawyers, and other "deep pockets" are the most common defendants in civil Section 10(b) secondary liability suits.
1. Section 10(b)'s "Directly and Indirectly" Language

The Supreme Court began its analysis in *Central Bank* by stating "especially in cases interpreting [Section] 10(b)" 29 the statutory language is controlling. Section 10(b) does not expressly address the question of aiding and abetting liability. Rather, the text of Section 10(b) makes it "unlawful for any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance." 30 In an *amicus curiae* brief, the SEC urged Congress' inclusion of the term "indirectly" in Section 10(b) "suggests a legislative purpose fully consistent with the prohibition of aiding and abetting." 31 The Court, however, found the SEC's argument unpersuasive for two reasons.

First, noting the federal courts have never relied on Section 10(b)’s "directly or indirectly" language as a basis for imposing aiding and abetting liability, the Court remarked the Commission's flawed interpretation of the section arises from a fundamental misunderstanding of the nature of aiding and abetting liability. The Court explained "aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." 32 Thus, the phrase "directly or indirectly" necessarily excludes aiders and abettors, who merely lend some degree of aid to those who, *directly or indirectly*, engage in proscribed conduct.

Second, numerous provisions of the 1934 Act use the phrase "directly or indirectly" in a manner that does not impose aiding and abetting liability. 33

---

32. 114 S. Ct. at 1447.
33. For example, Section 7(f)(2)(C), 15 U.S.C. § 78g(f)(2)(C) (1988), prohibits foreign corporate and noncorporate entities, in which any United States person "directly or indirectly" owns more than a 50% interest, from borrowing money for the purpose of purchasing any United States securities.

Section 9(b)(2)-(3), 15 U.S.C. § 78(b)(2)-(3) (1988), makes it unlawful for any person to manipulate the price of any security in which he "directly or indirectly" has any interest in a put, call, straddle, option, or privilege. "Puts" and "calls" are options which permit their holders to buy or sell a stock or commodity "at a fixed price for a stated quantity and within a stated period." *Black's Law Dictionary* 204, 1237 (6th ed. 1990). A "straddle" is "a type of hedge" by which a securities investor acquires an equal number of puts and calls on the same security or commodity. *Id.* at 1237. An "option" in the context of the commodities markets is "[t]he right—but not the obligation—to buy or sell a futures contract at a specified price within a fixed period." *Id.* at 1421. "A stock option" is the right to buy stock in the future at a fixed price. *Id.* at 1094.

Section 13(d)(1), 15 U.S.C. § 78m(d)(1) (1988), directs any person who, "directly or indirectly," becomes the beneficial owner of more than 5% of any registered security to notify the issuer and the relevant exchanges of his acquisition.

And, Section 20, 15 U.S.C. § 78t (1988), concerning the liabilities of controlling persons, makes those who, "directly or indirectly," control anyone liable under any provision of the 1934 Act jointly and severally liable for the controlled person's conduct.
Thus, to interpret the phrase "directly and indirectly" in Section 10(b) as imposing liability on aiders and abettors is inconsistent with the meaning of similar language used in other sections of the same statute.

The Court concluded there is no support for the SEC's contention that Section 10(b)'s "directly and indirectly" language extends liability to aiders and abettors. Reinforcing its conclusion, the Court stated "Congress knew how to impose aiding and abetting liability when it chose to do so." Thus, the Court reached:

[The uncontroversial conclusion . . . that the text of the 1934 Act does not itself reach those who aid and abet a [Section] 10(b) violation . . . . We think that conclusion resolves the case. It is inconsistent with settled methodology in [Section] 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text.]

2. Inferring Congressional Intent

Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act . . . not . . . giving aid to a person who commits a manipulative or deceptive act." The Court stated this finding alone was sufficient grounds upon which to base its holding that Section 10(b) excludes private liability for aiders and abettors. Nevertheless, the Court added that even if Section 10(b)'s language was not dispositive, a consideration of Congress' intent in enacting the section would lead to the same conclusion.

To infer how the 73rd Congress would have approached the question of aiding and abetting liability, the Court examined the express private causes of action in both the 1934 Act and the contemporaneous Securities Act of 1933 (hereinafter "the 1933 Act"). It premised that had Congress expressly provided for a private Section 10(b) action, it would resemble similar private actions in the securities law. The Court noted both express private causes of action in the 1933 Act limit who may be liable thereunder, and neither extends liability to aiders and abettors. Likewise, none of the four express private

35. 114 S. Ct. at 1448.
36. Id. (citations omitted).
38. Section 11, 15 U.S.C. § 77k (1988), prohibits the making of misrepresentations or the omission of material facts in the registration statements of securities. The section expressly identifies which categories of defendants may be liable for such misrepresentations, but makes no mention of aiders and abettors. Similarly, Section 12, 15 U.S.C. § 77l (1988), which makes unlawful the sale of unregistered securities and the sale of securities by means of a prospectus or oral communication including a material misstatement or omission, expressly imposes liability only on those who sell the
Thus, liability is not imposed on aiders and abettors in any of the express private causes of action in either the 1933 or the 1934 Acts. From this finding the Court inferred:

[C]ongress likely would not have attached aiding and abetting liability to [Section] 10(b) had it provided a private [Section] 10(b) cause of action. There is no reason to think that Congress would have attached aiding and abetting liability only to [Section] 10(b) and not to any of the express private rights of action in the Act.40

3. Aiding and Abetting Liability in Federal Law

In an alternative theory, Central Bank and other amici contended Congress implicitly intended to include civil liability for aiding and abetting in the 1934 Act because aiding and abetting is such a well-established feature of tort law. The Court, however, found no support for this contention in the origins of aiding and abetting liability or in its current position in the federal law.

The Court explained aiding and abetting is "an ancient criminal law doctrine."41 The doctrine recognizes that one who knowingly aids another in

security. Recently, in Gustafson v. Alloyd Co., 115 S. Ct. 1061 (1995), the Court held Section 12(2) creates private liability only for material misstatements or omissions made in connection with an initial public offering and not with secondary transactions.

39. Section 9, 15 U.S.C. § 78i (1988), prohibits anyone from "creating a false or misleading appearance of active trading in any security" by the use of wash sales (a "fictitious kind of sale" in which a broker who has simultaneously received a buy and a sell order for the same stock or commodity circumvents the securities market by transferring the stock or security directly from the seller to the buyer and pocketing the difference. Black's Law Dictionary 1589 (6th ed. 1990)), matched orders (a means by which a person effects an artificial appearance of active trading in a stock or commodity by simultaneously executing a purchase and a sale of the same stock or security, 15 U.S.C. § 78(a)(1) (1988)), and other forms of spurious trading. "Anyone" in Section 9 is qualified by the same "directly and indirectly" language used in Section 10(b) and, therefore, excludes aiders and abettors.


Section 18, 15 U.S.C. § 78r (1988), prohibits anyone from making fraudulent statements in reports mandated by the SEC. "Anyone" here is qualified by the phrase "who shall make or cause to be made" which necessarily excludes aiders and abettors who merely lend some degree of aid to primary wrongdoers.


40. Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439, 1449 (1994) (citations omitted). Similarly, in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 736, 95 S. Ct. 1917, 1925-26 (1975), the Court said it would be "anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action."

41. 114 S. Ct. at 1450. See generally United States v. Peoni, 100 F.2d 401 (2d Cir. 1938); 1 M. Hale, Pleas of the Crown 615 (1736).
the commission of a crime himself commits a crime. An analogous doctrine is found in the common law of torts. In 1909, Congress enacted 18 U.S.C. § 2, a general aiding and abetting statute applicable to all federal crimes. Under 18 U.S.C. § 2, one who aids and abets another in the commission of any federal criminal offense, including a criminal violation of the securities laws, is subject to prosecution as an aider and abettor. Congress, however, has not enacted a general civil aiding and abetting statute. Rather, it has chosen to impose civil aiding and abetting liability on a statute-by-statute basis. Accordingly, civil aiding and abetting liability exists only where Congress has expressly provided for it. This premise is supported by provisions of the securities laws that expressly provide for aiding and abetting liability in actions brought by the SEC. Thus, the Court concluded that considering the disposition of aiding and abetting liability in federal law, it is unlikely Congress meant to include aiding and abetting liability under Section 10(b) without expressly using language to that effect.

Civil aiding and abetting liability, therefore, is not an implicit component of Section 10(b), nor can it be implied as an extension of the general federal criminal aiding and abetting statute. The Court stated, "[w]e have been quite reluctant to infer a private right of action from a criminal prohibition alone." To do so, the Court explained, would be contrary to conventional statutory interpretive principles and would create far-reaching consequences, namely the possibility that every criminal prohibition would carry with it the possibility of civil liability for aiding and abetting.

4. Tacit Congressional Acquiescence

Respondents contended that even if the 73rd Congress had not intended to include aiding and abetting within Section 10(b)'s prohibitive scope, subsequent congressional actions have amounted to a tacit acquiescence to civil Section 10(b) aiding and abetting liability. Respondents based this proposition on two theories. First, they pointed to two committee hearings in 1983 and 1988 that

42. Restatement (Second) of Torts § 876(b) (1977). See infra note 84.
46. Id.
obliquely made reference to Section 10(b) aiding and abetting liability. Respondents argued this was evidence that at least two Congresses have interpreted Section 10(b) to extend to aiders and abettors. Second, respondents argued Congress’ failure to legislatively overrule widespread judicial recognition of Section 10(b) aiding and abetting liability amounts to congressional acquiescence to such a construction of the section.

Countering respondent’s argument, Central Bank pointed to three proposed amendments to the securities law making it “unlawful . . . to aid, abet, counsel, command, induce, or procure the violation of any provision” of the 1934 Act. These bills show at least two Congresses have interpreted Section 10(b) as not extending to aiders and abettors. Furthermore, the ultimate failure of these amendments supports the proposition that Section 10(b) continues to exclude liability for aiding and abetting. The Court found neither party’s argument convincing. It stated such arguments “deserve little weight in the interpretive process” because they inevitably lead to equally tenable conclusions.

C. The Significance of Central Bank

Following Central Bank, Congress’ failure to enact provisions detailing the private Section 10(b) liability scheme can no longer be viewed by the courts as a mandate to “fill the void with implied remedies.” Rather, Central Bank has reestablished the primacy of the statute in interpreting Section 10(b). Having done such, Central Bank promises to have a significant impact on federal securities litigation in the future. These effects include the following:

1. The immediate dismissal of private Section 10(b) aiding and abetting claims. Twenty-five percent of the more than two thousand Section 10(b) cases brought between 1990 and 1993 involved claims against aiders and abettors. Following Central Bank, these claims no longer have a basis.

48. 114 S. Ct. at 1452.
49. Id.
51. 114 S. Ct. at 1453. The Court explained, “It is impossible to assert with any degree of assurance that congressional failure to act represents’ affirmative congressional approval of the [courts’] statutory interpretation. Congress may legislate, moreover, only through passage of a bill which is approved by both Houses and signed by the President. Congressional inaction cannot amend a duly enacted statute.” Id. (quoting Patterson v. McLean Credit Union, 491 U.S. 164, 175 n.1, 109 S. Ct. 2363, 2371 n.1 (1989) (quoting Johnson v. Transportation Agency, Santa Clara County, 480 U.S. 616, 671-72, 107 S. Ct. 1442, 1472-73 (1987) (Scalia, J., dissenting)) (citations omitted).
52. Olson et al., supra note 14, at 24.
53. Eisenberg, supra note 15, at 588-89.
2. The dismissal of SEC actions brought under the theory of aiding and abetting. The dissent noted, "[t]he majority leaves little doubt that the [1934 Act] does not even permit the Commission to pursue aiders and abettors in civil enforcement actions under Section 10(b)."54 The language found dispositive in Central Bank is the same language supporting SEC enforcement actions. Having lost one of its most important enforcement mechanisms, the SEC will be pressured to use its other statutory powers to prosecute Section 10(b) aiders and abettors.55

3. The attempted reformulation of aiders and abettors as primary violators. The preclusion of aiding and abetting liability, and presumably other forms of secondary liability under Section 10(b), will force plaintiffs to cast aiders and abettors as primary violators of the section. The Court noted any person "including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under [Section 10(b)], assuming all of the requirements for primary liability under [Section 10(b)] are met."57 However, considering the traditional elements of the private Section 10(b) action,58 it is uncertain how successful this repackaging will be.59

4. The overruling of other forms of secondary liability under Section 10(b). Central Bank's holding casts serious doubt on other well-established forms of


55. Applying the rationale of Aaron v. SEC, 446 U.S. 680, 100 S. Ct. 1945 (1980), the Court's holding in Central Bank applies equally to SEC actions. See infra part III.B.3. See also SEC v. Miliano, No. 89 CIV. 572, 1994 WL 285472, at *9 (S.D.N.Y. Jun. 23, 1994) ("While not specifically holding that the SEC may not bring a civil enforcement action for aiding and abetting ... the Supreme Court's ruling suggests such a result.").


58. The elements of the private Section 10(b) action include the following: "(1) use of an instrumentality of interstate commerce; (2) the making by the defendant of a material misrepresentation or omission; (3) an intent to deceive, manipulate or defraud (scienter); (4) reliance by the plaintiff on the defendant's misrepresentations; (5) causation; (6) damages flowing from the defendant's misconduct." Olson et al., supra note 14, at 23.

59. For example, in Central Bank respondents in oral arguments conceded Central Bank did not engage in manipulative or deceptive conduct within the meaning of Section 10(b). Transcript of Oral Argument of Miles M. Gersh, Esq., on Behalf of the Respondents at 31-32, Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439 (1994) (No. 92-854) ("Question: ... [D]o you concede that you could not have charged Central Bank as a primary violator ... ; Mr. Gersh: Yes, I would concede that. ... [T]he primary violation here was a fraudulent bond deal ... [T]he only way that we could reach [Central Bank] under the securities laws ... was ... aiding and abetting ... "). The recklessness issue, see infra note 100, becomes especially important in the context of implicating a secondary actor in a primary violation of Section 10(b).
secondary liability not expressly addressed in the securities laws. Similar to aiding and abetting, the liability actions of respondeat superior, conspiracy, and agency have no statutory basis under Section 10(b).60

5. Legislative activity. Central Bank has already resulted in legislative initiatives to overturn it. On January 18, 1995, the Private Securities Litigation Reform Act of 1995 was simultaneously introduced in the House and the Senate.61 Introducing the legislation in the House, Representative Edward J. Markey (D-Mass.) explained one of the express purposes of the bill is to “[o]verturn the Supreme Court’s Central Bank of Denver decision by fully restoring liability to those who knowingly or recklessly[ly] aid or abet securities fraud.”62 The House version of bill not only legislatively overrules Central Bank, but also gives the SEC the express statutory authority to prosecute aiders and abettors under Section 10(b).63 Senators Christopher J. Dodd (D-Conn.) and Pete V. Domenici (R-N.M.), who introduced the Senate version of the bill, have taken a less confrontational approach. As introduced, the Senate version of the Reform Act makes no reference to reviving Section 10(b) aiding and abetting liability, but its sponsors have indicated they “would be willing to address the Bank of Denver decision as part of our deliberations.”64 While this legislation is pending, the fate of Section 10(b) aiding and abetting liability remains uncertain.

The Court in Central Bank has put the securities bar on notice that other well-established Section 10(b) doctrines are now subject to attack. Following Central Bank, the Supreme Court will resolve future securities issues in the following manner:

(a) the scope of the statute should be determined, where possible, based exclusively on the language of the statute; (b) only if the language of the statute is unclear should the scope of the statute be determined by reference to the legislative history of the statute; (c) the relevant legislative history is the legislative history at the time the statute was enacted, not subsequent legislative history; (d) policy should not override statutory language and legislative history unless the statute would otherwise produce “bizarre” results that Congress could not have intended; and (e) perhaps most importantly, even a long-settled

60. For a thorough analysis of this proposition, see generally Fischel, supra note 1.
construction of a statute by the lower courts cannot provide a gloss to
the statute that is inconsistent with its language.  

III. THE JURISPRUDENTIAL CONTEXT

A. The Origin of Section 10(b) Aiding and Abetting Liability

The text of Section 10(b) provides no private remedies. Rather, the 1934
Act charges the SEC with enforcement of Section 10(b). Finding this enforce-
ment mechanism insufficient to meet the broad-based remedial purposes of the
1934 Act, courts have implied an extrastatutory private cause of action under
Section 10(b).

1. The Implied Private Section 10(b) Cause of Action

A private cause of action under Section 10(b) was first implied in Kardon
v. National Gypsum Co. This case concerned a scheme in which three
conspirators fraudulently induced Kardon to sell stock at a price far below its
true value. Upon discovery of the fraud, Kardon sued the conspirators for
damages, alleging they had engaged in conduct proscribed by Section 10(b). Arguing that no provision of Section 10(b) provided for civil suits, the
defendants moved for dismissal on the grounds of no right of action.

The defendants’ argument primarily focused on the statutory framework of
the 1934 Act. They contended Congress’ express inclusion of private rights of
action in other sections of the Act prohibited the implication of a private
action under Section 10(b). Inclusion unius est exclusio alterius. The court,
however, found the defendants’ argument unpersuasive. It reasoned, “[w]ere the
whole question one of statutory interpretation [the defendant’s argument] might
be convincing, but the question is only partly such.” The court stated, “[t]he
disregard of the command of a statute is a wrongful act and a tort.”

Moreover, the right of an injured party to recover damages resulting from the violation
of a statute is “fundamental and . . . deeply ingrained in the law.” Thus, in
the absence of legislative intent to the contrary, a private cause of action is
always implied by a proscriptive statute. Invoking the maxim ubi jus ibi remedi-
urn—where there is a right, there is a remedy—the court held a private plaintiff may bring suit under Section 10(b), even though the statute does not expressly provide for a private cause of action.

By 1971, the implied Section 10(b) private action had been recognized by the United States Supreme Court in *Superintendent of Insurance of New York v. Bankers Loss & Casualty Co.* And by 1976, the Court had stated:

Although Section 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established.

2. Civil Aiding and Abetting Liability Under Section 10(b)

Twenty years after civil liability under Section 10(b) was first implied in *Kardon*, the United States District Court for the Northern District of Indiana addressed the issue of whether this now “well established” action imposed civil liability on aiders and abettors. In *Brennan v. Midwestern United Life Insurance Co.*, the district court held “damages . . . may . . . be imposed upon persons who do no more than aid and abet a violation of Section 10(b).” *Brennan* involved a class action suit brought against Midwestern United Life Insurance Co. (“Midwestern”) by a group of its shareholders. The plaintiff-class alleged Dobrich Securities Corp. (“Dobrich”), a brokerage firm, had illegally retained proceeds from the sale of Midwestern’s stock for use in speculative investing: The plaintiff-class further alleged Midwestern had aided and abetted Dobrich’s fraud.

Conceding that Dobrich had, in fact, engaged in conduct proscribed by Section 10(b), Midwestern contended the section did not impose liability on aiders and abettors. Midwestern asserted that Section 10(b)’s legislative history

---

74. *Id.* at 513 (quoting Texas & Pac. Ry. v. Rigaby, 241 U.S. 33, 40, 36 S. Ct. 482, 484 (1916)). This maxim is reflected in Restatement (Second) of Torts § 286 (1977) which reads in pertinent part:

The violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, makes the actor liable for the invasion of an interest of another if; (a) the intent of the enactment is exclusive in part to protect an interest of the other as an individual; and (b) the interest invaded is one which the enactment is intended to protect.

The *Kardon* court stated “[t]his rule is more than merely a canon of statutory interpretation.” 69 F. Supp. at 513 (emphasis added).

75. 404 U.S. 6, 13 n.9, 92 S. Ct. 165, 169 n.9 (1971).


78. *Id.* (motion to dismiss denied), 286 F. Supp. 702 (N.D. Ind. 1968) (on merits after trial), aff’d, 417 F.2d 147 (7th Cir. 1969), cert. denied, 397 U.S. 989, 90 S. Ct. 1122 (1970).

79. 259 F. Supp. at 681.
supported its contention. The court disagreed, stating “this legislative history sheds little, if any, light on the Congressional understanding of the applicability of Section 10(b) to aiders and abettors.” Instead, the court followed the rationale used by the Kardon court in implying a private Section 10(b) action, by stating “[a]ppropriate general principles of law should continue to guide the development of federal common law remedies under Section 10(b).” General common-law tort principles dictate that “knowing assistance of . . . a fraudulent scheme . . . gives rise to liability equal to that of the perpetrators themselves.” The court concluded this principle, reflected in the Restatement of Torts, Section 876, promoted the underlying goal of the 1934 Act—full disclosure in the post-issuance securities markets—and was a “natural complement to the Kardon doctrine.”

Thus, Brennan established the Section 10(b) civil aiding and abetting private action. This doctrine subsequently became widely accepted.

B. The Dominant Rationale: Strict Statutory Construction

The private right of action implied under Section 10(b) is entirely a creation of the courts and is, therefore, subject to the vagaries of judicial interpretation. Because both the scope and the elements of the action are determined by the courts and not by Congress, it has assumed variable forms since its first recognition in Kardon. Prior to 1976, an expansive, activist approach to interpreting the private Section 10(b) action predominated in the lower courts. Section 10(b) became, in effect, the flexible tool used by the courts to combat

---

80. The Midwestern court cited Congress' failure to adopt amendments that expressly provided for Section 10(b) aiding and abetting liability as indicative of its intent to exclude such liability from the scope of the section. See S. 2545, 85th Cong., 1st Sess. § 20 (1957); S. 1179, 86th Cong., 1st Sess. § 22 (1959); S. 3770, 86th Cong., 2d Sess. § 20 (1960).
81. 259 F. Supp. at 677. After a lengthy consideration of the proposed legislation and the congressional deliberations thereof, the court concluded by quoting Justice Frankfurter: "To explain the cause of non-action by Congress when Congress itself sheds no light is to venture into speculative unrealities." Helvering v. Hallock, 309 U.S. 106, 119-20, 60 S. Ct. 444, 451 (1940).
82. 259 F. Supp. at 680.
83. Id. (quoting Pettit v. American Stock Exch., 217 F. Supp. 21, 28 (S.D.N.Y. 1963)).
84. Restatement (Second) of Torts § 876 (1977) reads in pertinent part:
For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he . . .
(b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
(c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.
85. See infra part IV.A.1.
86. 259 F. Supp. at 680.
87. See supra note 9. For a detailed exposition on the origin and development of aiding and abetting liability under Section 10(b) and other provisions of the securities laws prior to Central Bank, see Alan R. Bromberg & Lewis D. Lowenfels, Aiding and Abetting Securities Fraud: A Critical Examination, 52 Alb. L. Rev. 637 (1988).
any and all types of fraudulent conduct in the exchange of securities. By *ad hoc* incorporation of common-law principles, the private Section 10(b) action was defined and redefined at the courts' discretion. In time, the "catchall" Section 10(b) action assumed an amorphous and inconsistent form among the federal circuits. This inconsistency led to confusion and unpredictability in the litigious field of securities fraud. Then in the mid-1970's, the Supreme Court "awoke . . . to the rapid growth" of the private Section 10(b) action, and a new era of judicial restraint began.

In 1976 in *Ernst & Ernst v. Hochfelder*, the Supreme Court held statutory language was dispositive in determining the scope of Section 10(b). This pronouncement represented a shift in the Court's interpretation of Section 10(b). Judicial interpretations of Section 10(b) would now be subject to the strict constraints of the section's language. A trend of restrictive interpretation of Section 10(b) subsequently became evident in *Santa Fe Industries v. Green* and in *Aaron v. SEC.* Central Bank, which effectively overrules Brennan, is the most recent example of this restrictive trend.

1. *Ernst & Ernst v. Hochfelder*

In *Ernst & Ernst*, the issue was the mental state required for a Section 10(b) violation. Heralding the advent of a new, restrictive era in the interpretation of the Section 10(b) action, the Court stated "[i]n addressing this question, we turn first to the language of [Section] 10(b), for 'the starting point in every case involving construction of a statute is the language itself.'"

In *Ernst & Ernst*, the plaintiffs, customers of First Securities Co., a brokerage firm, alleged Ernst & Ernst, an accounting firm retained by First Securities, had violated Section 10(b) by failing to exercise reasonable care in auditing First Securities' operations. With the promise of high returns, First

---

88. Recognizing the extensive and creative uses the lower courts had made of the judicially implied private Section 10(b) action, Justice Rehnquist in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737, 95 S. Ct. 1917, 1926 (1975), characterized the Section 10(b) action as "a judicial oak which has grown from little more than a legislative acorn."


90. For example, the Seventh Circuit devised a significantly different test from the other circuits for imposing aiding and abetting liability under Section 10(b). See Robin v. Arthur Young & Co., 915 F.2d 1120, 1123 (7th Cir. 1990), *cert. denied*, 499 U.S. 923, 111 S. Ct. 1317 (1991); Mary T. Doherty, *Note, Aiding and Abetting Securities Fraud*, 25 Ind. L. Rev. 829, 840 & n.64 (1992).


96. *Id.* at 197, 96 S. Ct. at 1383 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756, 95 S. Ct. 1917, 1935 (1975) (Powell, J., concurring)).

97. These audits were made for the purposes of complying with Section 17(a) of the 1934 Act, 15 U.S.C. § 78q(a) (1988), which provides that securities brokers "make and keep . . . such records,
Securities' president, Leston B. Nay, had induced the plaintiffs to invest in a fraudulent securities scheme. Unknown to the plaintiffs, Nay had converted their funds to his personal use immediately upon receipt. Nay continued this scheme undetected for twenty-two years, until he committed suicide and left a note divulging the fraud and First Securities' insolvency.\textsuperscript{98}

The defrauded investors brought a Section 10(b) aiding and abetting suit against Ernst & Ernst. They alleged the accounting firm had negligently failed to use "appropriate auditing procedures\textsuperscript{99}" in auditing First Securities. An adequate audit would have led to the detection of Nay's fraudulent conduct. The Supreme Court granted certiorari to resolve the issue of "whether a private cause of action for damages will lie under [Section] 10(b) . . . in the absence of any allegation of 'scienter.'\textsuperscript{100}

In an \textit{amicus curiae} brief, the SEC argued the remedial purposes of the 1934 Act support its broad application. Specifically, the Commission contended that since the effect upon investors of fraudulent conduct, whether intentional or negligent, is indistinguishable, Congress must have intended to proscribe all such conduct. Rejecting this interpretation, the Court reasoned, "the Commission

\textsuperscript{98} Ernst & Ernst v. Hochfelder, 425 U.S. 185, 189, 96 S. Ct. 1375, 1379 (1976).
\textsuperscript{99} Id. at 190, 96 S. Ct. at 1379.
\textsuperscript{100} Id. at 193, 96 S. Ct. at 1381. In \textit{Ernst & Ernst}, the Court defined "scienter" as the "mental state embracing intent to deceive, manipulate, or defraud." \textit{Id.} at 193 n.12, 96 S. Ct. at 1381 n.12.

Black's Law Dictionary defines "scienter" to mean "[k]nowingly":

\begin{quote}
The term is used in pleading to signify an allegation . . . setting out the defendant's previous knowledge of the cause which led to the injury complained of, or rather his previous knowledge of a state of facts which it was his duty to guard against, and his omission to do which has led to the injury complained of. The term is frequently used to signify the defendant's guilty knowledge.
\end{quote}

Black's Law Dictionary 1345 (6th ed. 1990). The Courts of Appeals have uniformly held "recklessness is sufficient scienter for a primary violation of § 10(b)." First Interstate Bank v. Pring, 969 F.2d 891, 901 (10th Cir. 1992). The Supreme Court recognized that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act [sic]." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12, 96 S. Ct. 1375, 1381 n.12. The Court has, however, expressly declined to address the recklessness issue in the context of Section 10(b) liability. \textit{Id.} For an informative analysis of the Section 10(b) recklessness question, see Elaine E. Bucklo, \textit{The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochelder}, 29 Stan. L. Rev. 213 (1977).

Although the Supreme Court granted writs in \textit{Central Bank} in part on the question "[d]oes recklessness satisfies the scienter requirement for aiding and abetting even where there is no breach of a duty to disclose or to act," in its opinion it chose to ignore the question, finding dispositive its analysis of the \textit{sua sponte} question of whether Section 10(b) provided for private aiding and abetting liability. Central Bank of Denver v. First Interstate Bank of Denver, 113 S. Ct. 2927 (1993), \textit{petition for cert. filed}, (U.S. Nov. 16, 1992) (No. 92-854).

Recently, the recklessness issue has received congressional attention. On January 25, 1995, U.S. Representative Billy Tauzin introduced a bill to limit liability under Section 10(b) to instances of intentional conduct only. H.R. 681, 104th Cong., 1st Sess. (1995). The recklessness issue remains an important and unresolved question concerning Section 10(b) liability.
would add a gloss to the operative language of the statute quite different from its commonly accepted meaning.\textsuperscript{101} Moreover, the Court stated the SEC's argument ignored the "unmistakable"\textsuperscript{102} meaning of Section 10(b)'s text.

Turning to the statutory language, the Court reasoned the use of the words "manipulative\textsuperscript{103} or deceptive" in conjunction with 'device or contrivance' strongly suggests that Section 10(b) was intended to proscribe knowing or intentional misconduct\textsuperscript{104} and not negligence. Thus, the Court held a finding of scienter was a requirement for Section 10(b) liability. In addition to the text of Section 10(b) which "so clearly connotes intentional misconduct,"\textsuperscript{105} the Court supported its conclusion by considering the statutory framework. The Court noted that in every instance, in both the 1933 and 1934 Acts, in which Congress expressly created civil liability in favor of purchasers or sellers of securities, it specified the mental state required for recovery.\textsuperscript{106} Furthermore,

\begin{itemize}
  \item \textsuperscript{101} Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199-200, 96 S. Ct. 1375, 1383 (1976).
  \item \textsuperscript{102} Id. at 200, 96 S. Ct. at 1384.
  \item \textsuperscript{103} In the context of the securities laws the term "manipulate" is especially instructive: "It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." \textit{Id.}
  \item \textsuperscript{104} Id. at 197, 96 S. Ct. at 1383.
  \item \textsuperscript{105} Id. at 201, 96 S. Ct. at 1384.
  \item \textsuperscript{106} The 1933 Act, Sections 11, 12, and 15: Section 11, 15 U.S.C. § 77k (1988), makes an issuer absolutely liable, regardless of fault, for making misleading statements in a securities registration statement. \textit{See} § 11(a). Experts, such as "accountants, engineers, or appraisers," who have assisted in the preparation of such statements are accorded a defense to civil liability in that they may assert that "after reasonable investigation" they had "reasonable ground[s] to believe . . . that the statements therein were true." \textit{See} § 11(b)(3)(B)(i). The Supreme Court has recognized that "this is a negligence standard." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208, 96 S. Ct. 1375, 1388 (1976). Section 12, 15 U.S.C. § 77i (1988), imposes absolute liability on any person who "offers or sells" an unregistered security. \textit{See} § 12(1). Any person who offers or sells a security by means of a prospectus or oral communication which includes an untrue material fact or omits a material fact is liable to the person purchasing the security for the purchase price, unless he can "sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." \textit{See} § 12(2). Section 15, 15 U.S.C. § 77o (1988), makes every person who, by agreement or otherwise, controls any person liable under Sections 11 or 12, jointly and severally liable with the controlled person. The "controlling person" may escape liability by proving he had "no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." This likewise is a negligence standard.
  \item The 1934 Act, Sections 9, 18, and 20: Under Section 9, 15 U.S.C. § 78i (1988), liability is imposed on anyone who "willfully" creates the false appearance of active trading in any security. Section 18, 15 U.S.C. § 78r (1988), imposes liability on any person who makes a false or misleading statement in a report, application, or document filed pursuant to the 1934 Act, unless he proves "he acted in good faith and had no knowledge that such statement was false or misleading." Similar to Section 15 of the 1933 Act, Section 20, 15 U.S.C. § 78t (1988), creates civil liability for those who control any person who violates any provision of the 1934 Act. The "controlling person" may escape liability by proving he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."
  \item Each of these sections "contains a state-of-mind condition requiring something more than negligence." 425 U.S. at 209 n.28, 96 S. Ct. at 1388 n.28.
\end{itemize}
those sections of the securities acts that expressly provide for recovery for
negligent conduct do so subject to "significant procedural restrictions not
applicable under Section 10(b)." The absence of comparable procedural
limitations under Section 10(b) suggested to the Court that it would be
inconsistent with the statutory structure to extend the 10(b) action to include
negligent conduct. The Court stated it was reluctant to disturb this carefully
drawn statutory scheme.

Reiterating the need for strict adherence to the statute's text in defining the
scope of the Section 10(b) action, the Court concluded:

When a statute speaks so specifically in terms of manipulation and
decception, and of implementing devices and contrivances—the
commonly understood terminology of intentional wrongdoing—and
when its history reflects no more expansive intent, we are quite
unwilling to extend the scope of the statute to negligent conduct.

In the wake of Ernst & Ernst, at least one commentator recognized the
Court's approach "casts some doubt on the continued viability of aiding and
abetting liability." Professor Fischel, in a landmark article, noted that
although the Court purported to reserve the issue of aiding and abetting liability
in Ernst & Ernst, it had, in effect, all but determined the fate of secondary
liability under Section 10(b) by holding the section's language was controlling.
Foreshadowing Central Bank, Fischel concluded the Court in Ernst & Ernst
"implicitly held that aiding and abetting liability does not exist apart from
liability that could be imposed for a direct violation."

2. Santa Fe Industries v. Green

Less than a year after Ernst & Ernst, the Supreme Court again was faced
with a question concerning the substantive scope of Section 10(b). In Santa Fe
Industries v. Green, the issue was whether Santa Fe Industries ("Santa Fe"), a
majority shareholder in the Kirby Lumber Co. ("Kirby"), had violated Section
10(b) in connection with a Delaware "short-form merger." Pursuant to the

107. 425 U.S. at 208-09, 96 S. Ct. at 1388. For example, Section 11 of the 1933 Act, see supra
note 106, grants the court the discretion to require a plaintiff bringing suit under Sections 11, 12(2),
or 15 of the 1933 Act to post a bond for court costs and, in some instances, to assess costs at the
conclusion of the suit.
108. 425 U.S. at 210, 96 S. Ct. at 1389.
109. Id. at 215, 96 S. Ct. at 1391.
110. Fischel, supra note 1, at 88.
111. Id. The Court noted Professor Fischel's influential views in Central Bank v. First Interstate
Bank, 114 S. Ct. 1439, 1444 (1994): "Professor Fischel opined that the 'theory of secondary liability
[under Section 10(b)] was no longer viable in light of recent Supreme Court decisions strictly
interpreting the federal securities laws.'"
Delaware law, Santa Fe sought to acquire 100% ownership of its subsidiary Kirby by buying out the minority shareholders' interest. Unsatisfied with the terms of the statutory merger, a group of Kirby's shareholders brought suit in federal court against Santa Fe. They alleged Santa Fe had obtained a fraudulent appraisal of Kirby's assets for the purpose of "freezing out" the minority stockholders at a wholly inadequate price. This deceptive and manipulative conduct, the plaintiffs further alleged, was in violation of Section 10(b). The district court dismissed the plaintiffs' claim for failure to state a claim, and the Court of Appeals for the Second Circuit reversed. The United States Supreme Court granted Santa Fe's petition for certiorari to consider the substantive reach of Section 10(b).

Relying heavily on Ernst & Ernst and on the proposition that the "[a]scertainment of congressional intent with respect to the standard of liability created by a particular section of the [1933 and 1934] Acts must ... rest primarily on the language of that section," the Court reversed. It held Santa Fe had not engaged in any deceptive conduct within the meaning of Section 10(b).

Concerning the plaintiffs' allegation that Santa Fe had been manipulative in its dealings, the Court explained "the conduct alleged in the complaint was not 'manipulative' within the meaning of the statute." The Court stated "manipulative," as used in the context of the securities laws, is "virtually a term of art" referring generally to such specific practices as "wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." Whereas Congress intended Section 10(b) to prohibit the full gamut of "manipulative" devices, it did not intend to include within its scope such an "instance of corporate mismanagement" as had been alleged by the plaintiffs. To do so would be to extend Section 10(b) to an area

117. Santa Fe Indus. v. Green, 429 U.S. 814, 97 S. Ct. 1292, 1298 (1977) (mem.).
118. 430 U.S. at 473, 97 S. Ct. at 1300 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200, 96 S. Ct. 1375, 1384 (1976)).
119. Id. at 474-75, 96 S. Ct. at 1300-01.
120. Id. at 476, 97 S. Ct. at 1302.
121. Id. (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199, 96 S. Ct. 1375, 1384 (1976)).
122. Id. For an explanation of "wash sales," "matched orders," and "rigged prices," see supra note 39.
123. Id. at 477, 97 S. Ct. at 1302.
of corporate conduct traditionally relegated to state law and to pose a "danger of vexatious litigation which could result from a widely expanded class of plaintiffs." 124

3. Aaron v. Securities and Exchange Commission

In Aaron v. Securities and Exchange Commission, 122 the Court was confronted with a question it had expressly reserved in Ernst & Ernst—whether scienter is a necessary element of an injunctive action brought by the SEC under Section 10(b). 126 As in Santa Fe, the Court returned to Ernst & Ernst to resolve this issue.

In Aaron, the SEC brought an injunctive action, alleging violations of Section 10(b), against a manager of a New York brokerage firm. The Commission alleged the defendant intentionally failed to prevent his employees from making fraudulent misrepresentations concerning the financial condition of the Lawn-A-Mat Corp. These misrepresentations were made for the purposes of soliciting purchase orders for Lawn-A-Mat's stock.

Ordering the injunction, the District Court for the Southern District of New York found the defendant intentionally failed to take adequate steps to prevent the employees from making fraudulent statements concerning Lawn-A-Mat's financial condition. 127 The Court of Appeals for the Second Circuit affirmed, but declined to address the question of whether the defendant's conduct constituted scienter, a requirement for civil Section 10(b) liability as established by Ernst & Ernst. It held, instead, a finding of negligence is sufficient to support a claim for injunctive relief under the 1934 Act. 128 The Second Circuit distinguished Ernst & Ernst on the basis of "compelling distinctions between private damages actions and government injunction actions." 129 The Supreme Court granted writs to consider whether scienter must be alleged by the SEC in a suit for injunctive relief under Section 10(b). 130

124. Id. at 479, 97 U.S. at 1304 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740, 95 S. Ct. 1917, 1927 (1975)).
126. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12, 96 S. Ct. 1375, 1381 n.12 (1976). Injunctive relief is one of the civil enforcement mechanism expressly provided by the 1934 Act. Section 21(d) of the 1934 Act provides:
   (d)(1) When ever it shall appear to the Commission that any person is engaged in acts or practices constituting a violation of any provision of this title, . . . it may in its discretion bring an action . . . to enjoin such acts or practices . . . .
128. SEC v. Aaron, 605 F.2d 612, 619 (2d Cir. 1979).
129. Id. at 621. The Second Circuit proposed that the "two types of suits under § 10(b) advance different goals: actions for damages are designed to provide compensation to individual investors, whereas suits for injunctive relief serve to provide maximum protection to the investing public." Aaron v. SEC, 446 U.S. 680, 685 n.3, 100 S. Ct. 1945, 1950 n.3 (1980).
130. The Court in Aaron again expressly reserved a question that it had first reserved in Ernst
Finding the Second Circuit’s “compelling distinctions” unpersuasive, the Court applied *Ernst & Ernst* and held scienter is a necessary element for all violations of Section 10(b), regardless of who initiates the suit. Its conclusion “rested on several grounds,” including the “plain meaning” of Section 10(b), the section’s legislative history, and the statutory framework. The Court concluded, “[i]n our view, the rationale of [Ernst & Ernst] ineluctably leads to the conclusion that scienter is an element of a violation of Section 10(b) ... regardless of the identity of the plaintiff or the nature of the relief sought.”

Thus, the Court in *Santa Fe* and *Aaron* applied the interpretive approach established in *Ernst & Ernst* to restrict the substantive scope of Section 10(b). These cases represent the dominant approach employed by the Court since 1976 to resolve Section 10(b) issues.

C. An Inconsistent Rationale: The Duty to Disclose, *Chiarella, and Dirks*

After *Ernst & Ernst*, it appeared future Section 10(b) questions would be resolved in this same manner—by carefully considering the section’s text, the statutory framework, and Congress’ intent in enacting the statute. However, in 1980, *Chiarella v. United States* suggested otherwise.

1. *Chiarella v. United States*

In *Chiarella*, the issue was whether a person who learns of an impending corporate acquisition from the handling of company documents violates Section 10(b) if he fails to disclose the information before trading in the target company’s stock. Chiarella was employed as a “markup man” for a New York financial printer. Over a two-year period, he “marked-up” five corporate takeover bid announcements. Although the names of the acquiring and target companies were left blank, Chiarella was able to deduce the corporations’ identities from other information included in the documents. By trading on this information, Chiarella realized gains over $30,000.

Chiarella’s lucrative forays into the securities market did not go unnoticed. The SEC instituted an investigation into Chiarella’s suspicious trading activities.

---

& *Ernst*—whether recklessness may constitute scienter under some circumstances. 446 U.S. at 686 n.5, 100 S. Ct. at 1950 n.5. See *supra* note 100.

131. *Id.* at 690, 100 S. Ct. at 1952.

132. *Id.* at 691, 100 S. Ct. at 1955-3. The court noted Section 21(d) of the 1934 Act, see *supra* note 126, which authorizes the Commission to seek injunctive relief against violators or prospective violators of any provision of the 1934 Act, “neither ... add[s] nor ... detract[s] from the requisite showing of scienter” under Section 10(b) and Rule 10b-5. *Id.* at 700, 100 S. Ct. at 1957.

133. For an explanation of the “duty of disclosure” in the context of insider trading, see *infra* note 139.


135. *Id.* at 224, 100 S. Ct. at 1113.
Chiarella was indicted and convicted on seventeen counts of violating Section 10(b).\footnote{136} The trial court held Chiarella "owed a duty to everyone; to all sellers, indeed, to the market as a whole" to disclose knowledge of insider information before trading on it.\footnote{137} Chiarella's conviction was upheld by the United States Court of Appeals for the Second Circuit,\footnote{138} and the Supreme Court granted certiorari to ascertain the legal effect of Chiarella's insider trading.\footnote{139}

The Court began its analysis by acknowledging "the starting point of our inquiry is the language of [Section 10(b)],"\footnote{134} but then concluded "Section 10(b) does not state whether silence may constitute a manipulative or deceptive device."\footnote{141} It is at this point where the Court's interpretive approach diverged from the trend established by\textit{Ernst & Ernst} and its progeny. Instead of looking to the statutory structure and other indicia of congressional intent to determine

\begin{itemize}
\item \footnote{136} Section 32(a) of the 1934 Act, 15 U.S.C. § 78ff(a) (1988), sanctions criminal penalties against "[a]ny person who willfully violates any provision of the 1934 Act." Chiarella's seventeen counts represented his receipt of seventeen different stock purchase confirmation orders in a fourteen month period. Chiarella was the first case in which nondisclosure was the basis for the imposition of criminal liability upon a purchaser under Section 10(b). 445 U.S. at 236, 100 S. Ct. at 1118.
\item \footnote{137} Id. at 231, 100 S. Ct. at 1116.
\item \footnote{138} United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978).
\item \footnote{139} "Insider trading" refers to transactions in the securities of publicly held corporations by "persons with inside or advanced information on which the trading is based." Black's Law Dictionary 796 (6th ed. 1990). The general concept of insider trading was first recognized as prohibited by Section 10(b) in\textit{In re Cady, Roberts & Co.}, 40 S.E.C. 907 (1961):
\begin{quote}
We have already noted that the anti-fraud provisions are phrased in terms of "any person" and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation.
\end{quote}
\textit{Id.} at 912. In\textit{Cady, Roberts}, the Commission defined the two elements of an insider trading violation:
\begin{quote}
[F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.
\end{quote}
\textit{Id.} As a consequence of the "inherent unfairness" of an insider trading transaction, the SEC in\textit{Cady, Roberts} established a duty of disclosure on insiders explaining, "[i]f purchasers on an exchange had available material information known [only] by a selling insider, we may assume that their investment judgment would be affected and their decision whether to buy might accordingly be modified. Consequently, any sales by the insider must await disclosure of that information."\textit{Id.} at 914. Since\textit{Cady, Roberts}, the courts have been involved in an effort to determine what, if any, relationship a person must have with a corporation to be subject to the obligations of an insider.\textit{Chiarella} and\textit{Dirks v. SEC}, 463 U.S. 646, 103 S. Ct. 3255 (1983), represent the Supreme Court's attempts to delineate the contours of the Section 10(b) insider trading action and the correlative duty of disclosure.\textit{Central Bank} suggests these opinions, which borrow heavily from the common law of insider trading, are too restrictive. See infra part IV.A. For a thorough analysis of the history of insider trading under Section 10(b), see C. Edward Fletcher, Materials on the Law of Insider Trading 99-255 (1991).
\item \footnote{140} Chiarella v. United States, 445 U.S. 225, 226, 100 S. Ct. 1108, 1113 (1980) (quoting\textit{Ernst & Ernst} v. Hochfelder, 425 U.S. 185, 197, 96 S. Ct. 1375, 1382 (1976)).
\item \footnote{141} Id.
\end{itemize}
the legal effects of Chiarella’s silence, the Court turned to the common law of fraud.

The common law states a “party charged with failing to disclose market information must be under a duty to disclose it.” Historically, this duty arose by virtue of the “unfairness of allowing a corporate insider to take advantage of . . . [insider] information by trading without disclosure.” The Court stated this common-law duty had been adopted by the SEC in Cady, Roberts & Co. In Cady, Roberts, an administrative decision, the SEC held members of a brokerage firm had violated Section 10(b) by selling securities on the basis of material, nonpublic information obtained from a director of the issuer corporation, who was also employed by the same brokerage firm. The director, the SEC explained, was privy to “insider” information. As such, he was subject to the duty traditionally imposed on “insiders”—to disclose material information to persons with whom he deals in the trading of the securities of his corporation.

The Chiarella Court concluded Cady, Roberts stood for the following principle:

[ Silence in connection with the purchase or sale of securities may operate as a fraud actionable under Section 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to

142. Id. at 229, 100 S. Ct. at 1115 (quoting Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 282 (2d Cir. 1975)). Traditionally, the common law only imposes the duty to disclose material, nonpublic corporate information on corporate fiduciaries who personally (face-to-face) undertake stock transactions with other stockholders. Goodwin v. Agassiz, 186 N.E. 659, 661 (Mass. 1933) (“When a director personally seeks a stockholder for the purpose of buying his shares without making disclosure of material facts within his peculiar knowledge and not within reach of the stockholder, the transaction will be closely scrutinized and relief may be granted . . . .”). See also Strong v. Rip tide, 213 U.S. 419, 29 S. Ct. 521 (1909) (holding plaintiff-shareholder stated a cause of action by alleging majority shareholder used agents to purchase stock from plaintiff without first disclosing impending, lucrative real estate deal); Hoichkiss v. Fischer, 16 P.2d 531, 535 (Kan. 1932) (“Directors act in a fiduciary capacity in management of corporate affairs, and a director negotiating with a shareholder for purchase of shares acts in a relation of scrupulous trust and confidence. . . . Such transactions must be subject to the closest scrutiny . . . .”). This common-law duty does not extend to fiduciaries who trade on impersonal stock exchanges. 186 N.E. at 661.

In Chiarella, the Court ignores the distinction between impersonal market trading and personal transactions and evokes a “common-law” duty of disclosure that extends to all fiduciaries who engage in insider trading through the securities markets or otherwise.

143. 445 U.S. at 227, 100 S. Ct. at 1114 (quoting In re Cady, Roberts & Co., 40 S.E.C. 907, 912 & n.15 (1961)).

144. 40 S.E.C. 907 (1961). This assertion is somewhat disingenuous in light of the open-ended language of the Cady, Robert’s decision, the plain meaning of Section 10(b), and the 73d Congress’ intent in adopting the 1934 Act. See infra part IV.A.

145. Id. at 914.
disclose arising from a relationship of trust and confidence between parties to a transaction.\textsuperscript{146}

Applying this "common law rule,"\textsuperscript{147} the Court reversed the Second Circuit and held that in the absence of a duty to speak, Section 10(b) does not impose a general duty to disclose inside information before trading on it. The Court found Chiarella had no fiduciary (or quasi-fiduciary relationship) with any of the target corporations in whose stock he traded. Accordingly, he had no affirmative duty to disclose to the sellers, or to the public-at-large, his knowledge of inside information before trading in the target corporations' stock. Therefore, the Court held Chiarella had not violated Section 10(b).\textsuperscript{148}

2. Dirks v. SEC

The Supreme Court revisited the issue of nondisclosure under Section 10(b) in \textit{Dirks v. SEC}.\textsuperscript{149} Again, the Court ignored \textit{Ernst & Ernst}. The issue was whether an investment analyst who received material, nonpublic information from a corporate insider violated Section 10(b) by relaying this information to his clients who, in turn, traded upon it. Secrist, a former insider of Equity Funding, a California insurance company, had informed Dirks, the analyst, that the company was vastly overvalued as a result of fraudulent bookkeeping.

The Commission found Dirks had aided and abetted violations of Section 10(b) by disclosing insider information to his clients concerning Equity Funding's condition. Establishing a "disclose-or-refrain-from-trading" rule applicable to tippees,\textsuperscript{150} the SEC's administrative hearing judge concluded:

Where "tippees"—regardless of their motivation or occupation—come into possession of material "corporate information that they know is confidential and know or should know came from a corporate insider," they must either publicly disclose that information or refrain from trading.\textsuperscript{151}

Dirks appealed to the Court of Appeals for the District of Columbia Circuit. Affirming the SEC's holding, the court reiterated the Commission's position stating, "the obligations of corporate fiduciaries pass to all those to whom they

\textsuperscript{147} Id. at 229, 100 S. Ct. at 1115.
\textsuperscript{148} Id. at 234, 100 S. Ct. at 1118.
\textsuperscript{149} 463 U.S. 646, 103 S. Ct. 3255 (1983).
\textsuperscript{150} In securities law, a "tippee" is a "person who acquires material nonpublic information from another who enjoys a fiduciary relationship with the company to which such information pertains." Black's Law Dictionary 1484 (6th ed. 1990). A tippee has neither a fiduciary nor a quasi-fiduciary relationship with the corporation or its shareholders.
disclose their information before it has been disseminated to the public at large.\textsuperscript{152} The Supreme Court granted certiorari and reversed.\textsuperscript{153}

The Court extended the common-law rule of disclosure adopted in \textit{Chiarella} to tippees. By the Court's own admission, however, the application of the \textit{Chiarella} rule to tippees created "analytical difficulties."\textsuperscript{154} In particular, under what circumstances, if any, do tippees "inherit" the insider's duty to disclose?\textsuperscript{155} The SEC proposed that the Court adopt a "disclose-or-refrain-from-trading" rule applicable to tippees. Under the SEC's proposal, "anyone who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading."\textsuperscript{156} This rule, the Commission contended, was the logical extension of \textit{Chiarella}.

The Supreme Court rejected the SEC's argument for the same reason it previously had declined to impose a general duty of disclosure in \textit{Chiarella}. The SEC's position in both \textit{Chiarella} and \textit{Dirks} was falsely "rooted in the idea that the antifraud provisions [of the federal securities acts] require equal information among all traders."\textsuperscript{157} The Court stated this "radical" parity-of-information rule is not supported by congressional intent. Rather, because the disclose-or-refrain-from-trading rule is extraordinary, it attaches only when a party has preexisting legal obligations. These obligations arise "from the relationship between the parties . . . and not merely from one's ability to acquire information because of his position in the market."\textsuperscript{158}

Nevertheless, the Court recognized the general prohibitions of the 1934 Act impose a ban on at least some tippee trading.\textsuperscript{159} If insiders are prohibited from using undisclosed, insider information for their advantage, then they are likewise forbidden to benefit from that information by giving it to an outsider. In some circumstances, the Court explained, a tippee could serve as the conduit through which an insider breaches his fiduciary duty. The Court concluded "some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them improperly."\textsuperscript{160} The test for determining whether such a disclosure is improper is "whether

\begin{itemize}
\item \textsuperscript{152} Dirks v. SEC, 681 F.2d 824, 839 (D.C. Cir. 1982).
\item \textsuperscript{153} Dirks v. SEC, 463 U.S. 646, 652, 103 S. Ct. 3255, 3260 (1983).
\item \textsuperscript{154} \textit{Id.} at 655, 103 S. Ct. at 3261.
\item \textsuperscript{155} The court draws a distinction between outsiders who become fiduciaries of corporate stockholders by means of a confidential relationship with a corporation, such as lawyers, accountants, and consultants, and tippees who have no independent fiduciary duty. The first owes an independent duty to disclose material nonpublic information before trading on it. \textit{Id.} at 656 n.14, 103 S. Ct. at 3262 n.14. The source of a tippee's duty to disclose, however, is not as clear.
\item \textsuperscript{156} \textit{Id.} at 656, 103 S. Ct. at 3262 (emphasis added).
\item \textsuperscript{157} \textit{Id.} at 657, 103 S. Ct. at 3263.
\item \textsuperscript{158} \textit{Id.} at 657-58, 103 S. Ct. at 3263.
\item \textsuperscript{159} For example, Section 20(b), 15 U.S.C. § 78t(b) (1988), makes it "unlawful for any person, directly or indirectly, to do an act or thing which it would be unlawful for any such person to do under the provisions of this chapter . . . through or by means of any other person."
\item \textsuperscript{160} Dirks v. SEC, 463 U.S. 646, 660, 103 S. Ct. 3255, 3264 (1983).
\end{itemize}
the insider personally will benefit, directly or indirectly, from his disclosure. 
Absent some personal gain, there has been no breach of duty to stockholders. And 
absent a breach by the insiders, there is not a derivative breach [by the tippee]."\textsuperscript{161} Thus, the Court held that because Secrist had not disclosed inside information to 
Dirks out of a desire for personal gain, Dirks inherited no duty of disclosure under 
Section 10(b).

\textbf{D. Analytical Inconsistency}

The rationale utilized by the Court in \textit{Chiarella} and \textit{Dirks} is fundamentally 
inconsistent with that employed in \textit{Ernst & Ernst, Santa Fe,} and \textit{Aaron}. In the 
latter decisions, the Court restricted the scope of Section 10(b) by adhering to the 
section's language, the statutory structure, and congressional intent. In \textit{Chiarella} 
and \textit{Dirks}, on the other hand, where strict construction would have led to an 
expansive reading of the section, the Court turned to common-law doctrines to limit 
Section 10(b)'s reach. This inconsistency suggests the Court's decisions have 
largely been result-driven. In short, since 1976, the Court has acted to narrow the 
scope of the Section 10(b) action at the cost of analytical uniformity and, to an 
extent, predictability.

The Court in \textit{Central Bank} strongly reasserts strict construction as the norm in 
interpreting Section 10(b). This suggests a willingness on the Court's part to 
reexamine established Section 10(b) doctrines that are inconsistent with \textit{Central 
Bank}. In particular, following the \textit{Central Bank} decision, \textit{Chiarella, Dirks}, and 
even the existence of the private 10(b) action itself are subject to attack.

\textbf{IV. DOCTRINES SUBJECT TO ATTACK FOLLOWING CENTRAL BANK}

\textit{Central Bank} unequivocally asserts the primacy of the statute in the judicial 
interpretation of the federal securities laws. By concluding "the text of the statute 
controls our decision,"\textsuperscript{162} the Supreme Court rejected the use of common-law 
principles as a means for expanding the securities laws. \textit{Central Bank} strongly 
suggests that other extrastatutory Section 10(b) doctrines are ripe for review. This 
Part will consider two such doctrines to be reconsidered in the interest of analytical 
uniformity and intellectual honesty.

\textbf{A. Rethinking Insider Trading Under Section 10(b)}

\textbf{1. The Principle of Full Disclosure Underlying the Federal Securities Law}

In \textit{Dirks} and \textit{Chiarella}, the Supreme Court looked to the common-law 
definition of fraud to define insider trading under Section 10(b). In \textit{Chiarella},

\textsuperscript{161} \textit{Id.} at 662, 103 S. Ct. at 3265.
the Court held that in the absence of a duty to speak, there is no duty to disclose inside information before trading upon it. In Dirks, the Court held a tippee who receives material, nonpublic information from an insider inherits the insider’s duty to speak only when the insider stands to benefit, directly or indirectly, from his disclosure. These holdings suggest the common law of insider trading governs despite the language, legislative intent, and statutory structure of the 1934 Act.

In Chiarella, the majority refused to recognize a general duty to disclose insider information under Section 10(b), observing “neither the Congress nor the Commission has adopted a parity-of-information rule” applicable to the exchange of securities. The Court itself, however, has suggested the contrary. For example, in Ernst & Ernst, the Court explained “[t]he Securities Act of 1933 . . . was designed to provide investors with full disclosure of material information.” In Santa Fe, the Court acknowledged the “fundamental purpose of the 1934 Act” was “to substitute a philosophy of full disclosure for the philosophy of caveat emptor.” And in Chiarella, Chief Justice Burger, dissenting, noted “[t]he antifraud provisions [of the 1934 Act] were designed in large measure ‘to assure that dealing in securities is fair and without undue preferences or advantages among investors.’” Indeed, the goal of full disclosure in the exchange of securities has been recognized by the Court as the fundamental impetus behind Congress’ enactment of the federal securities laws.

165. 445 U.S. at 233, 100 S. Ct. at 1117. See infra note 171, defining the “parity-of-information” rule.
169. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 95 S. Ct. 1917 (1975), the Court described the origins of the federal securities laws:

During the early days of the New Deal, Congress enacted two landmark statutes regulating securities. The 1933 Act was described as an Act “to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent fraud in the sale thereof . . . .” The [1934 Act] was described as an Act “to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets. . . .”

Id. at 727-28, 95 S. Ct. at 1921-22 (citation omitted) (emphasis added). Later, in Basic Inc. v. Levinson, 485 U.S. 224, 108 S. Ct. 978 (1988), Justice Blackmun stated clearly: “This Court repeatedly has described the “fundamental purpose” of the [1934] Act as implementing a
Recognizing that full disclosure of insider information is an impracticality, Congress has delegated to the courts the duty of implementing this legislative goal in a manner consistent with the smooth operation of the securities markets. Thus, the courts must determine where the balance of imperfection is going to lie. However, without engaging in this difficult balancing process, the Supreme Court in Chiarella and Dirks applied the more straightforward common law of insider trading, thereby narrowly construing the duty to disclose under Section 10(b). These decisions remain in derogation of the philosophy of full disclosure, the structure of the 1934 Act, and the analytical framework established by the Court in Ernst & Ernst and reaffirmed in Central Bank.

2. The Parity-of-Information Rule and Insider Trading

Common sense dictates the possession of material, nonpublic corporate information by anyone engaged in the exchange of that corporation's securities constitutes an "undue preference or advantage." Chiarella and Dirks stand in stark contrast to this proposition.

The Court asserted in Chiarella and Dirks that a general duty of disclosure under Section 10(b) is unsupported by statutory language or legislative intent. This assertion, however, is disingenuous. Even a cursory examination of administrative and judicial decisions indicates a philosophy of full disclosure is inherent in the 1934 Act. Indeed, had the Court in these cases adhered to the interpretive method established in Ernst & Ernst (and now reaffirmed in Central Bank) and turned, in the absence of controlling language, to a consideration of congressional intent, it would have established a broader definition of insider trading under Section 10(b) based on the parity-of-information rule.

In Chiarella and Dirks, the Court relied on Cady, Roberts as a basis for rejecting the parity-of-information rule. The Court interpreted Cady, Roberts as indicative of the SEC's intent to superimpose the common-law rules of disclosure on Section 10(b). Chief Justice Burger, dissenting in Chiarella, suggested otherwise. He proposed that a closer
reading of Cady, Roberts reveals no intent on the part of the SEC to adopt the common law of insider trading. The Chief Justice argued the two criteria relied upon by the SEC in Cady, Roberts to impose a duty of disclosure on insiders reveal no intent to predicate that duty on a preexisting duty to speak. Indeed, Justice Burger stated, "both of these factors are present whenever a party gains an informational advantage by unlawful means." Thus, the Chief Justice interpreted Cady, Roberts as adopting a disclose-or-refrain-from-trading rule applicable to anyone who possesses material, nonpublic corporate information. In support of his conclusion, Chief Justice Burger noted the SEC applied the disclose-or-refrain-from-trading rule to tippees in a subsequent decision, Blyth & Co.

The Court's decisions in Chiarella and Dirks also largely ignored the seminal case SEC v. Texas Gulf Sulphur Co. In Texas Gulf, the United States Court of Appeals for the Second Circuit engaged in an in-depth analysis of the legislative history of Section 10(b) and concluded "the securities laws should be interpreted as an expansion of the common law both to effectuate the broad remedial design of Congress . . . and to insure uniformity of enforcement." In Texas Gulf, the SEC brought suit against Texas Gulf Sulphur Co. ("TGS") and thirteen individuals alleging violations of Section 10(b). The SEC alleged the defendants, including some insiders, had purchased TGS stock on the basis of material, nonpublic information. Relying on Cady, Roberts the court remarked:

The essence of the Rule [10b-5] is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to the information to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public.

The Second Circuit held the insiders had violated Section 10(b) by trading on the information. The court further held Section 10(b) "is also applicable to one possessing the information who may not be strictly termed an 'insider'

173. 445 U.S. at 241, 100 S. Ct. at 1121 (Burger, C.J., dissenting).
174. The two criteria are the following: "(1) . . . access . . . to inside information intended to be available only for a corporate purpose and not for the personal benefit of anyone; and (2) the unfairness inherent in trading on such information when it is inaccessible to those with whom one is dealing." Id.
175. Id. at 241-42, 100 S. Ct. at 1121 (emphasis added).
176. 43 S.E.C. 1037 (1969). In Blyth & Co., the Commission concluded a tippee, who gained confidential Treasury Department information from an employee of a Federal Reserve Bank and traded thereupon, had violated Section 10(b) by improperly using insider information.
178. Id. at 855 (footnote omitted).
179. Id. at 848 (quoting Cady; Roberts & Co., 40 S.E.C. 907, 912 (1961)) (emphasis added).
within the meaning of [the 1934] Act.\textsuperscript{180} Thus, those defendants who were not insiders but who nevertheless possessed nonpublic, corporate information, had violated Section 10(b) by failing to disclose their informational advantage before trading upon it. Establishing a clear parity-of-information rule under Section 10(b), the Second Circuit stated:

\textit{[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.}\textsuperscript{181}

The Court stated this conclusion was necessitated by “[t]he dominant congressional purpose underlying the Securities Exchange Act of 1934 [which is] to promote free and open securities markets and to protect the investing public from suffering inequalities in trading”\textsuperscript{182} and by the fundamental policy supporting Section 10(b)—that “all investors trading on impersonal exchanges have relatively equal access to material information.”\textsuperscript{183}

Thus, in light of congressional intent, judicial interpretation, and administrative policy, the Court’s conclusion in \textit{Chiarella} and \textit{Dirks} that the parity-of-information rule is unsupported is baseless. By enacting the securities laws, Congress sought to insure an equitable, open, and public marketplace in securities. The parity-of-information rule is consistent with this goal. Moreover, the recognition of a rule of disclosure broader than that imposed by the common law is consistent with the remedial purpose of the securities laws. By enacting a comprehensive body of securities legislation, Congress sought to supplant the common law, whose remedies had proven insufficient to govern a modern securities market.

Had the Court in \textit{Chiarella} and \textit{Dirks} been true to the interpretive principles it adopted in \textit{Ernst \\& Ernst} and strictly limited its interpretation of Section 10(b) to the section’s language, the statutory framework, and congressional intent, it would have reached the conclusion that anyone who trades on nonpublic, corporate information without first disclosing that information does so in

\textsuperscript{180} \textit{Id.} (quoting \textit{In re Cady, Roberts \\& Co.}, 40 S.E.C. 907, 912 (1961)). Section 16(b) of the 1934 Act, 15 U.S.C. § 78p(a) (1988), implicitly defines who may be considered an insider:

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reasons of his relationship to the issuer, any profit realized by him from any purchase or sale, or any sale and purchase . . . shall inure to and be recoverable by the issuer . . . or by the owner of any security of the issuer in the name and in behalf of the issuer . . .

\textit{Id.}

\textsuperscript{181} \textit{Id.} at 848 (emphasis added).

\textsuperscript{182} \textit{Id.} at 858.

\textsuperscript{183} \textit{Id.} at 848.
violation of Section 10(b). Instead, the court embraced the common law of fraud and reached a less expansive conclusion.

B. Rethinking the Section 10(b) Private Cause of Action

In Central Bank, the Supreme Court exhibited a willingness to overrule "hundreds of judicial and administrative proceedings in every circuit in the federal system." By holding Section 10(b) does not reach aiders and abettors, the Court signaled the beginning of the end of implied remedies under Section 10(b). Taken to its logical conclusion, the Court's rationale leaves little room for the continued recognition of the extrastatutory Section 10(b) private action.

It is fundamentally inconsistent for the Court to espouse strict adherence to the statutory language in interpreting the securities laws, while continuing to acknowledge the private 10(b) action—an action which the Court itself has recognized as a judicially created, extrastatutory right. Simply, there is no statutory basis for civil liability under Section 10(b) and thus, under the rationale of Central Bank, no basis for the Section 10(b) private action.

1. Impling Private Causes of Action Under Section 10(b): From Kardon to Central Bank

The courts have relied on three separate bases for implying private causes of action under the securities laws: (1) the tort law doctrine, (2) the enforcement doctrine, and (3) the Cort v. Ash criteria. Each of these rationales has, in turn, been rejected by the Supreme Court. No extrastatutory basis for implying the private Section 10(b) action currently exists.

In Kardon v. National Gypsum Co., the United States District Court for the Eastern District of Pennsylvania relied on Restatement of Torts, Section 286, to imply a private right of action under Section 10(b). Although other sections of the 1934 Act expressly provided for private causes of action, "the existence of other express remedies was insufficient to manifest an intent 'to deny a remedy and to wipe out a liability which, normally, by virtue of basic principles of tort law accompanies the doing of the prohibited act.'" Thus,
Kardon relied exclusively on tort principles to imply a private remedy under Section 10(b).

Lower courts have applied this tort law rationale as a basis for implying private causes of action under the securities laws, but the Supreme Court has followed a different approach. In J.I. Case Co. v. Borak, the Supreme Court implied a private right of action under Section 14(a) of the 1934 Act. Section 14(a) makes it unlawful for any person to obtain authorization for corporate action by means of a fraudulent proxy solicitation. The Court reasoned that private enforcement of the proxy rules provides a necessary supplement to Commission action and thus implied a private remedy under Section 14(a) to effectuate that purpose. This enforcement rationale was subsequently narrowed by the Court in Cort v. Ash. In Ash, the Court failed to find an implied private right of action under a federal election statute that imposed criminal penalties on corporations that make political contributions under certain circumstances. Restricting the enforcement rationale of Borak, the Court established a four-part test for determining whether to imply a private right of action.

The tort law rationale of Kardon and the enforcement rationale of Borak and Ash suffered from the same defect. They invited the courts to imply causes of action "without any finding that Congress intended to confer such a remedy." In the mid-1970's, the Court began to reject the idea of extrastatutory judicial rulemaking and to favor a more traditional interpretive role.

Without expressly abrogating the implied private Section 10(b) action, the Court has repudiated the tort law rationale of Kardon. In Touche Ross & Co. v. Redington, the Court declined to recognize a private right of action under Section 17(a) of the 1934 Act. The Court dismissed arguments favoring the implication of such a cause of action based upon widely accepted tort principals as "entirely misplaced." It reasoned the mere existence of a person, injured by conduct which is prohibited by statute, does not confer on that person a private right of action against the violator. Rather, the Court explained the

194. 337 U.S. at 432, 84 S. Ct. at 1560.
197. The Ash four-part test asks "(1) whether the plaintiff is part of a class for whose benefit the statute was enacted; (2) whether there is any relevant legislative intent; (3) whether the implication of a remedy is consistent with the legislative scheme; and (4) whether the cause of an action is traditionally relegated to state law." Fischel, supra note 1, at 90.
198. Id. at 91.
200. Id. at 568, 99 S. Ct. at 2485.
appropriate question for its consideration "is one of congressional intent, not one of whether this Court thinks it can improve upon the statutory scheme that Congress enacted into law." Thus, the Court expressly repudiated the tort law rationale for implying private causes. Nevertheless, in subsequent cases the Court continued to acquiesce to the private Section 10(b) action, despite its discredited origin.

In *Transamerica Mortgage Advisors v. Lewis*, the Court effectively refuted the enforcement rationale of *Borak* and *Ash* by declining to imply a private action to effectuate broad-based statutory goals. In *Transamerica*, the Court proclaimed statutory construction is the exclusive basis for finding implied remedies and not "the desirability of implying private rights of action in order to provide remedies thought to effectuate the purposes of a given statute." Thus, without demonstrated proof of congressional intent, the Court refused to imply a private remedy under Section 201 of the Investment Advisors Act of 1940.

*Touche Ross* and *Transamerica* left little room for the implication of private causes of action under the securities acts without a finding of congressional intent. Whatever latitude remained was effectively erased by *Central Bank*:

We reach the uncontroversial conclusion, accepted even by those courts recognizing a Section 10(b) aiding and abetting cause of action, that the text of the 1934 Act does not itself reach those who aid and abet a Section 10(b) violation. *Unlike those courts, however, we think that conclusion resolved the case.*

Nevertheless, in *Central Bank* itself, the Court acknowledged the continued existence of the private Section 10(b) action by stating "[t]his case concerns the most familiar private cause of action: the one we have found to be implied by Section 10(b), the general antifraud provision of the 1934 Act." Following *Central Bank*, congressional intent, as determined by statutory language and structure, is the touchstone of liability under Section 10(b). Nevertheless, the courts continue to acquiesce to the private Section 10(b) action, even though Congress never intended such an action to exist. Moreover, every rationale used by the courts to imply private actions has been refuted by the Supreme Court. The private Section 10(b) action is unsupported and should be overturned. Congress, not the judiciary, must address the need—if any—for further regulation of the securities markets.

---

201. *Id.* at 578, 99 S. Ct. at 2490.
203. *Id.* at 15, 100 S. Ct. at 245.
206. *Id.* at 1445.
Prior to 1976, judicial activism resulted in the expansion of the federal securities laws. Under the general antifraud provision of the 1934 Act, Section 10(b), the courts implied an extrastatutory private cause of action and then expanded the reach of that implied action to various secondary actors, including aiders and abettors. These actions, however, found no support in the language or history of the 1934 Act. Rather, they arose as a result of the courts' improper incorporation of common-law doctrines into the securities laws.

In 1976, with *Ernst & Ernst v. Hochfelder*, the Supreme Court began the process of reversing the unwarranted expansion of Section 10(b). In *Ernst & Ernst* and in a series of cases thereafter, the language of Section 10(b) was found to be controlling, and the scope of the Section 10(b) action was thereby narrowed. In the context of insider trading, however, the Court continued to rely on common-law doctrines to define Section 10(b)'s proscriptive reach. This inconsistency suggests the Court's decisions have been result-oriented, driven by a philosophical desire to narrow the federal securities laws even at the cost of analytical uniformity.

*Central Bank*, which abrogated the judicially implied Section 10(b) aiding and abetting action, firmly reestablishes the primacy of the statute in the interpretation of the federal securities laws. Following *Central Bank*, congressional intent, as determined by the language and structure of the 1934 Act, is the clear touchstone of liability under Section 10(b). Accordingly, Section 10(b) doctrines having extrastatutory bases are subject to attack.

In *Chiarella* and *Dirks*, the Court defined insider trading under Section 10(b) in common-law terms, premising liability for trading on material, nonpublic information on a preexisting duty to speak. Congressional intent, however, suggests this is too narrow of a definition of insider trading under Section 10(b). Congress enacted the federal securities laws in response to the perceived inadequacy of the common law to govern the modern securities markets. The 1934 Act was grounded in the belief that full disclosure in the post-issuance exchange of securities is essential for a fair and equitable marketplace. A definition of insider trading under Section 10(b) should, therefore, comport with the philosophy of full disclosure. Such a definition would include a general duty to disclose insider information before trading on it applicable to anyone in possession of such information, and not just to those having a preexisting duty to speak.

Taken to its logical extreme, *Central Bank*'s rationale calls into question the continued existence of the private Section 10(b) action itself. Wholly a creation of the judiciary, the private 10(b) action has no basis in statutory language or congressional intent. Moreover, theories previously relied upon by the courts to imply private causes of action under the federal securities laws have uniformly been rejected by the Supreme Court. Although the Court continues to acquiesce to private liability under Section 10(b), its continued existence is untenable in the
absence of additional judicial justification or, more favorably, congressional action.

In conclusion, the recognition of a general rule of disclosure under Section 10(b) and the abrogation of the judicially created Section 10(b) private action would restore analytical uniformity to the interpretation of the federal securities laws and reserve rulemaking for Congress.

John Kalmbach*

* Recipient of the Vinson & Elkins Best Student Article Award, 1995.