University of Dayton Law Review

Volume 7 | Number 1 Article 11

1981

Securities Laws: The Exclusivity of the Private Right of Action under Section 18 of the 1934 Act and Its Relationshp to Rule 10b-5

Mark Manovich
University of Dayton

SECURITIES LAWS: THE EXCLUSIVITY OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 18 OF THE 1934 ACT AND ITS RELATIONSHIP TO RULE 10b-5, *Ross v. A.H. Robins*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

INTRODUCTION

The issue resolved in *Ross v. A.H. Robins*[1] concerns the viability of an action filed under section 10(b) of the Securities Exchange Act of 1934[2] and rule 10b-5[3] when section 18[4] of the same Act contains an express civil remedy. Section 18 imposes liability for making "any statement in any . . . document filed . . . ; which statement was . . . false and misleading with respect to any material fact"[5] to one who relies upon such statement and purchases or sells securities at a price affected by the statement. Section 10(b) and rule 10b-5 make it "unlawful for any person, . . . to make any untrue statement of a material fact or to omit to state a material fact . . . in connection with the purchase or sale of any security."[6]

---

1. 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).
2. 15 U.S.C. § 78j(b) (1976).
3. 17 C.F.R. § 240.10b-5 (1979).
4. 15 U.S.C. § 78r (1976).
5. Section 18 states:

Liability for misleading statements

(a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, which statement was at the time in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that the statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suits, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

(b) Every person who becomes liable to make payment under this section may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment.

(c) No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued.

6. Section 10b states:

Manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any

To decide this issue the Second Circuit Court of Appeals first examined the legislative history of the 1933 and 1934 Securities Exchange Acts. The court also examined the differences between the two sections to determine the exclusivity of section 18. The court concluded that section 18 did not provide an exclusive remedy. Thus section 10(b) and rule 10b-5 could be used. Finally, the court examined rule 9(b)[7] of the Federal Rules of Civil Procedure to determine the sufficiency of the pleadings of the plaintiffs.

Facts and Holdings

Defendant A.H. Robins is a pharmaceutical company. Other named defendants in the suit were directors and/or officers of the company.[8] In its 1970 and 1971 annual reports, Robins released information about a new intrauterine birth control device it had developed, the Dalkon Shield.[9] The annual reports and press releases issued by the company in 1973 and 1974 stated that the device was safe and effective. These company reports were enthusiastic about the effect its marketing would have on the company.[10] In July 1973, plaintiffs Kalman and Anita Ross bought 100 shares of A.H. Robins stock. In May of the following year "information about the serious medical problems which were resulting from the use of the Dalkon Shield began to be disclosed to the public."[11] Problems with the Shield included septic abortions and other severe complications. Over 500 pro-

---

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 Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operate or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

7. FED. R. CIV. P. 9(b). *See* note 19 *infra*.

8. 607 F.2d at 547.

9. *Id.* at 548.

10. *Id.* at 550.

11. *Id.* As of September 1980, the number of product liability suits pending against Robins was 4,460. Dayton Journal Herald, Sept. 28, 1980, at 28, col. 1.

duct liability suits were instituted and the value of Robins stock dropped from $19 to $13 per share.[12]

The plaintiffs instituted a class action suit on March 23, 1977. This complaint was dismissed but leave was given to amend. The June 1, 1978 amended complaint, which was also dismissed by the district court, was the subject of this appeal.[13] According to the appellate court:

> The gravamen of the complaint is that the defendants manipulated and artificially inflated the market price of Robins' common stock by disseminating false and misleading information about the effectiveness and safety of the Dalkon Shield, . . . and by failing to reveal information which indicated that the shield was less effective and more dangerous than the company's earlier public statements had indicated.[14]

In the complaint, the plaintiffs alleged that the defendants "knew or recklessly disregarded the fact that there were serious questions as to the safety and efficiency of the Dalkon Shield."[15] This claim as based on information contained in an unpublished study that indicated the Shield was not as effective in preventing pregnancies as Robins had claimed and that severe complications were possible.[16] Because of misstatements in 10-k forms, press releases, and Annual Reports, prices were inflated when plaintiffs bought their stock.

At the district level the court considered whether to allow a suit under section 10(b) of the Securities Exchange Act of 1934 when section 18 of the same act provided a civil remedy. A question of the sufficiency of the complaint was also presented.[17] After analyzing both sections the court concluded that section 18 provided the exclusive civil remedy for material misstatements and omissions contained in documents filed with the Securities Exchange Commission.[18]

On the procedural issue the district court concluded that the complaint did not meet the "particularity" requirement of the Federal

---

12. 607 F.2d at 547 n.1.
13. *Id.* at 547.
14. *Id.* at 548 n. 5.
15. *Id.* at 548.
16. *Id.* The plaintiffs based their claim that defendant knew or recklessly disregarded on the unpublished study of Mary Gabrielson, set out in full in a footnote to the court's opinion. Some of the information contained in Gabrielson's report included the findings that; (1) pregnancy rates were higher than claimed by Robins; (2) the removal of the Shield caused more pain, infections and bleeding than the 1970 annual report stated; (3) there were no studies conducted longer than 5.5 months on the Shield.
17. 465 F. Supp. 904 (S.D.N.Y. 1979).
18. *Id.* at 913.

Rules of Civil Procedure 9(b).[19] Two pleading deficiencies were found. First, the complaint failed to state the time at which defendants allegedly knew or recklessly disregarded the undisclosed information.[20] Second, the complaint did not set forth "the circumstances which lead [plaintiffs] to believe that the defendants knew or recklessly disregarded the information contained in the 1972 study prior to their own purchase of Robins common stock."[21] The complaint was dismissed with prejudice because the plaintiffs had already been given an opportunity to amend.

On appeal, the case was reversed and remanded by the Second Circuit of Appeals. The appellate court questioned "whether allowing invocation of the section 10(b) remedy would impermissibly nullify the limitations and requirements inherent in section 18."[22] It held that "section 18 did not provide an exclusive remedy and that plaintiffs could proceed under section 10(b) and rule 10b-5."[23] While the court upheld the lower court's decision regarding pleading deficiencies, it chose to allow the plaintiffs another opportunity to amend, rather than foreclose a possibly successful claim.

Rationale For Holding

A. History and Analysis of sections 10(b) and 18

The court's holding in *Ross v. A.H. Robins* turned upon its interpretations of sections 10(b), 18 and rule 10b-5. To analyze these sections the court examined the legislative histories of the Securities Exchange Acts of 1933 and 1934. Two of the objectives of the 1933 Act were "to protect investors by requiring adequate and accurate diclosure . . . and to outlaw fraud in the sale of all securities."[24] The 1934 Act was designed to prohibit market manipulation, to regulate exchanges, and to regulate trading in over-the-counter-deals.[25] The main objective of the 1934 Act is to change the doctrine of *caveat emptor* in favor of a policy of full disclosure. Therefore, these acts should be in-

19. FED. R. CIV. P. 9(b) states: "(b) Fraud, Mistake, Condition of the Mind. In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

20. 465 F. Supp. at 909.

21. *Id.*

22. 607 F.2d at 553.

23. *Id.* at 556.

24. Gadsby, *Historical Development of the SEC - The Government View*, 28 GEO. WASH. L. REV. 7,9 (1959).

25. *Id.* at 10. *See also* Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 GEO. WASH. L. REV. 214, 217 (1959).

terpreted broadly to achieve their purpose of preventing fraud.[26] Furthermore, the two acts are to be read *in pari materia.*[27]

Section 10(b) gives the Securities and Exchange Commission power to promulgate rules and regulations as the need arises. In 1942 the Securities and Exchange Commission promulgated rule 10b-5 pursuant to its power under section 10(b).[28] Neither section 10(b) nor rule 10b-5 provides for a private right of action.[29] Nevertheless, in *Kardon v. National Gypsum Co.*[30], a private right of action was implied from section 10(b) and rule 10b-5. This implied right has never been rejected by the Supreme Court and was explicitly accepted by it in *Blue Chip Stamps v. Manor Drug Store.*[31]

It appears that before the mid-seventies the use of rule 10b-5 was allowed to cover acts expressly prohibited by another section.[32] With the Supreme Court decisions of *Blue Chip Stamps* and *Ernst & Ernst v. Hochfelder,*[33] a new trend emerged in which the Court limited the expansion of securities liabilities. In *Ernst* the Supreme Court noted that the availability of a rule 10b-5 action when an exclusive remedy was provided had not yet been decided.[34] District courts in Michigan,

26. Seiden v. Nicholson, 69 F.R.D. 681, 686 (N.D. Ill. 1976).

27. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976). For further examination of the legislative histories and purposes of the Securities Exchange Acts of 1933 and 1934 *see* K. BIALKIN, THE 10B SERIES OF RULES (1975); A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD (1979) [hereinafter cited as SECURITIES FRAUD AND COMMODITIES FRAUD]; 3 L. LOSS, SECURITIES REGULATION (2d ed. 1961).

28. *See* note 6 *supra.* Section 10(b) allows "such rules and regulations as the Commission may prescribe as necessary or appropriate. . . ." 15 U.S.C. § 78j(b) (1976).

29. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). The court stated that there wasn't any indication that either Congress or the Commission had considered the possibility of private suits arising under these sections. *See generally* SECURITIES FRAUD AND COMMODITIES FRAUD, note 27 *supra.*

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

31. 421 U.S. 723, 730 (1975).

32. 1 SECURITIES FRAUD AND COMMODITIES FRAUD, *supra* note 27, § 2.4 at 401. *See also* Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964).

Another trend of importance was the one which allowed section 10(b) actions when the defendant's conduct was only negligent, 22 VAND. L. REV. 359, 367 (1969). *See also Plaintiff's Duty of Care After Ernst & Ernst v. Hochfelder,* 73 Nw. U.L. REV. 158 (1978), which stated that the emerging tend toward loosening the standard of care was abruptly halted by *Ernst.*

33. 425 U.S. 185 (1976); 1 SECURITIES FRAUD AND COMMODITIES FRAUD, *supra* note 27, § 2.4 at 384.2. *See also* 607 F.2d at 554.

34. 1 SECURITIES FRAUD AND COMMODITIES FRAUD, *supra* note 27, § 2.4 at 384.5. *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). Footnote 31 in *Ernst* states that "we need not consider the question whether a cause of action may be maintained under section 10(b) on the basis of actions that would constitute a violation of section 18." *See also* 1 SECURITIES FRAUD AND COMMODITIES FRAUD, *supra* note 27, § 2.4 at 384.5.

Washington, D.C., and Texas have construed the Court's dictum to mean that there is no implied right of action under 10b-5 when a suit can be brought under section 18.[35]

From the recent Supreme Court decisions *Touche Ross v. Redington,*[36] *Ernst & Ernst,* and *Blue Chip Stamps*, the argument can be made "that section 10(b) could be viewed as a 'catch-all' provision intended to prevent the use of manipulative and deceptive devices not proscribed by other provisions of the Act."[37] Although *Ernst* did not reach the issue presented by *Ross*, the court implied that section 10(b) could not be so broadly used.[38] The Second Circuit in *Ross*, however, decided that rule 10b-5 required substantially different proof than was necessary under section 18. Because of these differences, the court held plaintiffs should be allowed to proceed under section 10(b) and rule 10b-5.[39]

In *Ross*, the court decided that the history of the statute was not determinative of the issue. The cases concerning the implied right of action under rule 10b-5 were held inapplicable because the court was not considering a new implied right.[40] The real issue, according to the

---

35. *Id. See also* Kulchok v. Government Employees Ins. Co., [1977-1978] FED. SEC. L. REP. CCH ¶ 96,602 (D.D.C. 1977); and Note, *Exclusivity of Express Remedy Under Section 18(a) of the Securities Exchange Act of 1934,* 46 GEO. WASH. L. REV. 845 (1978) [hereinafter cited as *Exclusivity of Express Remedy*]. *See also* note 62 *supra.*

36. 442 U.S. 560 (1979).

37. 607 F.2d at 554.

38. *Id.* at 551. *See* note 34 *supra.*

39. *Id.* at 555.

40. *Id.* at 553. The court disregarded the defendants' argument that the case was controlled by Nat'l R.R. Passenger Corp. v. National Ass'n of R.R. Passengers, 414 U.S. 453 (1974) (holding that the exclusive remedies under one section of the Rail Passenger Service Act of 1970, 45 U.S.C. § 501 (1970) precluded the finding of an implied cause of action).

The *Ross* court also disregarded the case the plaintiff considered to be controlling, Cort v. Ash, 422 U.S. 66 (1975). The court in *Cort* stated four principles to be used to determine when to imply a private right of action under a federal statute. The four questions which must be asked are:

1. Does the statute create a federal right in favor of the plaintiff?
2. Is there any indication of legislative intent to create or deny such a remedy?
3. Is it consistent with the underlying scheme of the legislation to imply such a remedy?
4. Is the cause of action one traditionally relegated to state law? 422 U.S. at 78.

In *Ross* these questions were not considered because the court decided that it was not implying a private right of action, but rather was determining if an already established implied right could be used where an exclusive remedy was also provided. 607 F.2d at 553.

In *Exclusivity of Express Remedy, supra* note 35, the author examined the exclusivity of section 18 in light of the four questions presented in *Cort*. The conclusion reached is that the second, third, and fourth questions all fail to pass the test and that section 18 should be the exclusive remedy for misstatements or omission contained in documents filed with the SEC. *Id.* at 858-60.

Ross court, was whether a plaintiff could use rule 10b-5 when section 18 provided express civil remedies for misstatements or omissions contained in documents filed with the SEC. The court next examined one of its previous decisions, *Fischman v. Raytheon.*[41] *Fischman* involved analysis of a conflict between section 11 and section 10(b) to decide whether there was a rationale for allowing a 10b-5 action when an express civil remedy was provided in another section.[42]

The court in *Ross* relied heavily on its holding in *Fischman.* In *Fischman*, preferred and common stockholders were trying to sue the company under section 11 of the Securities Act of 1933. The common stockholders, however, did not have a claim, since they had not purchased securities discussed in the prospectus and registration statement at issue. Thus the district court in *Fischman* held that the common stockholders could not sue under section 10(b). This holding was reversed in a decision at the appellate level, which held section 11 did not require proof of fraud while rule 10b-5 did.[43] Therefore, the court reasoned that Congress intended that section 10(b) be used by victims of fraud. The court indicated that the presence of fraud activates section 10(b), regardless of whether the action could be maintained under section 11.[44]

The integral finding for the court in *Ross*, to allow the activation of section 10(b) and rule 10b-5, would be that element of fraud plus a finding that the burden of proof would be heavier under section 10(b) than section 18. This finding would negate the need for the reliance requirements of section 18.[45]

It is necessary to distinguish proving a *prima facie* case under section 10(b) and rule 10b-5 from proceeding under section 18. Section 18 requires that a plaintiff establish knowledge of and reliance upon the alleged misstatements contained in any document filed with the SEC.[46] The defendant in a section 18 action can avoid liability if he can "prove that he acted in good faith and had no knowledge that such statement was false or misleading."[47] Section 18 is also limited by the procedural requirements that suit be filed within the statute of limitations and that a discretionary bond for reasonable costs of the suit be posted.[48]

41. 188 F.2d 783 (2d Cir. 1951).
42. *Id.* at 785. *See also* 607 F.2d at 555.
43. 188 F.2d at 785.
44. *Id.* at 786.
45. 607 F.2d at 555.
46. *Id.* at 552. *See also* 4 SECURITIES FRAUD AND COMMODITIES FRAUD, *supra* note 27, § 8.4 at 204.97. *See* note 2 *supra.*
47. 15 U.S.C. § 78r (1976); *see* note 5 *supra.*
48. *Id.*

Pleading requirements under section 10(b) and rule 10b-5 are different from those under section 18. Reliance under section 10(b) may be "presumed once the materiality of an omission is established, . . . or the material misrepresentation affected the price of stock traded on the open market."[49] Section 10(b) has no bond requirement and its statute of limitations varies with governing state law. To the court, the most important difference was the scienter requirement in proving and pleading a section 10(b) violation. The court noted that *Ernst & Ernst* established the need to prove that a defendant acted with scienter to sustain a section 10(b) action. Like the Supreme Court in *Ernst & Ernst*,[51] the appellate court failed to define "scienter."

In *Ross* the court held that the difference in the burdens facing the plaintiff under section 10(b) as compared with section 18 was critical. Because of the greater burden with the former, the court dispensed with the reliance requirement. Under section 10(b) the burden of proving scienter is on the plaintiff, while under section 18 the burden is upon the defendant to prove "good faith or no knowledge."[52] According to the court, "the far more difficult task which confronts a plain-

---

49. 607 F.2d at 553 (citations and footnotes omitted).

50. 425 U.S. 185 (1976).

51. *Id.* at 193. Footnote 12 is as follows:

> In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. *In certain areas of the law recklessness is considered* to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under section 10(b) and rule 10b-5.

Id. n.12 (emphasis added). However, the dissent of Justice Blackmun stated that the Congressional intent to provide a remedy to investors should be construed to extend 10b-5 liability to cover negligent activity. *Id.* at 215-17.

See also Bucklo, *The Supreme Court Attempts to Define Scienter under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213 (1977).

In this article Bucklo states that "[s]cienter is a many faceted concept, . . . ranging from intention to deceive, to knowledge of undisclosed facts, *to a reckless failure to acquire* knowledge of the true facts. . . .[T]he court failed to state explicitly whether scienter is present even when knowledge is shown but when there is no proof of an intent to deceive." *Id.* at 214 (footnotes omitted, emphasis added).

With the above quotes in mind, consider the implications of the following. Suppose that somewhere in Robins' files a copy of Mary Gabrielson's study is discovered. Has a *prima facie* case been made? Is the good faith defense still open to the defendant? Is the necessary scienter present since knowledge is shown although there is no showing of defendant's intent to deceive? These questions become even more difficult to answer in this case because of the area involved. Common experiences in past years have shown the danger of placing drugs and devices on the market without adequate testing. The thalidomide problem in the early sixties and the toxic shock syndrome of the late seventies are two well-known examples of what can occur. For a definition of recklessness, *see* W. PROSSER, THE LAW OF TORTS 184 (4th ed. 1971).

52. 607 F.2d at 556. *See* note 5 *supra*.

tiff seeking to proceed under section 10(b) provides a rationale for dispensing with the reliance requirement inherent in section 18."[53]

The court in *Ross* failed to explain the meaning or importance of the procedural differences between section 10(b) and section 18. Although the court called these differences "significant,"[54] it gave no explanation why they were not given further consideration. Perhaps the court's decision on the scienter burden issue was enough to override any concern it may have had with the procedural differences between the two statutes.[55] The court in *Ross* presented several reasons why the plaintiff could proceed under section 10(b). First was its view that a plaintiff who had to plead and prove scienter had a more difficult problem than one who had only to plead reliance and material misrepresentation.[56]

Second, the court said that to hold "conduct is not proscribed by section 10(b) merely because it is also subject to section 18 would effectively deprive open market investors who relied on misleading market information of any remedy simply because the misinformation happened to be lodged in a form filed with the SEC."[57] In the appellate court's view, "even if plaintiffs were able to prove the defendant's wrongdoing, under the district court's view that section 18 provides the exclusive basis of liability for misstatements contained in filed reports, they would be left without a remedy."[58]

The court in *Ross* also stated that, given the intention to use 10b-5 to aid open market investors, an incongruous result would be reached if an investor's remedy would be closed out simply because the documents were filed with the SEC.[59] Another justification given by the court was that "no rational purpose . . . would be furthered by creating a structure where liability for material misrepresentation adversely affecting investors would vary tremendously depending upon

53. 607 F.2d at 556.

54. *Id.* at 553 n.16.

55. *Id.* at 556; *see* text accompanying note 46 *supra; see also* text accompanying notes 56-61 *infra.*

56. 607 F.2d at 556.

57. *Id. But see* SECURITIES FRAUD AND COMMODITIES FRAUD, *supra* note 27, where Bromberg stated that few people actually see or rely on the documents filed pursuant to the 1934 Act. 4 SECURITIES FRAUD AND COMMODITIES FRAUD, *supra* note 27, § 8.4 at 204.96-97.

As long as 10b-5 can be used for investors who rely on press releases or such containing material misstatements or omissions, valid claims will not be closed out. *See* Pearlstein v. Justice Mortgage Investors, [current] FED. SEC. L. REP (CCH) ¶ 96,760 (N.D. Tex. 1978). *See* note 73 *infra.*

58. 607 F.2d at 553.

59. *Id.* at 556.

whether the statement happened to be filed with the SEC."[60] Finally the court said that its holding would discourage corporate managers from including "their misrepresentations in material filed with the SEC., for the sole purpose of insulating themselves from liability under section 10(b) and restricting the class of potential plaintiffs to the unlikely few who actually viewed and relied on the misleading information."[61] These justifications will be discussed in light of an opposite holding.

This issue of the exclusivity of section 18 has not been addressed recently by any other appellate court. District courts have answered the question both ways.[62] The most extensive and well reasoned opinion presenting a view opposite *Ross* is *Pearlstein v. Justice Mortgage Investors.*[63] In *Pearlstein* the plaintiff brought a class action under 10(b) and rule 10b-5.[64] Plaintiff alleged that material misrepresentations were made and material facts omitted by defendant in various annual reports, press releases, and reports filed with the SEC.[65] According to this court, before *Ernst & Ernst*, implied actions were permitted under section 10(b) even though the action could be brought under section 18.[66]

In *Pearlstein*, the court analyzed the differences between section 10(b) and section 18. In its opinion the burden of proving scienter had little importance.[67] According to the court, "[a]part from the burden of proof, the scienter requirement for the causes of action under the two sections are essentially the same."[68] Next the *Pearlstein* court ex-

60. *Id.*
61. *Id.*
62. Cases holding that section 18 was not the exclusive remedy include Wachovia Bank and Trust Co. v. National Student Marketing Corp., 461 F.Supp. 999 (D.D.C. 1978); Seiden v. Nicholson, 69 F.R.D. 681 (N.D. Ill. 1976); Fischer v. Kletz 266 F. Supp. 180 (S.D.N.Y. 1967); Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964); Heit v. Weitzen, 402 F.2d 909 (2d Cir.), *cert. denied*, 395 U.S. 903 (1968) (impliedly allowed 10b-5 though not stated by court); Rekant v. Desser, 425 F.2d 872 (5th Cir. 1972) (10b-5 action allowed when one annual report was misleading and the next one was late.)

The following cases have held that section 18 provides the exclusive remedy: McKee v. Federals Inc., [1979] FED. SEC. L. REP. (CCH) ¶ 96,958 (E.D. Mich. 1979); Pearlstein v. Justice Mortgage Investors, [1979] FED. SEC. L. REP. (CCH) ¶ 96,760 (N.D. Tex. 1978); Berman v. Richford Indus., Inc., [1978] FED. SEC. L. REP. (CCH) ¶ 96,518 (S.D.N.Y. 1978); Kulchok v. Government Employees Ins. Co., [1977-1978] FED. SEC. L. REP. (CCH) ¶ 96,002 (D.D.C. 1977).
63. [1979] FED. SEC. L. REP (CCH) ¶ 96,760 at 84,474 (N.D.Tex. 1978).
64. *Id.* at 84,475.
65. *Id.*
66. *Id.*
67. *Id.* at 84,477.
68. *Id.*

amined the reliance, causation, and materiality standards of each statute. The court held that in each of these areas the requirements of proof under section 18 are "no less difficult than proving a similar action under section 10(b)."[69]

Having reached this conclusion, directly opposite from the one reached in *Ross*, the court held that in actions concerning misstatements or omissions in documents filed with the SEC, plaintiffs must proceed under section 18.[70] The rationale for this holding was that "the plaintiff should not be allowed to avoid the procedural requirements of section 18, when no greater obligation is imposed upon him by the implied action of section 10(b)."[71] The court said that if given the choice most plaintiffs would proceed under section 10(b), thereby eliminating any need for section 18.[72]

One could argue that plaintiffs should be allowed to proceed under 10b-5 in view of the broad intent of Congress to prevent fraud and allow investors remedies. On the other hand a more restrictive view could be taken that allowing plaintiffs recovery under 10b-5 would virtually eliminate any need for section 18. The *Ross* court's holding would be justifiable if its rationale concerning the consequences were proven true. If corporate directors filed documents with the SEC simply to avoid 10(b)-5 liability, then a 10b-5 action should be permitted. At this time, however, the court's rationale appears to be unjustified.[73] As long as information contained in documents both filed and not filed with the SEC can be the basis of 10b-5 action, no possibly meritorious plaintiff will be closed out.[74] There is no support for the claim that Congressional intent was that section 10(b) should provide relief regardless of whether an expressed remedy was already provided.[75] If evidence showing companies deliberately file all

69. *Id.*
70. *Id.*
71. *Id.*
72. *Id.*
73. The court in *Pearlstein* also addressed and answered a question foreclosed by the decision in *Ross*. The question deals with the breadth and scope of section 18. [1979] FED. SEC. L. REP. (CCH) ¶ 96,760 at 84,477 (N.D. Tex 1978). Should material in press releases (or any other document not filed with the SEC) come under section 18 if the material in those releases is similar or identical to documents filed with the SEC? The court decided that section 18 should not "be extended to cover these unfiled documents, especially in light of a number of decisions which have held that reliance on the actual filed document is required under that section." *Id.* The court allowed the plaintiffs' 10(b) action based on the quarterly reports and press releases to continue.
74. *Id.*
75. *See* note 21. *See also Exclusivity of Express Remedy, supra* note 35, at 850-52 in which the statutory tort theory and the statutory voidability theory are used to explain the implied 10b-5 remedy. Briefly, the statutory tort theory is that a statute

documents containing material misstatements and omissions to avoid responsibility becomes available, the legislature will be able to intervene and either eliminate section 18 or expand the scope of rule 10b-5 to cover the acts in question.

Finally, the current trend of Supreme Court decision, is to restrict the availability of rule 10b-5 actions. Although the Court has not directly answered the question whether section 18 provides the exclusive remedy, indications are that it would not view favorably further expansion of rule 10b-5. By denying certiorari in the *Ross* case, however, the Court has postponed deciding the issue. Because use of section 18 is not extensive, the opportunity for the Court to decide this issue may be far in the future.

B. Pleading Requirements under Fed. Rule Civ. Pro. 9(b)

After allowing the action to be brought under section 10(b) the *Ross* court examined the pleadings to determine whether the lower court's dismissal of the complaint was proper. The appellate court reversed the dismissal, giving plaintiffs a final opportunity to amend, even though the pleadings were deficient.

According to Fed. Rule Civ. Pro. 9(b), when a plaintiff pleads "all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity."[76] This does not mean that 9(b) pleadings must be long or complex. "Rule 9(b) must be read in the light of rule 8(b). While fraud must be particularized, the allegations must still be short, plain, simple, concise, and direct as is reasonable under the circumstances."[77]

The *Ross* court considered the pleading requirement's policies of notice and protection of defendants from spurious claims. It held the pleadings were deficient in four respects.[78] The court stated "[a] defen-

---

describes standard of conduct established by the legislation. *See* W. PROSSER, THE LAW OF TORTS 190-204 (4th ed. 1971). Since investors were the class of people to be protected by section 10(b), violation of that statute should allow them some remedy.

The statutory voidability theory is based upon section 29(b) of the 1934 Act. That section voids every contract made in violation of any provision of the Act. "[S]ection 29(b) supports a broad private remedy under rule 10b-5 by reasoning that any fraudulent purchase or sale of a security rests on a contract violative of rule 10b-5 and that section 29(b) would be ineffective unless the innocent party to the void contract could apply to the courts for a remedy." *Exclusivity of Express Remedy, supra* note 35, at 851.

The court in *Ross* considered neither of these theories because it was not implying a new remedy.

76. C. WRIGHT, HANDBOOK OF THE LAW OF FEDERAL COURTS, 326 (3d ed. 1976). *See also* note 13 *supra*.

77. *Id.*

78. 607 F.2d at 557.

dant is entitled to a reasonable opportunity to answer the complaint and must be given adequate information to frame a response."[79]

The first of the deficiencies concerned the circumstances that would give rise to fraud. The court in *Ross* held the complaint failed to plead how defendants knew or recklessly disregarded the question of the safety and efficiency of the Dalkon Shield. Plaintiffs gave no indication defendants had knowledge of the Shield's inefficiency.[80]

A second deficiency was the failure to specify when defendants came into the possession of information indicating inefficiency of the Shield.[81] Only if the defendants acquired this knowledge, and hence a duty to disclose it, before the plaintiffs bought Robins stock would the plaintiffs be proper class representatives.

The court held that "[i]t is reasonable to require that the plaintiffs specifically plead those events which they assert give rise to a strong inference that the defendants had knowledge of the facts contained in paragraph 18 dealing with Mary Gabrielson's report of the complaint or recklessly disregarded their existence."[82] Plaintiffs do not have to plead defendant's actual knowledge.[83]

Finally, by failing to specify the time period in which the stock fell from $19 to $13 per share the plaintiffs made it impossible to determine if any loss has been suffered.[84] Because the Federal rules were designed to deemphasize the pleadings and encourage litigation to reach the claims, the court allowed the plaintiffs a final opportunity to conform their pleadings.[85]

CONCLUSION

The court's decision follows a trend which saw the growth of private actions under 10b-5 to become "a judicial oak which has grown from little more than a legislative acorn."[86] This expansion has been limited in the 1970's by the Supreme Court's decisions in *Ernst & Ernst, Blue Chip Stamps* and *Touche Ross*.[87]

Legislative history is sparse concerning the intent and reach of 10b-5. Strong policy reasons exist for both allowing and disallowing a 10b-5 action when section 18 provides an exclusive remedy. An action

79. *Id.* at 557-58.
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.* at 559.
85. *Id.* at 557. *See* text accompanying note 76 *supra*.
86. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).
87. *See* text accompanying notes 35-39 *supra*.

should be allowed if the remedial aspect of the 1934 Act is considered most important. If the courts decide that less judicial and more legislative activity is needed to clarify the situation, then section 18 should be the exclusive remedy.

The court in *Ross* decided that because the element of fraud was present and the burden of proof was heavier under 10b-5 than under section 18, plaintiff should be allowed to proceed under section 10(b). It should be noted, however, that the emerging trend today is to narrow the scope of actions possible under section 10(b). Consistent with this trend, some district courts are resolving the issue presented in *Ross* in the opposite manner.[88]

Mark Manovich

88. *See* text accompanying note 62 *supra*.