

# THE SUPREME COURT, RULE 10B-5 AND THE FEDERALIZATION OF CORPORATE LAW

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## INTRODUCTION

Beginning in 1975, the U.S. Supreme Court decided a series of cases that effectively limited the reach of Rule 10b-5 of the Securities Exchange Act of 1934,<sup>1</sup> the principal antifraud provision under the federal securities laws.<sup>2</sup> The Court did this either directly, by narrowly interpreting Rule 10b-5 and section

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1. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994) (holding that there is no basis for aider and abettor liability under Rule 10b-5); *Dirks v. SEC*, 463 U.S. 646, 665 (1983) (holding that an analyst who passed along material nonpublic information about a public company to his clients did not violate Rule 10b-5 because he did not receive the information from someone who breached his fiduciary duty to the public company); *Marine Bank v. Weaver*, 455 U.S. 551, 555 (1982) (holding that neither a bank certificate of deposit nor a private profit sharing arrangement was a security); *Chiarella v. United States*, 445 U.S. 222, 235 (1980) (purchasing securities based on nonpublic information does not violate Rule 10b-5 because the purchaser had no common law duty of disclosure to the sellers); *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 570 (1979) (finding that a noncontributory, compulsory pension plan is not an investment contract and therefore not a security); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 475-76 (1977) (ruling that breach of fiduciary duty cannot be the basis for a claim under Rule 10b-5; the plaintiff must allege and prove that the defendant engaged in manipulative or deceptive conduct to state a claim under the Rule); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) (holding that negligence cannot be the basis for an action under Rule 10b-5 and that the plaintiff must allege and prove scienter); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975) (finding that only purchasers and sellers of securities have standing to maintain a private cause of action for damages under Rule 10b-5 and that mere offerees do not); *see also* *Gustafson v. Alloyd Co.*, 513 U.S. 561, 584 (1995) (holding that the remedy under section 12(a)(2) of the Securities Act of 1933 is limited to purchasers of securities in a public offering by an issuer or a controlling shareholder of the issuer).

2. 17 C.F.R. § 240.10b-5 (1998). The Rule provides:

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 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.

10(b),<sup>3</sup> on which the Rule is based, or by interpreting the definition of “security” narrowly.<sup>4</sup> In either case, the Court’s apparent intent was to limit the reach of the Rule. In *Blue Chip Stamps v. Manor Drug Stores*,<sup>5</sup> the Court held that a private cause of action under the Rule was available only to purchasers and sellers of securities.<sup>6</sup> Offerees who alleged that they were dissuaded from purchasing stock by an intentionally misleading prospectus thus lacked standing to maintain an action. Although there was support for the plaintiffs’ position, the Court opted for a narrow reading by citing the threat of “vexatious litigation.”<sup>7</sup>

The Court’s skepticism of litigation under Rule 10b-5 was evident in several other prominent decisions,<sup>8</sup> culminating in its 1994 decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*<sup>9</sup> There, the Court denied a cause of action under the Rule against alleged aiders and abettors of a primary violator of the Rule.<sup>10</sup> This decision was particularly striking because the issue had not been raised by the defendant/petitioner in its initial appeal of an unfavorable ruling below on other issues; rather, the Court directed the parties to brief this issue in its grant of certiorari.<sup>11</sup> The Court’s decision was also striking because the lower federal courts had consistently recognized an implied right of action under Rule 10b-5 against aiders and abettors.<sup>12</sup> The Court in *Central Bank* seemed to be intent on continuing to rein in Rule 10b-5 private actions. One theme common to several of these cases, and especially prominent in the 1977 decision of *Santa Fe Industries, Inc. v. Green*,<sup>13</sup> was a recognition of the possible role of state law in providing a remedy for the plaintiff. Even in the absence of an express recognition of a role for the states, these decisions had the effect of curbing national power, recognizing a limit to the growth of the “oak”

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3. 15 U.S.C. § 78j(b) (2000).

4. See cases cited *supra* note 1.

5. 421 U.S. 723 (1975).

6. *Id.* at 754-55.

7. *Id.* at 724. The Court reversed a contrary holding of the Ninth Circuit Court of Appeals, *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136 (9th Cir. 1973), *rev'd*, 421 U.S. 723 (1975), and drew a stinging dissent from three Justices. *Blue Chip Stamps*, 421 U.S. at 762 (Blackmun, J., dissenting) (“[T]he Court exhibits a preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping, it seems to me, with our own traditions and the intent of the securities laws.”).

8. See cases cited *supra* note 1.

9. 511 U.S. 164 (1994).

10. *Id.* at 191.

11. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 508 U.S. 959 (1993).

12. *Cent. Bank*, 511 U.S. at 192 (Stevens, J., dissenting) (“In *hundreds* of judicial and administrative proceedings in every Circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under § 10(b) and Rule 10b-5.”) (referring to 5B A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 40.02 (rev. ed. 1993)).

13. 430 U.S. 462, 478 (1977).

tree that litigation under the Rule had become.<sup>14</sup>

The tendency to be stingy in anti-fraud cases was also evident in another strain of Rule 10b-5 cases—the insider trader cases. In *Chiarella v. United States*<sup>15</sup> and *Dirks v. SEC*,<sup>16</sup> the state law of fiduciary duty played a prominent role in the Court's decision to reject claims that the defendants in those cases engaged in insider trading in violation of Rule 10b-5. Not everyone in possession of material, nonpublic information was prohibited from trading on or selectively disclosing that information.<sup>17</sup> Only those who breached a fiduciary duty by trading on the information, or those who received the information from someone who breached a fiduciary duty, could violate the Rule.

Although this twenty-year history of jurisprudence was not without exceptions,<sup>18</sup> the thrust of the Court's jurisprudence seemed undeniable. As the 1990s drew to a close, however, the Court seemed to adopt a different tack. In the four most recent cases that it has decided under Rule 10b-5 and the federal securities laws, the Court has expanded the reach of both. Even though each of the decisions is defensible on its own terms, the cases taken together appear to reject the philosophy of the Court's earlier decisions. In the sole case involving a private action for damages, *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*,<sup>19</sup> the plaintiff had a well-established, common law remedy against the defendant, yet the Court upheld the claim under the Rule.<sup>20</sup> In two SEC enforcement actions, *SEC v. Edwards*<sup>21</sup> and *SEC v. Zandford*,<sup>22</sup> the Court upheld the Commission's use of the Rule by giving a liberal reading to two different sections of the Exchange Act. Similarly, in *United States v. O'Hagan*,<sup>23</sup> the Court upheld a criminal conviction under a broad reading of the Rule.<sup>24</sup> With the exception of the *O'Hagan* case, which has drawn a significant amount of

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14. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) (“When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn.”).

15. 445 U.S. 222, 235 (1980).

16. 463 U.S. 646, 655 (1983).

17. See *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 843 (2d Cir. 1968) (holding that anyone who trades on the basis of material, nonpublic information violates Rule 10b-5). *But see Chiarella*, 445 U.S. at 225 (purchasing securities based on nonpublic information does not violate Rule 10b-5 because the purchaser had no common law duty of disclosure to the sellers).

18. See, e.g., *Reves v. Ernst & Young*, 494 U.S. 56, 73 (1990) (holding that demand notes issued by farmer's cooperative are securities); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-87 (1983) (finding a remedy available under Rule 10b-5 despite availability of a remedy under section 11 of the Securities Act of 1933).

19. 532 U.S. 588 (2001).

20. *Id.* at 595-97.

21. 540 U.S. 389, 397 (2004).

22. 535 U.S. 813, 825 (2002).

23. 521 U.S. 642 (1997).

24. *Id.* at 667.

scholarly comment,<sup>25</sup> these decisions have gone largely unnoticed.

Scholars and other court observers who have postulated about the “new federalism” in the Supreme Court—the notion that the Court has a new-found respect for the role of state law in our federal system—would be well advised to consider these securities laws cases. These cases signal a different judicial philosophy. This philosophy is not only at odds with a few high-profile decisions under the Commerce Clause<sup>26</sup> and the Tenth Amendment,<sup>27</sup> but it is also at odds with earlier decisions of the Court in the area of securities law. Indeed, a cynic might consider the new federalism cases to be an anomaly, with the reality being that the Court is still as nationalistic in its approach as it traditionally has been. If the securities laws cases discussed in this Article are any indication, the Court is becoming even more nationalistic.<sup>28</sup>

This Article examines Supreme Court jurisprudence since 1997 under the federal securities laws, particularly Rule 10b-5, in light of the Court’s earlier decisions and its recent decisions construing the Constitution and federal statutes as they relate to the regulation of business. Part I considers the Court’s earlier decisions under the federal securities laws, which stand in contrast to the more recent decisions (*O’Hagan*, *Wharf*, *Zandford*, and *Edwards*) discussed in Part II. Part III then considers developments beyond the Supreme Court’s Rule 10b-5 jurisprudence and places those developments in the context of the Court’s tendency to prefer national solutions to a wide variety of problems, thereby directly or indirectly preempting state law. The cases in Part III present the question of federal-state relations or the role of federalism on our legal landscape. Although in general this topic does not beg for further scholarly

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25. See, e.g., Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589 (1999); Richard W. Painter et al., *Don’t Ask, Just Tell: Insider Trading After United States v. O’Hagan*, 84 VA. L. REV. 153 (1998); A.C. Pritchard, *United States v. O’Hagan: Agency Law and Justice Powell’s Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13 (1998). But see Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of United States v. O’Hagan*, 8 FORDHAM J. CORP. & FIN. L. 865 (2003) (supporting the Court’s holding but noting the scholarship critical of the Court).

26. See *United States v. Morrison*, 529 U.S. 598, 617 (2000) (holding unconstitutional the Federal Violence Against Women Act); *United States v. Lopez*, 514 U.S. 549, 551 (1995) (holding unconstitutional the Gun-Free School Zones Act of 1990); see also *infra* notes 146-69.

27. See *Printz v. United States*, 521 U.S. 898, 935 (1997) (holding that Congress lacked the authority to “commandeer” state officials into implementing a federal regulatory program); *New York v. United States*, 505 U.S. 144, 149 (1992) (same). But see *Reno v. Condon*, 528 U.S. 141, 149 (2000) (holding that no commandeering occurs if Congress restricts the ability of state officials to share a driver’s personal information without consent).

28. See, e.g., ROBERT F. NAGEL, *THE IMPLOSION OF AMERICAN FEDERALISM* (Oxford University Press 2001). Viewing the new federalism cases in a broader context, Professor Nagel concluded that: “[T]he record as a whole is mixed enough to cast doubt on the idea that devotion to decentralized decision making is now an overriding value for most members of the Court.” *Id.* at 28.

commentary,<sup>29</sup> little note has been taken of the Court's work in the commercial area or how the Court's decisions interpreting federal law have limited the traditional role of the states.

### I. THE COURT'S EARLIER DECISIONS

The Court's 1975 decision in *Blue Chip Stamps* was an indication that the Court believed that Rule 10b-5 had to be cabined. That decision was a reaction not only to the increase in securities litigation in the federal courts (which have exclusive jurisdiction over securities fraud cases under Rule 10b-5),<sup>30</sup> but also to decisions of the Warren Court recognizing "implied rights of action" under federal statutes. A prime example of this was the 1964 decision in *J.I. Case Co. v. Borak*,<sup>31</sup> in which the Court recognized an implied right of action under section 14(a) of the Exchange Act, which regulates the solicitation of proxies in publicly held companies.<sup>32</sup> In *Borak*, the Court reasoned that a private right of action, even though not provided for by Congress, would promote investor protection and would serve as an important supplement to SEC enforcement actions;<sup>33</sup> private plaintiffs would then serve as "private attorneys general."<sup>34</sup> The Warren Court thus adopted an instrumental test for recognizing implied rights.<sup>35</sup>

The Burger Court rejected this judicial philosophy and announced, in *Cort v. Ash*,<sup>36</sup> a new standard for recognizing an implied right of action.<sup>37</sup> Henceforth, the plaintiff seeking recognition of an implied right would have to satisfy a four-part test:

In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant. First, is the

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29. Dozens of articles on federalism are published annually. See, e.g., Erwin Chemerinsky, *The Federalism Revolution*, 31 N.M. L. REV. 7 (2001); Erwin Chemerinsky, *Formalism and Functionalism in Federalism Analysis*, 13 GA. ST. U. L. REV. 959 (1997); Allison H. Eid, *Federalism and Formalism*, 11 WM. & MARY BILL RTS. J. 1191 (2003); Richard H. Fallon, Jr., *The "Conservative" Paths of the Rehnquist Court's Federalism Decisions*, 69 U. CHI. L. REV. 429 (2002); Vicki C. Jackson, *Federalism and the Uses and Limits of Law: Printz and Principle?*, 111 HARV. L. REV. 2180 (1998); Larry Kramer, *Understanding Federalism*, 47 VAND. L. REV. 1485 (1994); Philip J. Weiser, *Towards a Constitutional Architecture for Cooperative Federalism*, 79 N.C. L. REV. 663 (2001).

30. Securities Exchange Act of 1934, 15 U.S.C. § 78a (2000).

31. 377 U.S. 426 (1964).

32. *Id.* at 432-34.

33. *Id.* at 432.

34. *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 61 n.13 (1977) (noting the importance of this concept in enforcing federal law); see *Borak*, 377 U.S. at 432.

35. The Court stated: "While [§ 14(a)] makes no specific reference to a private right of action, among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result." *Borak*, 377 U.S. at 432.

36. 422 U.S. 66 (1975).

37. *Id.* at 78.

plaintiff “one of the class for whose especial benefit the statute was enacted,”—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?<sup>38</sup>

At issue in *Cort* was whether the plaintiff could maintain a derivative suit alleging an implied right of action under a federal criminal statute that prohibited corporations from making campaign contributions in Presidential elections.<sup>39</sup> The plaintiff, a shareholder of Bethlehem Steel Corp., claimed that the president of the corporation violated the federal statute and sought injunctive relief and monetary damages. Applying its four-factor test, the Court concluded that the plaintiff could not maintain a derivative action based on the statute.<sup>40</sup>

With regard to the fourth part of the test, which focuses on the role of state law, the Court expressed several concerns. First, if the defendant’s conduct violates his fiduciary duties under state law, the claim should rest on that.<sup>41</sup> Second, just the opposite may be the case—state law may permit corporations to contribute to state elections, in which case shareholders would be on notice that corporate funds could be so employed and that there could be no federal recovery.<sup>42</sup> Finally, and most importantly, the presence or lack of a state remedy would have no effect on the realization of Congress’s purpose in enacting the statute in question.<sup>43</sup> Congress was not concerned with regulating the internal affairs of corporations, as it was when it regulated the solicitation of proxies, but rather it sought to “dull[] [corporations’] impact upon federal elections.”<sup>44</sup> To achieve this, it was not critical to recognize a private right of action for violation of the statute, or, in the Court’s words: “the existence or nonexistence of a derivative cause of action for damages would not aid or hinder this primary goal.”<sup>45</sup>

One can quibble with the Court’s analysis. Surely the potential of a private damage remedy would add a deterrent effect to corporate officers who otherwise would be inclined to violate the statute. Logically, a private action would further Congress’s goal of dulling the corporate impact on federal elections. Even if state law permitted corporate contributions to state elections, shareholders would not be on notice that corporate funds could be expended for federal elections.

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38. *Id.* (citations omitted).

39. 18 U.S.C. § 610 (2000); *Cort*, 422 U.S. at 68.

40. *Cort*, 422 U.S. at 85.

41. *Id.* at 84.

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

Indeed, considering the federal criminal statute, shareholders could expect just the opposite. In light of these factors, it appears that the Court was simply reluctant to recognize an implied right of action and was backpedaling on *Borak*.

More importantly, in *Cort*, the Court was demonstrating a high sensitivity to state law. Although an intentional violation of a criminal statute would constitute a breach of fiduciary duty under state law,<sup>46</sup> the plaintiff preferred to base its claim on a federal statute to avoid having to post security for expenses. Perhaps the Court merely wanted to avoid interfering with the state policy of regulating derivative actions. If that is true, the Court was subordinating the importance of federal election laws to this state policy,<sup>47</sup> and demonstrating a sensitivity to state law that contrasts sharply with its recent decisions.

In retrospect, *Cort* was only a weigh station on the route to the virtual demise of implied private actions under federal statutes. In 1979, the Court refused to find an implied right of action under the antifraud provision of the Investment Advisors Act section 206<sup>48</sup> or section 17(a) of the Exchange Act, which is also an antifraud provision.<sup>49</sup> In the case decided under the Investment Advisors Act, the Court explained its evolved view on private rights of action:

The question whether a statute creates a cause of action, either expressly or by implication, is basically a matter of statutory construction. While some opinions of the Court have placed considerable emphasis upon the desirability of implying private rights of action in order to provide remedies thought to effectuate the purposes of a given statute, [citing] *J. I. Case Co. v. Borak*, what must ultimately be determined is whether Congress intended to create the private remedy asserted, as our recent decisions have made clear. We accept this as the appropriate inquiry to be made in resolving the issues presented by the case before us.<sup>50</sup>

The implied right of action cases are a nice compliment to the restricted view the Court took in Rule 10b-5 cases starting with *Blue Chip Stamps*. The Court seemed to say in *Blue Chip Stamps* that although it could not recede from recognizing a private action under Rule 10b-5, because a private right had been long recognized by the federal courts, the right would have to be limited.<sup>51</sup> *Blue*

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46. See, e.g., *Twenty First Century L.P.I v. LaBianca*, 19 F. Supp. 2d 35, 40-44 (E.D.N.Y. 1998).

47. See Alison Grey Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934*, 70 VA. L. REV. 813, 826 (1984).

48. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 18 (1979); see 15 U.S.C. §§ 80b-1 to 80b-15 (2000).

49. *Touche Ross & Co. v. Redington*, 442 U.S. 560, 573-74 (1979); see 15 U.S.C. § 78g (2000).

50. *Transamerica*, 444 U.S. at 15-16 (citations omitted).

51. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975) ("This Court had no occasion to deal with the subject until 25 years [after a district court recognized a private right of action in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1945)], and at that time we confirmed with virtually no discussion the overwhelming consensus of the District Courts and

*Chip Stamps* fits nicely into this rubric. The Court based its decision on policy considerations, primarily holding that recognizing a claim under these circumstances would enhance the possibility of groundless and vexatious litigation.<sup>52</sup>

Two years after *Blue Chip Stamps*, the Court decided *Santa Fe Industries, Inc. v. Green*, a case laden with potential significance.<sup>53</sup> In *Santa Fe*, the plaintiffs, minority shareholders of Kirby Lumber Corp., sought to use Rule 10b-5 to challenge a freeze-out merger engineered by Kirby's ninety-five percent stockholder, Santa Fe. The plaintiffs complained that Santa Fe breached its fiduciary duty to the minority shareholders by failing to pay a fair price for their shares. Reversing the appellate court, the Supreme Court again limited the reach of Rule 10b-5 by holding that only manipulations and deceptions are within the Rule's proscriptions.<sup>54</sup> According to the Court, breaches of fiduciary duty not involving a manipulation or deception are matters of state law, not federal law.<sup>55</sup>

*Santa Fe* provided the Court with the opportunity to apply its recent decision in *Cort v. Ash*. Focusing particularly on the effect on state law of recognizing a private right of action under the Rule for breach of fiduciary duty, the Court noted that such an "extension of the federal securities laws would overlap and quite possibly interfere with state corporate law."<sup>56</sup> The Court explained that federal courts would have to craft a uniform rule of fiduciary duty that might diverge from the law in some states.<sup>57</sup> In theory, conduct could violate this federal fiduciary duty rule and not violate state fiduciary standards. However, it is unclear why, from a policy perspective, this would be problematic. If certain conduct constituted a breach of fiduciary duty under the federal rule but not the state rule, the complaining shareholder would have a federal but not a state claim, and vice versa, if the conduct violated state standards but not federal standards. In the area of disclosure, a similar divergence exists; a misrepresentation may be material for purposes of state law, but not federal.<sup>58</sup> The important point is not

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Courts of Appeals that such a cause of action did exist.").

52. *Id.* at 740.

53. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

54. *Id.* at 474.

55. *Id.* at 478-80.

56. *Id.* at 479.

57. *Id.*

58. For instance, the Delaware Supreme Court has announced a bright-line rule that merger negotiations are not material until the parties have agreed on the price and structure of the transaction. *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 847 n.5 (Del. 1987). The federal rule is that merger negotiations may be material at an earlier stage. *Basic Inc. v. Levinson*, 485 U.S. 224, 249 (1988). *But see Alessi v. Beracha*, 849 A.2d 939, 946-50 (Del. Ch. 2004) (questioning the rule in *Bershad* and holding that merger negotiations may become material at an earlier point). If the Delaware Supreme Court affirms the lower court's decision in *Alessi*, state and federal law would be consistent; however, several Delaware decisions since the *Bershad* decision have followed it. *See, e.g., In re MONY Group Inc. S'holder Litig.*, 852 A.2d 9, 29 (Del. Ch. 2004); *Krim v. Pronet, Inc.*, 744 A.2d 523, 528-29 (Del. Ch. 1999); *Shamrock Holdings, Inc. v. Polaroid Corp.*,

whether the standards are different, but instead what is the effect of different standards. In the area of fiduciary duties, different standards may mean that fiduciaries have to be cognizant of, and conform to, the higher standard, be it federal or state. This may be a good thing, at least from the perspective of investors. Regardless of whether there would be real interference, the significance of *Santa Fe* is that the Court respected the traditional sphere of state law.

This approach was prominent in another 1977 decision, *Piper v. Chris-Craft Industries, Inc.*,<sup>59</sup> a case deciding whether an unsuccessful tender offeror had standing under section 14(e) of the Exchange Act to bring an action alleging fraud by the successful competitor and others. Section 14(e) of the Williams Act, which is a federal statute adopted in 1968 to regulate tender offers, is similar in structure and content to Rule 10b-5;<sup>60</sup> on that basis alone, there was a rationale for finding a private right of action.<sup>61</sup> Based on its review of the legislative history of the Williams Act, and an application of the four-factor *Cort* test, the Court concluded that the plaintiff did not have standing.<sup>62</sup> With reference to the relevance of state law, the Court approved the appellate court's conclusion that, under common law principles, the plaintiff would have a cause of action for interference with prospective economic advantage.<sup>63</sup> The presence of this state law remedy helped persuade the Court not to recognize a federal remedy under the Williams Act.<sup>64</sup>

State law continued to be a consideration for the Court in several prominent cases related to the federal securities laws. In *Burks v. Lasker*,<sup>65</sup> the Court

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559 A.2d 257, 275 (Del. Ch. 1989).

59. 430 U.S. 1, 54 (1977).

60. Securities Exchange Act of 1934, § 14(e), as amended 15 U.S.C. § 78n(e), provides:

(e) Untrue statement of material fact or omission of fact with respect to tender offer  
It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 78n(e) (2000). See generally Mark J. Loewenstein, *Section 14(e) of the Williams Act and the Rule 10b-5 Comparisons*, 71 GEO. L.J. 1311 (1983) (explaining why 14(e) might be more broadly construed than Rule 10b-5).

61. *Piper*, 430 U.S. at 41.

62. *Id.* at 42 n.28.

63. *Id.* at 16.

64. *Id.* at 41, 42.

65. 441 U.S. 471, 486 (1979) (alleging violations of the Investment Company Act and the Investment Advisors Act).

decided that the trial court should look to state law to determine whether a committee appointed by the board of directors of a federally regulated investment company had the authority to terminate a shareholder's derivative action alleging violations of the federal securities laws by the directors. Also, in *CTS Corp. v. Dynamics Corp.*,<sup>66</sup> the Court upheld a state law limiting the ability of a tender offeror to consummate an offer over objections that the state statute was (1) inconsistent with the Williams Act and thus preempted by it, and (2) ran afoul of the Commerce Clause, because it interfered with interstate offers for securities.<sup>67</sup> In the course of its opinion, the Court noted the role of state law:

It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares. A State has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs.<sup>68</sup>

By 1994, however, this sensitivity to the relationship between state and federal law was remarkably absent from an opinion that sharply limited Rule 10b-5.<sup>69</sup> In its controversial *Central Bank* decision, the Court held that neither the language of section 10(b) nor the general structure of the federal securities laws supported the recognition of a claim under Rule 10b-5 for civil liability against alleged aiders and abettors of primary violators.<sup>70</sup> *Central Bank* was

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66. 481 U.S. 69 (1987).

67. *Id.* at 94.

68. *Id.* at 91.

69. The shift in the Court's securities laws jurisprudence may simply be explained by the retirement of Justice Powell after the 1986-87 term. Justice Powell had an interest and expertise in business law that he brought to bear as a member of the Court. He had a profound influence on the Court during his tenure, authoring several key decisions. With his departure, the Court took fewer securities laws cases and seemed to do an inferior job in deciding them. Professor Pritchard's excellent article details this history. A. C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841 (2003). He concludes:

Since Powell's retirement, the Court's forays into [the federal securities laws] have been occasionally impenetrable and sometimes bizarre. On other occasions the Court simply regurgitates the party line offered by the SEC. Overall, "scholars and learned practitioners are giving the Court's securities law opinions low grades for logic, clarity, and usefulness in future cases."

*Id.* at 949 (quoting Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 868 (1995) (citations omitted)). In this Article, I seek to sort out this chaos with an explanation that harmonizes the Court's securities laws opinions with its broader tendency to prefer national solutions to problems. Justice Powell resisted this tendency, making securities laws decisions during his tenure somewhat distinctive from the rest of the Court's jurisprudence.

70. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191-92 (1994).

decided against a long history of recognition of aider and abettor liability; all eleven U.S. Courts of Appeals that considered the issue upheld a private cause of action against aiders and abettors.<sup>71</sup> Indeed, as Justice Stevens noted in his dissent, the petitioner in this case “*assumed* the existence of a right of action against aiders and abettors, and sought review only of the subsidiary questions.”<sup>72</sup> The Court, *sua sponte*, asked the parties to address the issue.<sup>73</sup> *Central Bank* thus represents a Court actively seeking to limit the contours of the Rule without concern for the interrelationship of federal and state law.

In fact, the securities laws of some states include provisions allowing for aider and abettor liability.<sup>74</sup> The denial of a federal claim raises the importance of state law in this area in the same way that denial of a claim under *Santa Fe* did, yet the *Central Bank* Court did not cite that as a justification for its holding.<sup>75</sup> This oversight raises doubt whether the concern about state law expressed in *Santa Fe* was genuine. Indeed, as noted above, the Court’s expressed concern in *Santa Fe* is difficult to assess on its own terms. Perhaps, recognizing the vacuity of such a concern, the Court abandoned all reference to it in *Central Bank*. In any case, the absence of an expressed state law concern, even in the context of a limitation on Rule 10b-5, is consistent with the approach taken in the modern cases, as explained in the next section.<sup>76</sup>

## II. A NEW APPROACH?: THE *O’HAGAN*, *WHARF*, *ZANDFORD*, AND *EDWARDS* CASES

### A. O’Hagan

*O’Hagan*, the first decision in a quartet of cases, answered a significant

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71. *Id.* at 192-93 (Stevens, J., dissenting).

72. *Id.* at 194.

73. *Id.* at 194-95.

74. *See, e.g.*, Conn. Nat’l Bank v. Giacomi, 699 A.2d 101, 117 (Conn. 1997) (recognizing aider and abettor liability under Connecticut law).

75. *Central Bank*, 511 U.S. at 191-92.

76. The notion that federalism is merely a mask for policy preference and not a real concern in securities law cases was the focus of an article written some twenty years ago by Professor Anderson. Anderson, *supra* note 47, at 856. She concluded that the Court’s federalism concerns were less than sincere:

In the corporate and securities area, the rhetoric of federalism should not be allowed to confuse and obscure discussion of the major substantive policy choices that usually lie behind the invocation of state interests, including questions concerning the appropriate balance of managerial autonomy and shareholder protection, the proper role of individual litigation in corporate governance, the benefits and evils of insider trading, and the social value of contested takeovers. Although these issues all involve difficult empirical questions and controversial value choices that are unlikely to be readily resolved, eliminating the vocabulary of federalism from the discussion will at least clear the air.

question in the world of insider trading—whether one who is not himself an insider but who misappropriates inside information and trades on that information violates Rule 10b-5?<sup>77</sup> James O'Hagan was a partner in Dorsey & Whitney, a law firm that represented Grand Metropolitan PLC, a U.K. company that planned to make a hostile tender offer for the Pillsbury Company. Knowing of the plans of his firm's client, and expecting a quick, risk-free profit, O'Hagan purchased shares and call options of Pillsbury over the stock exchange and sold those securities at a large profit when Grand Metropolitan's offer was made public.<sup>78</sup> He thus "misappropriated," for his own use, the confidential plans of his client. The government charged that this misappropriation was a violation of section 10(b) and Rule 10b-5. Because section 10(b) limits federal jurisdiction to manipulative or deceptive devices or contrivances used in connection with the purchase or sale of a security, the government had to demonstrate how O'Hagan's misappropriation satisfied the jurisdictional requirement.<sup>79</sup> O'Hagan, the misappropriator of inside information, may have "deceived" his client<sup>80</sup> and purchased securities; however, are the two sufficiently linked? That is, in the parlance of section 10(b), was the deception "in connection with" the purchase or sale of a security?<sup>81</sup> In *O'Hagan*, the Court concluded that they were sufficiently linked, pushing the "in connection with" requirement to its outer limit, or perhaps beyond.<sup>82</sup>

To reach its conclusion, the Court sought support in the language of section 10(b): "[The section], as written, does not confine its coverage to deception of a purchaser or seller of securities; rather, the statute reaches any deceptive device used 'in connection with the purchase or sale of any security.'"<sup>83</sup> This is true enough, but it begs the question of whether there is a sufficient nexus between the deception and the securities transaction. If a person's deception causes another to entrust her with a valuable piece of art which she then sells, using the proceeds to purchase corporate stock, there is a deception and a securities transaction, but is there a violation of section 10(b)? No court or commentator

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77. *United States v. O'Hagan*, 521 U.S. 642 (1997). This issue first came before the Supreme Court in *Chiarella v. United States*, 445 U.S. 222 (1980), as an alternative basis for upholding the defendant's conviction on charges of insider trading. A majority of the Court, however, decided that the issue had not been raised below and therefore was not properly before the Court. *Chiarella*, 445 U.S. at 236-37.

78. *O'Hagan*, 521 U.S. at 647-48.

79. *Id.* at 650-51.

80. The deception arises because the misappropriator does not disclose to the source that he or she intends to trade on the information. Thus, if the misappropriator discloses his intentions, there is no deception and no violation of section 10(b) (or Rule 10b-5). However, this use of the term "deception" is a bit unusual because the source of the information was not "deceived" into taking any action, a typical element in the tort of deception. The problem is more acute if the misappropriator forms his intention after acquiring the information.

81. *O'Hagan*, 521 U.S. at 653.

82. *Id.* at 656.

83. *Id.* at 651 (citation omitted).

has ever suggested that a violation exists in such a situation.<sup>84</sup>

Perhaps mindful of this slippery slope, the Court grounded its decision on a policy basis, opining that the misappropriation theory is “well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence.”<sup>85</sup> This policy-based argument drew a vigorous dissent from Justice Thomas (joined by Chief Justice Rehnquist), who wrote:

[R]epeated reliance on such broad-sweeping legislative purposes reaches too far and is misleading in the context of the misappropriation theory. It reaches too far in that, regardless of the overarching purpose of the securities laws, it is not illegal to run afoul of the “purpose” of a statute, only its letter. The majority’s approach is misleading in this case because it glosses over the fact that the supposed threat to fair and honest markets, investor confidence, and market integrity comes not from the supposed fraud in this case, but from the mere fact that the information used by O’Hagan was nonpublic.<sup>86</sup>

Justice Thomas might have added that the majority opinion lacked any empirical basis for its assertions on investor confidence and market integrity. Even under the majority’s view, O’Hagan could have traded if he made disclosure to his client; such disclosure would have eliminated the “deception.” However, trading of this nature would still leave other traders in the market at an informational disadvantage, as they often are. Apparently, neither this sort of informational

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84. The Court cited with approval the Commission’s use of a similar illustration to establish the boundaries of the misappropriation theory:

In such a case, the Government states, “the proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained.” In other words, money can buy, if not anything, then at least many things; its misappropriation may thus be viewed as sufficiently detached from a subsequent securities transaction that § 10(b)’s “in connection with” requirement would not be met.

*Id.* at 656-57 (citations omitted). The problem is the phrase’s vagueness. As Professor Ribstein has pointed out: “With respect to insider trading, [‘in connection with’] can range from requiring privity between the plaintiff and defendant, as the Eighth Circuit held in *O’Hagan*, to requiring only some effect on securities markets, as the Supreme Court held.” Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123, 142 (1998).

85. *O’Hagan*, 521 U.S. at 658. The Court further explained:

Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor’s informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.

*Id.* at 658-59.

86. *Id.* at 689 (Thomas, J., dissenting).

disadvantage, nor other kinds of informational disadvantages, has destroyed investor confidence. In any case, if the purpose of the federal securities laws is to protect investors, it is unclear how a ban on insider trading achieves that.<sup>87</sup> In addition, if the purpose of the law is to enhance pricing accuracy, a ban on insider trading works in the opposite direction because insider trading either has no effect on prices or, more likely, has a signaling effect that moves the market in the right direction.<sup>88</sup> Finally, and most importantly, the Court departed from what Congress apparently sought to achieve with section 10(b).<sup>89</sup> There is no support for the idea that Congress sought to address insider trading in section 10(b), having expressly dealt with that issue in § 16(b) of the Exchange Act.<sup>90</sup>

Although there are various arguments to ban or limit insider trading,<sup>91</sup> the issue in *O'Hagan* was whether the Court should stray from an analysis based on text and legislative history to implement what it perceived as sound public policy. In an apparent departure from its earlier precedents, as discussed above, the Court demonstrated a willingness to move beyond the text of section 10(b). What is missing from the Court's decision is any consideration of whether O'Hagan's conduct is better addressed by state law. At most, O'Hagan's offense was using information of his firm's client for his personal enrichment, thereby committing a gross breach of fiduciary duty. Such conduct may well violate state

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87. See HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 93-110 (1966) (challenging the then prevailing notion that insider trading should be banned as harmful to investors); Jonathan R. Macey, *Securities Trading: A Contractual Perspective*, 50 CASE W. RES. L. REV. 269, 273 (“[A]s long as the insider trading did not cause the trading by the outsider—that is, as long as the outsider would have traded anyway—then insider trading may be seen as beneficial, at least to the shareholders who are selling while the insiders are buying and those buying while the insiders are selling.”). But see WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* 41-117 (1996) (identifying potential harms to individual investors from insider trading).

88. See Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 DUKE L.J. 977 (1992) (analyzing the benefits from repealing insider trading limitations); Ribstein, *supra* note 84, at 127-28 (reviewing the arguments against restrictions on insider trading).

89. See *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235-36 (2d Cir. 1943) (suggesting that Congress addressed insider trading through section 16(b), a strict liability prophylactic rule). When the SEC adopted Rule 10b-5, it did not indicate that it was intended to address insider trading. See 7 Fed. Reg. 3804 (1942); see also *Conference on Codification of Federal Securities Laws*, 22 BUS. LAW. 793, 921-23 (1967) (explaining that the rule was originally drafted to address market manipulation). But see Quinn, *supra* note 25, at 865 (arguing that *O'Hagan* was correctly decided). See generally Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 55-69 (1980); Painter et al., *supra* note 25, at 160 n.29 (describing scholarship on the purpose of section 10(b)); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 425-61 (1990).

90. 15 U.S.C. § 78p(b) (2000).

91. See generally WANG & STEINBERG, *supra* note 87, at 29-39 (discussing whether insider trading harms securities markets, the issuer, or the trader's employer).

criminal law,<sup>92</sup> but, in any event, it is a stretch to conclude that this is the sort of conduct that Congress had in mind when it adopted section 10(b). The Court is correct that Congress sought to protect investors through the federal securities laws, but the *O'Hagan* decision addresses breach of fiduciary duty, the sort of conduct that *Santa Fe* held was *not* covered by section 10(b).<sup>93</sup> As noted above, in *Santa Fe*, the directors breached their fiduciary duty to the shareholders, enabling them to purchase shares at an unfair price.<sup>94</sup> So framed, *O'Hagan* is difficult to distinguish.

### B. Zandford

Like *O'Hagan*, *Zandford* raised the “in connection with” test in the context of an SEC enforcement action against a stockbroker who stole money from his clients: an elderly man in poor health and his mentally retarded daughter.<sup>95</sup> Zandford, who had discretion to manage his clients' account, sold securities in the account and transferred the proceeds to himself. After his criminal conviction for mail fraud, the SEC brought this enforcement action, claiming a violation of section 10(b) and Rule 10b-5. The district court entered summary judgment against Zandford, but the Court of Appeals for the Fourth Circuit reversed, holding that there was not a sufficient connection between Zandford's theft and a securities transaction: “Here, Zandford's securities sales were incidental to his scheme to defraud. Zandford's fraud lay in absconding with the proceeds of the sales. The record contains no suggestion that the sales themselves were conducted in anything other than a routine and customary fashion.”<sup>96</sup> The Supreme Court reversed the appellate court, relying, in part, on its decision in *O'Hagan*.<sup>97</sup>

Key to the Court's decision was the principle that there need not “be a misrepresentation about the value of a particular security in order to run afoul of the [Securities Exchange] Act.”<sup>98</sup> Additionally, although one of the purposes of the Act was to preserve “the integrity of the securities markets,”<sup>99</sup> section 10(b) covers deceptions involving securities transactions that are conducted face to face as well as in organized markets.<sup>100</sup> Thus, the only question was whether the admitted “fraud coincided with the sales” of the securities.<sup>101</sup> That occurred here because the respondent's scheme, formed shortly after the account was opened, was to misappropriate the proceeds of securities sales. The Court observed that

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92. *E.g.*, *People v. Napolitano*, 724 N.Y.S.2d 702, 708 (App. Div. 2001).

93. *Sante Fe Indus. v. Green*, 430 U.S. 462, 474-76 (1977).

94. *Id.* at 466-67.

95. *SEC v. Zandford*, 535 U.S. 813, 815 (2002).

96. *SEC v. Zandford*, 238 F.3d 559, 564 (4th Cir. 2001), *rev'd*, 535 U.S. 813 (2002).

97. *Zandford*, 535 U.S. at 825.

98. *Id.* at 820.

99. *Id.* at 821 (quoting *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 9 (1971)).

100. *Id.* at 822.

101. *Id.* at 820.

the actual misappropriation was not a necessary element of the claim.<sup>102</sup>

The Court's decision is eminently defensible and supported by its own precedents.<sup>103</sup> Yet, like *O'Hagan*, one wishes for more. The case recognizes an implied cause of action for what is essentially a breach of fiduciary duty and, unlike *O'Hagan*, that breach of fiduciary duty does not even remotely threaten the integrity of the securities markets or investor confidence. To the extent that the respondent's conduct adversely affects the markets because unsophisticated investors might be deterred from participating, it is important to bear in mind that Zandford was criminally convicted of federal wire fraud and was sentenced to fifty-two months in prison.<sup>104</sup> If the federal wire fraud statute, state criminal law, discipline by the National Association of Securities Dealers,<sup>105</sup> actions by state securities administrators,<sup>106</sup> and private damage actions, not to mention summary dismissal from employment and lifetime banishment from the securities industry, do not provide deterrence to this conduct, it is unlikely that an SEC enforcement action under Rule 10b-5 would. In short, a remedy was not needed under the Exchange Act to address the evils inherent in Zandford's conduct, nor was a remedy needed to realize the purposes of the Act. The limitations expressed in *Santa Fe* do not surface in the Court's opinion. Instead, the more expansive decision in *O'Hagan* is the guiding light of the opinion. Consequently, conduct arguably beyond the reach of section 10(b) is now squarely within it.

### C. Wharf

Of the four Supreme Court cases considered here, only *Wharf* involved a private damage action under the securities laws.<sup>107</sup> In *Wharf*, the plaintiff had an oral contract with the defendant, which, under certain circumstances, entitled the plaintiff to purchase a ten percent interest in a business of the defendant's. When the plaintiff sought to exercise its contractual rights, the defendant refused to perform. The plaintiff brought an action under the federal securities laws, claiming that it had purchased an option from the defendant and that the defendant had acted fraudulently in failing to disclose that it had intended not to honor plaintiff's rights under the option.<sup>108</sup> Affirming the lower court, the Supreme Court held that an oral option is enforceable and that defendant's

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102. *Id.* at 822.

103. *Id.* at 819; *Bankers Life*, 404 U.S. at 6. The Court also indicated that it would defer to the SEC under the principle of *Chevron v. Natural Resources Defense Council*, 467 U.S. 837 (1984), and found that section 10(b) was ambiguous and that the SEC's interpretation was reasonable.

104. *Zandford*, 535 U.S. at 816.

105. See Brief of NASD Regulation, Inc. as Amicus Curiae in Support of Petitioner at 15, *SEC v. Zandford*, 535 U.S. 813 (2001) (No. 01-147), 2001 WL 1663774 (“[I]t is undoubtedly true that NASD Regulation would have authority to bring disciplinary proceedings against [Zandford] for misappropriating his client's assets . . .”).

106. See, e.g., MD. CODE ANN., CORPS. & ASS'NS § 11-417 (West 2003).

107. *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588 (2001).

108. *Id.* at 590.

“secret reservation” amounted to an actionable misrepresentation.<sup>109</sup>

As in the other cases discussed here, the result in *Wharf* is defensible. Technically, the plaintiff’s contractual right to purchase a ten percent interest in the defendant could be characterized as an option, and, clearly, an option is included within the definition of a security.<sup>110</sup> Less clear is the Court’s conclusion that the “secret reservation” amounted to fraud.<sup>111</sup> One might question whether the defendant had a duty, under the federal securities laws, to disclose its intentions to the plaintiff, with whom it was dealing at arm’s length. In other circumstances, the Court has said that a person does not commit securities fraud by failing to disclose material, nonpublic information unless he or she has an independent duty to the other party to the transaction to make the disclosure.<sup>112</sup> In other words, mere possession of “inside information” is insufficient to trigger a disclosure obligation. Without citing this line of decisions, the Court supported its conclusion with a reference to the Restatement (Second) of Torts: “Since a promise necessarily carries with it the implied assertion of an intention to perform[,] it follows that a promise made without such an intention is fraudulent.”<sup>113</sup>

What is missing from the *Wharf* opinion is a consideration of the broader issue of whether this sort of transaction *ought* to be covered by the federal securities laws. It is not as though the Court had no choice but to recognize federal jurisdiction in this case. The definition of “security” is prefaced by the phrase “unless the context otherwise requires,”<sup>114</sup> and this case is one in which the Court might have considered the context. In *Marine Bank v. Weaver*,<sup>115</sup> for instance, the Court held that neither a certificate of deposit issued to the plaintiff by a federally insured bank nor a profit sharing arrangement entered into between the bank’s borrower and the plaintiff were securities because, in each instance, the context suggested otherwise.<sup>116</sup> As to the certificate of deposit, the Court rejected the lower court conclusion that the certificate was indistinguishable from other long-term debt obligations by noting that unlike other long-term debt, a certificate of deposit issued by a federally regulated bank was “virtually guaranteed” by the FDIC.<sup>117</sup> The “abundant” protection that accrues to bank certificate holders makes it “unnecessary to subject issuers [of the certificates] to liability under the antifraud provisions of the federal securities laws.”<sup>118</sup>

As to the profit sharing arrangement, which entitled the plaintiff to a share

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109. *Id.* at 596.

110. 15 U.S.C. § 77b(a)(1) (2000).

111. *Wharf*, 532 U.S. at 597.

112. *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980).

113. *Wharf*, 532 U.S. at 596 (quoting RESTATEMENT (SECOND) OF TORTS § 530, cmt. c (1976)) (alteration in original).

114. 15 U.S.C. § 77b(a) (2000).

115. 455 U.S. 551 (1982).

116. *Id.* at 560-61.

117. *Id.* at 558.

118. *Id.* at 559.

of the borrower's profits, plus a fixed sum each month and certain other benefits,<sup>119</sup> the Court relied on the unique and private nature of the agreement: "[T]he [borrowers] distributed no prospectus to the [plaintiffs] or to other potential investors, and the unique agreement they negotiated was not designed to be traded publicly."<sup>120</sup> This, of course, describes the arrangement in *Wharf* as well. While *Marine Bank* may be an easier case than *Wharf* for denying the applicability of the federal securities laws, it at least compels a consideration of a context exception. The oral contract in *Wharf* may not, in the words of *Marine Bank*, be "commonly considered to be securities in the commercial world,"<sup>121</sup> and it was not offered to other investors. Most importantly, the defendant's default in *Wharf* appears to be indistinguishable from a garden-variety breach of contract or, possibly, the common law tort of deceit. A Court sensitive to issues of federalism would at least have explored the ramifications of its decision in this light. Instead, a simple state law cause of action is now within the federal securities laws.

#### D. Edwards

Like *Wharf*, *Edwards* is a case that received short shrift in the Supreme Court, and undeservedly so. *Edwards* involved a payphone leasing business.<sup>122</sup> The defendant, through independent distributors, sold payphones to investors and offered them a site lease, a five-year leaseback and management agreement, and a buyback agreement. The investors received a fixed return under the leaseback agreement, amounting to fourteen percent of the purchase price. The arrangement had the trappings of many other investments,<sup>123</sup> and the Court had little trouble finding that the investors had purchased a type of security known as an investment contract.<sup>124</sup> Thus, the district court had jurisdiction under the federal securities laws to adjudicate the SEC's petition for an injunction.<sup>125</sup>

The case centered on the Court's venerable decision in *SEC v. W.J. Howey Co.*,<sup>126</sup> where the Court stated that an investment contract consists of: "an investment of money in a common enterprise with profits to come solely from the

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119. Subject to the borrower's discretion, the plaintiffs could use the barn and pasture held by the borrower's corporation, and the plaintiffs had the right to veto future borrowing by the corporation. *Id.* at 560.

120. *Id.*

121. *Id.* at 559.

122. *SEC v. Edwards*, 540 U.S. 389 (2004).

123. *See, e.g.*, *Wash. Square Sec., Inc. v. Aune*, 385 F.3d 432 (4th Cir. 2004); *In re Alpha Telecom, Inc.*, No. CV01-1283-PA, 2004 WL 3142555 (D. Or. Aug. 18, 2004); *Hornor, Townsend & Kent, Inc. v. Hamilton*, No. CIV.A.1:02-CV-2979J, 2003 WL 23832424 (N.D. Ga. Sept. 29, 2003); *Leroy v. Paytel III Mgmt. Ass'n, Inc.*, No. 91-CIV-1933, 1992 WL 367090 (S.D.N.Y. Nov. 24, 1992); *State ex rel. Miller v. Pace*, 677 N.W.2d 761 (Iowa 2004); *State v. Justin*, 779 N.Y.S.2d 717 (Sup. Ct. 2003).

124. *Edwards*, 540 U.S. at 397.

125. *Id.*

126. 328 U.S. 293 (1946).

efforts of others.”<sup>127</sup> The Eleventh Circuit had concluded that this scheme was not an investment contract because the investors were not looking to the business’s profits for a return; rather, they were promised a fixed rate of return.<sup>128</sup> Moreover, that court ruled, because the investors were promised a fixed return, they were not dependent on anyone’s efforts:

[T]he determining factor is the fact that the investors were entitled to their lease payments under their contracts with ETS. Because their returns were contractually guaranteed, those returns were not derived from the efforts of Edwards or anyone else at ETS; rather, they were derived as the benefit of the investors’ bargain under the contract.<sup>129</sup>

The Eleventh Circuit’s decision was highly questionable. It narrowly read the Supreme Court’s earlier decision in *United Housing Foundation, Inc. v. Forman*,<sup>130</sup> where in referring to the “profit” test of *Howey*, the Court had suggested that profits meant capital appreciation or earnings.<sup>131</sup> It would be nonsensical to so limit the concept of an “investment contract” and the Supreme Court correctly reversed the appellate court on that issue. But what makes *Edwards* worthy of comment is that the Court did not discuss the second element of *Howey*—the requirement that there be a *common enterprise*.<sup>132</sup> Here, apparently, each investor entered into separate contracts with Edwards’s companies. The invested funds were apparently not pooled into a common fund.<sup>133</sup> Rather, there was only what some courts have referred to as “vertical commonality”<sup>134</sup>: each investor’s success was dependent on the success or, at least the efforts, of the promoter.<sup>135</sup> The problem with concluding that vertical

127. *Id.* at 301.

128. *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1284-85 (11th Cir. 2002), *rev’d sub nom.* *SEC v. Edwards*, 540 U.S. 389 (2004).

129. *Id.* at 1285.

130. 421 U.S. 837 (1975).

131. *Id.* at 852.

132. *Howey*, 328 U.S. at 301.

133. Judge Lay, concurring in the appellate court decision, observed the lack of pooling of funds. *ETS Payphones*, 300 F.3d at 1287 (Lay, J., concurring) (“In the present case, there was no pooling of money in a common venture . . .”).

134. For a note on the meaning of commonality, see Rodney L. Moore, Note, *Defining an “Investment Contract”: The Commonality Requirement of the Howey Test*, 43 WASH. & LEE L. REV. 1057 (1986).

135. Steinberg summarizes two views of vertical commonality, succinctly set forth in *Mechigian v. Art Capital Corp.*, 612 F. Supp. 1421, 1425-26 (S.D.N.Y. 1985):

There is a split in the courts that have applied the “vertical commonality” approach regarding precisely what is necessary to satisfy this standard. The courts applying the more restrictive definition state that “vertical commonality” exists where “the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties.” *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 n.7 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). Thus, the Ninth

commonality is sufficient is that it reads the second prong out of the *Howey* test; vertical commonality simply means the investor's fortunes were somehow dependent on the efforts (or, in some jurisdictions, the fortunes) of the promoter. This dependency is, of course, inevitable in virtually any investment and, in any event, is the third prong of the *Howey* test. Moreover, the requirement of horizontal commonality links the definition of a security to the investor's participation in broader capital markets—the focus of the federal securities laws.<sup>136</sup>

The question of whether vertical commonality is sufficient to satisfy the *Howey* test has divided the circuits,<sup>137</sup> and prompted Justice White to urge the granting of certiorari in a 1985 case.<sup>138</sup> Moreover, the Court's 1982 decision in *Marine Bank v. Weaver*<sup>139</sup> has been read as implying that only horizontal commonality will satisfy the definition of a security.<sup>140</sup> With that background, and given the facts of *Edwards*, it is surprising that the Court did not address the commonality issue. What can be made of this? One answer is that the Court was implicitly deciding that, despite *Marine Bank*, vertical commonality is sufficient to satisfy the definition. Another possibility is that the Court was removing the commonality test in its entirety; a security is then defined as an investment of money with the expectation of an investment return (in the form of a share of the

Circuit appears to require merely that there be a "direct relation between the success or failure of the promoter and that of his investors." *Mordaunt v. Incomco*, 686 F.2d 815, 817 (9th Cir. 1982), *cert. denied*, 469 U.S. 1115 (1985). However, absent such a direct relation, the Ninth Circuit will not find "vertical commonality."

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A broader definition of "vertical commonality" seems to have been articulated by the Fifth Circuit which has held that "the requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy of the [promoter's efforts]." *SEC v. Continental Commodities*, 497 F.2d 516, 522 (5th Cir. 1974) (quoting *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974)). Thus, rather than requiring a tie between the fortunes of the investors and the *fortunes* of the promoters, as is necessitated under the restrictive definition of "vertical commonality," the broader definition merely requires a link between the fortunes of the investors and the *efforts* of the promoters. Judge Robert J. Ward of this court has noted that the application of this broader definition of "vertical commonality" essentially eliminates the "common enterprise" prong of the *Howey* test because the only inquiry required is whether the success or failure of the investment is dependent upon the promoter's efforts—i.e. the third prong of the *Howey* test. *Savino v. E.F. Hutton & Co., Inc.*, 507 F. Supp. 1225, 1237-38 n.11 (S.D.N.Y. 1981).

MARC I. STEINBERG, *SECURITIES REGULATION* 42-43 (4th ed. 2004) (citations altered). *See generally id.* and authorities cited therein.

136. *ETS Payphones*, 300 F.3d at 1287 (Lay, J., concurring).

137. *See* STEINBERG, *supra* note 135.

138. *Mordaunt v. Incomco*, 469 U.S. 1115, 1116 (1985) (White, J., dissenting).

139. 455 U.S. 551 (1982).

140. STEINBERG, *supra* note 135, at 76-77.

profits, capital appreciation, or a fixed return) as a result of the efforts of others. Both explanations are troubling, however, in view of the careful analysis given by the Court in previous cases raising the definition of a security.<sup>141</sup> Clearly, though, the Court was unwilling to define away the SEC's power to bring an enforcement action under these facts. This is understandable considering that, according to the Commission's complaint, more than \$300 million was raised from over 10,000 investors.<sup>142</sup> This fraud (if it was one)<sup>143</sup> had national implications and, perhaps, was sufficient to invoke the protections of the federal securities laws. On the other hand, the Court has previously noted that the federal securities laws were not intended to address all frauds<sup>144</sup>—only those involving securities. While the definition of a security is broad, it is not without boundaries, and the Court's decision in *Edwards* failed to consider one of those important boundaries. There is a certain judicial arrogance in this; the fine distinctions made in earlier cases have been rendered unimportant, unworthy of even a passing mention. The decision can thus be characterized as one preferring a national solution—in this case under the securities laws—to alternative approaches.

### III. FEDERALISM AND CORPORATE LAW

In each of these cases, the Court elected an expansive view of the federal securities laws that threatens displacement of state law.<sup>145</sup> There has been no

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141. In addition to *Howey* and *Edwards*, the Court has decided numerous cases over the years regarding the definition of a "security." *E.g.*, *Reves v. Ernst & Young*, 494 U.S. 56, 58 (1990) (finding short term notes to be securities); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 697 (1985) (rejecting the "sale of business" doctrine); *Marine Bank v. Weaver*, 455 U.S. 551, 555 (1982) (finding that neither bank certificate of deposit nor unique profit sharing arrangements are securities); *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 570 (1979) (holding interest in noncontributory pension plan is not a security); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 860 (1975) (deciding stock in a housing cooperative is not a security); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 349 (1943) (finding that oil leases, as structured, were investment contracts).

142. *SEC v. Edwards*, 540 U.S. 389, 391 (2004).

143. There was no indication in either of the published opinions that *Edwards* was running a scam. It could well have been the case, as Judge Lay noted in his concurring opinion in the court of appeals, that "ETS made a good faith effort to run a legitimate business." *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1288 (11th Cir. 2002), *rev'd sub nom. SEC v. Edwards*, 540 U.S. 389 (2004).

144. *See, e.g., Marine Bank*, 455 U.S. at 556 ("[W]e are satisfied that Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.").

145. An expansive view of federal legislation in general, as discussed in this section, has an analog in the Court's interpretation of individual liberties, guaranteed by the Constitution, against attempts by the states to further competing interests. For instance, in *R.A.V. v. City of St. Paul*, 505 U.S. 377 (1992), the Court's interpretation of freedom of speech invalidated the state's attempt to regulate the use of "fighting words," which had been regarded as a form of unprotected speech. *Id.* at 381. For a discussion of several recent cases demonstrating the same tendency, noting

concern that these cases represent a rejection of federalism, despite the contemporaneous decisions in *United States v. Lopez*,<sup>146</sup> which held unconstitutional the Gun-Free School Zones Act of 1990, and *United States v. Morrison*,<sup>147</sup> which held unconstitutional the Federal Violence Against Women Act. Each of these cases suggested a profound commitment to federalism. *Lopez* and *Morrison* raised the question as to whether there were limits to Congress's power when acting under the Commerce Clause; the Court said that there were. In the securities laws cases considered here, there is no question that Congress has the power to regulate securities transactions occurring in interstate commerce; rather, the issue is how its legislation should be interpreted.<sup>148</sup>

The Court has, in the past, demonstrated a sensitivity to expansive readings of federal legislation, observing "[t]hat an activity is of local character may help in a doubtful case to determine whether Congress intended to reach it."<sup>149</sup> This dictum from its 1942 decision in *Wickard v. Filburn*<sup>150</sup> reflects a judicial sentiment absent from the Rule 10b-5 cases considered here; the *Wickard* dictum suggests that if Congress intended to regulate a local activity it would do so unambiguously.<sup>151</sup> Can it be said that section 10(b) clearly indicates an intention to reach the breach of fiduciary duty in *O'Hagan*, the misappropriation of client funds in *Zandford*, the breach of contract in *Wharf*, or, with respect to *Edwards*, that the definition of a security includes the contractual arrangements present there?

The dictum in *Wickard* seems not to have had a great deal of influence in Supreme Court jurisprudence. *Wickard* is itself an example of an expansive reading of a federal statute; the Court interpreted the Agricultural Adjustment Act to limit the ability of a farmer to grow wheat for personal consumption.<sup>152</sup>

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particularly how the Court's most conservative Justices prefer national interests to state interests, see NAGEL, *supra* note 28, at 27.

146. 514 U.S. 549, 602 (1995) (holding Congress does not have power under the Commerce Clause to regulate firearm possession in local schools).

147. 529 U.S. 598, 627 (2000).

148. One could be so bold as to raise the question of whether, at least in *Zandford*, interstate commerce was involved. The case seems local if one views it as a simple theft of money by a Maryland broker from a Maryland brokerage account owned by Maryland residents. Interstate commerce enters into the case because the securities were sold on a national securities exchange and the funds were transferred between New York and Maryland. These facts, of course, were tangential to the theft in question, but sufficient to satisfy the jurisdictional elements of the Exchange Act. Whether these jurisdictional elements were satisfied was not an issue in the case.

149. *Wickard v. Filburn*, 317 U.S. 111, 124 (1942).

150. *See Fed. Trade Comm'n v. Bunte Bros.*, 312 U.S. 349, 351 (1941) ("But bearing in mind that in ascertaining the scope of congressional legislation a due regard for a proper adjustment of the local and national interests in our federal scheme must always be in the background, we ought not to find in § 5 radiations beyond the obvious meaning of language unless otherwise the purpose of the Act would be defeated.").

151. *Wickard*, 317 U.S. at 124.

152. *See Jim Chen, Filburn's Legacy*, 52 EMORY L.J. 1719, 1747 (2003) (suggesting that, in

In *Wickard*, however, it may have been the case that Congress intended to reach this activity because, in the aggregate, the production of wheat by farmers for personal consumption could have a substantial economic effect on the market for wheat, the object of the legislation.<sup>153</sup> By contrast, the Exchange Act was concerned with the national market for securities; the oral “option contract” between the parties in the *Wharf* case had at best only a tenuous relationship to that market. The constitutionality of applying the Exchange Act to the facts of *Wharf* was not even an issue in the case.

An expansive reading of Congress’s power under the Commerce Clause is a consistent theme, until perhaps recently, of the Court’s post-New Deal jurisprudence. The Court upheld the Civil Rights Act of 1964, which prohibited racial discrimination in certain places of public accommodation, as a valid exercise of Congress’s power, over challenges that the regulated activity was not interstate commerce.<sup>154</sup> In *Heart of Atlanta Motel*,<sup>155</sup> for instance, the Court held that the renting of motel rooms was commerce that concerns more than one state and thus prohibiting racial discrimination in the renting of rooms was within Congress’s power.<sup>156</sup>

While the Civil Rights Act was intended to reach racial discrimination in such places, other cases reflected the Court’s willingness to interpret federal legislation to reach activities that were likely not the intent of congressional legislation. A typical case was *Goldfarb v. Virginia State Bar*,<sup>157</sup> in which the Court held that the Sherman Act reached the actions of a state bar that published a fee schedule that operated as price floor on legal fees. *Goldfarb* and other cases<sup>158</sup> have suggested to many commentators that Congress’s power under the

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view of the Court’s modern federalism cases, *Filburn* may represent a high water mark under the Commerce Clause).

153. One might explain *Wickard* as the Court’s concession to practical necessity. To assure the success of its attempt to regulate the market for wheat, Congress had to regulate all production. See Robert F. Nagel, *The Future of Federalism*, 46 CASE W. RES. L. REV. 643, 651 (1996) (“In [*Wickard v. Filburn*], the practical necessities of administering a national program were a reason for devaluing the proposition that there is some regulatory authority that is beyond the power of Congress.”).

154. *Heart of Atlanta Motel, Inc. v. United States*, 379 U.S. 241, 278 (1964).

155. *Id.* *C.f.* *Verizon Commc’ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 406 (2004) (finding that section 2 of the Sherman Act did not reach Verizon’s refusal to enter into contracts with competitors, as required by the Telecommunications Act of 1996, in part because the Telecommunications Act provided that nothing in it “shall be construed to modify, impair, or supersede the applicability of any of the antitrust laws.” (quoting 47 U.S.C. § 152 (2000))).

156. *Heart of Atlanta Motel*, 379 U.S. at 278. See also *Katzenbach v. McClung*, 379 U.S. 294, 305 (1964), a companion case to *Heart of Atlanta Motel*, which upheld the applicability of the Act to restaurants.

157. 421 U.S. 773 (1975).

158. *E.g.*, *Perez v. United States*, 402 U.S. 146, 156-67 (1971) (upholding the constitutionality of the federal anti-loansharking statute to a private, intrastate loan). As in the civil rights cases, this case involved the finding of constitutionality of a federal statute to a situation to which it was

Commerce Clause was virtually limitless<sup>159</sup> until several recent cases upset conventional wisdom. Examples of these “new federalism” cases are *United States v. Lopez* and *United States v. Morrison*. In *Lopez*, decided in 1995, the Court held that the Gun-Free School Zones Act of 1990,<sup>160</sup> which made it a federal offense “for any individual knowingly to possess a firearm . . . at a place the individual knows, or has reasonable cause to believe, is a school zone,”<sup>161</sup> was unconstitutional. The Court found that the Act “neither regulates a commercial activity nor contains a requirement that possession be connected in any way to interstate commerce.”<sup>162</sup> The Act, therefore, exceeded Congress’s power under the Commerce Clause.

In *Morrison*, the Court, relying heavily on *Lopez*, held that the Violence Against Women Act of 1994<sup>163</sup> was also an unconstitutional exercise of Congress’s power under the Commerce Clause.<sup>164</sup> This Act sought to afford a private civil remedy for persons who were the victims of “crimes of violence motivated by gender.”<sup>165</sup> The Court found that the necessary effects on interstate commerce were simply not present, at least when the regulated activity is noneconomic in nature.<sup>166</sup>

*Lopez* and *Morrison* raise two questions for our purposes. First, do they represent, as some scholars have suggested, a new attitude of the Court with respect to the powers of Congress under the Commerce Clause?<sup>167</sup> Second, of

intended to apply.

159. E.g., Ann Althouse, *The Alden Trilogy: Still Searching for a Way to Enforce Federalism*, 31 RUTGERS L.J. 631, 658 (2000); Richard A. Epstein, *Constitutional Faith and the Commerce Clause*, 71 NOTRE DAME L. REV. 167, 173 (1996).

160. 18 U.S.C. § 922(q) (2000).

161. *Id.* § 922(q)(2)(A).

162. *United States v. Lopez*, 514 U.S. 549, 551 (1995). The Court did not rebut evidence presented by the dissent that there were effects on commerce. Thus, *Lopez* might be read as holding that if the statute does not regulate a typically “commercial” activity, the relationship between the regulation and commerce must be direct. For an interesting comment on the case, see Donald H. Regan, *How to Think About the Federal Commerce Power and Incidentally Rewrite United States v. Lopez*, 94 MICH. L. REV. 554 (1995).

163. 42 U.S.C. § 13981 (2000).

164. *United States v. Morrison*, 529 U.S. 598, 601 (2000). Interestingly, the states themselves, the supposed beneficiaries of federalism, did not support the outcome that the Court reached in *Morrison*. Only one state supported a pro-federalism position before the Court, while thirty-five states took the position in amici briefs that Congress had the power under the Commerce Clause to provide a federal tort remedy for gender-based violence. See Michael S. Greve, *Business, the States, and Federalism’s Political Economy*, 25 HARV. J.L. & PUB. POL’Y 895, 910 (2002).

165. 42 U.S.C. § 13981 (2000).

166. *Morrison*, 529 U.S. at 617-18 (“We . . . reject the argument that Congress may regulate noneconomic, violent criminal conduct based solely on that conduct’s aggregate effect on interstate commerce. The Constitution requires a distinction between what is truly national and what is truly local.”) (citing *Lopez*, 514 U.S. at 568).

167. E.g., MICHAEL S. GREVE, REAL FEDERALISM: WHY IT MATTERS, HOW IT COULD HAPPEN

what relevance are those cases to the federal securities laws, inasmuch as they invalidated acts of Congress while the constitutionality of the federal securities laws were well established? As to the first question, this author does not believe that *Lopez* and *Morrison* represent a sea change in constitutional adjudication and, therefore, the Court's expansive reading of the Rule and other sections of the federal securities laws is likely to be unaffected. Professor Nagel, in his 2001 book, *The Implosion of American Federalism*, took a longer view of the role of the judiciary in preserving notions of federalism. He observed that "[t]he terms of constitutional debate, as well as a sober assessment of the outcomes of judicial cases, indicate that federal judges do not and cannot appreciate a robust federalism."<sup>168</sup> Decisions in the past few years discussed in this Article confirm his observation.

As to the second question, if *Lopez* and *Morrison* were harbingers of a new jurisprudence, their effect should be felt in the interpretation of federal statutes.<sup>169</sup> That is, the Court should be sensitive to an interpretation, even

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(1999); Steven G. Calabresi, *A Government of Limited and Enumerated Powers: In Defense of United States v. Lopez*, 94 MICH. L. REV. 752 (1995); Keith E. Whittington, *Dismantling the Modern State? The Changing Structural Foundations of Federalism*, 25 HAST. CONST. L.Q. 483 (1998).

168. NAGEL, *supra* note 28, at 11; *see, e.g.*, Allison H. Eid, *Federalism and Formalism*, 11 WILLIAM & MARY BILL RGTS. J. 1191, 1229 (2003) (observing that "[t]he federalism 'revival' is a limited one").

169. The effect should also be reflected in a more robust reading of the Eleventh Amendment: "[t]he judicial power of the United States shall not be construed to extend to any [suit], commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens of Subjects of any Foreign States." U.S. CONST. amend. XI. Indeed, several recent cases have suggested that the Court vigorously enforces the federalism principles reflected in the Eleventh Amendment. *See, e.g.*, *Bd. of Tr. of Univ. of Ala. v. Garrett*, 531 U.S. 356, 374 (2001) (finding that Title I of the American with Disabilities Act unconstitutionally abrogated states' immunity from suit); *Kimel v. Fla. Bd. of Regents*, 528 U.S. 62, 91 (2000) (deciding that states are not subject to suit under the Age Discrimination Act of 1967 despite provision in the Act subjecting states to suit); *Alden v. Maine*, 527 U.S. 706, 712 (1999) (holding that sovereign immunity bar announced in a prior decision applies to lawsuits against states in state court); *Coll. Sav. Bank v. Fla. Prepaid Postsecondary Educ. Expense Bd.*, 527 U.S. 666, 691 (1999) (invalidating the Trademark Remedy Clarification Act, which had subjected the states to federal lawsuits brought by business that competed with the states complaining of false and misleading advertising); *Fla. Prepaid Postsecondary Educ. Expense Bd. v. Coll. Sav. Bank*, 527 U.S. 627, 647 (1999) (invalidating Patent and Plant Variety Protection Remedy Clarification Act, which had expressly abrogated the states' sovereign immunity from claims of patent infringement); *Seminole Tribe of Fla. v. Florida*, 517 U.S. 44, 65 (1996) (finding that Congress cannot abrogate a state's Eleventh Amendment immunity when acting under its commerce power).

Cases from the last two terms, however, reflect restraint. *See Tennessee v. Lane*, 541 U.S. 509, 531 (2004) (holding that Congress acted within its powers in subjecting states to liability for monetary damages under Title II of the American with Disabilities Act); *Nev. Dep't of Human Res. v. Hibbs*, 538 U.S. 721, 740 (2003) (finding the State of Nevada subject to suit under the Family

though constitutional, that stretches a statute beyond its apparent intent, which is, of course, the *Filburn* dictum. But the post-*Lopez* cases do not support this principle. Rather, the modern securities laws cases discussed above suggest an expansive reading of the federal statutes regulating business.

The Court's broad reading of the federal securities laws over the past several years is matched by the Court's interpretation of the Federal Arbitration Act ("FAA").<sup>170</sup> Unlike the Court's varied view of the federal securities laws, however, the Court has more consistently taken an expansive view of the FAA. In *Southland Corp. v. Keating*,<sup>171</sup> for instance, Chief Justice Berger, writing for six members of the Court in 1984, ruled that the FAA established a substantive rule of law that arbitration agreements are enforceable in state courts,<sup>172</sup> despite the impressive legislative history assembled by Justice O'Connor that suggested otherwise.<sup>173</sup> At issue was a California statute<sup>174</sup> protecting franchisees that, according to the California Supreme Court,<sup>175</sup> entitled franchisees to litigate their claims under the law in state court. The California court voided arbitration clauses in franchise agreements. The Supreme Court reversed, thus deciding that the FAA preempted the California statute. That Congress in 1925 intended to create a substantive rule that state courts would have to enforce arbitration agreements, even in the face of contrary state law, seems on its face at least startling, if not incredible.<sup>176</sup> Justice Stevens, concurring in part, frankly conceded as much.<sup>177</sup>

The expansive reading of the FAA reflected in *Southland* was matched during the period of "heightened sensitivity" to federalism in *Circuit City Stores Inc. v. Adams*,<sup>178</sup> decided in 2001, well after *Lopez* was decided and a year after *Morrison* came down. At issue in *Circuit City* was whether the FAA covered

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Medical Leave Act of 1993, as Congress validly abrogated the states' Eleventh Amendment rights by invoking its powers under Section 5 of the Fourteenth Amendment).

170. 9 U.S.C. §§ 1-307 (2000).

171. 465 U.S. 1 (1984).

172. *Id.* at 16.

173. *Id.* at 21 (O'Connor, J., dissenting).

174. CAL. CORP. CODE § 31512 (West 2005).

175. *Keating v. Sup. Ct. Alameda County*, 645 P.2d 1192, 1203-04 (Cal. 1982).

176. See Laura Kaplan Plourde, *Analysis of Circuit City Stores, Inc. v. Adams in Light of Previous Supreme Court Decisions: An Inconsistent Interpretation of the Scope and Exemption Provisions of the Federal Arbitration Act*, 7 J. SMALL & EMERGING BUS. L. 145, 165 (2003) ("[I]n 1924, the year prior to the passage of the FAA, congressional Commerce Clause authority was limited to items or persons 'engaged in commerce.' Further, the narrow understanding of Commerce Clause authority continued through the drafting of the FAA.") (citations omitted).

177. *Southland*, 465 U.S. at 17 (Stevens, J., concurring in part and dissenting in part) ("Although Justice O'Connor's review of the legislative history of the [FAA] demonstrates that the 1925 Congress that enacted the statute viewed the statute as essentially procedural in nature, I am persuaded that intervening developments in the law compel the conclusion that the Court has reached.").

178. 532 U.S. 105 (2001).

ordinary employment contracts. The FAA generally makes arbitration agreements “evidencing a transaction involving commerce . . . valid, irrevocable and enforceable,” but exempts “contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce.”<sup>179</sup> While a strong argument can be made that employment agreements are not transactions involving commerce,<sup>180</sup> and thus are not within the scope of the FAA, earlier precedent foreclosed this question.<sup>181</sup> Thus, *Circuit City* focused on whether the exemptive provision included all employment agreements “involving commerce,” or only those agreements involving transportation workers, as several appellate courts had previously held.<sup>182</sup> A closely divided Court opted for the latter interpretation, giving a narrow reading to the exemptive provision.<sup>183</sup>

The liberal Justices dissented, probably reflecting a discomfort with the notion of relegating employees to arbitration where, presumably, employers have an advantage. The conservative Justices, on the other hand, were seemingly protective of the freedom of contract, such as it is in these cases.<sup>184</sup> Scant attention was paid by either side to whether this essentially private transaction—a garden variety employment contact between a “sales counselor” and a retailer of consumer electronics—is so “local” in character that, absent clear congressional intention to the contrary, the FAA was unlikely to cover this agreement.<sup>185</sup> No serious inquiry into congressional intent can take place without considering what Congress believed its Commerce Clause power was in 1925 and whether, in the political climate of the time, Congress sought to encroach on

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179. 9 U.S.C. §§ 1-2 (2000).

180. See *Circuit City*, 532 U.S. at 124 (Stevens, J., dissenting) (“If we were writing on a clean slate, there would be good reason to conclude that . . . the phrase . . . ‘contract evidencing a transaction involving commerce’ was [not] intended to encompass employment contracts.”).

181. *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991).

182. See *McWilliams v. Logicon, Inc.*, 143 F.3d 573 (10th Cir. 1998); *O’Neil v. Hilton Head Hosp.*, 115 F.3d 272 (4th Cir. 1997); *Pryner v. Tractor Supply Co.*, 109 F.3d 354 (7th Cir. 1997); *Cole v. Burns Int’l Sec. Servs.*, 105 F.3d 1465 (D.C. Cir. 1997); *Rojas v. TK Commc’ns, Inc.*, 87 F.3d 745 (5th Cir. 1996); *Asplundh Tree Expert Co. v. Bates*, 71 F.3d 592 (6th Cir. 1995); *Erving v. Va. Squires Basketball Club*, 468 F.2d 1064 (2d Cir. 1972); *Dickstein v. DuPont*, 443 F.2d 783 (1st Cir. 1971); *Tenney Eng’g Inc. v. United Elec., Radio & Mach. Workers*, 207 F.2d 450 (3d Cir. 1953).

183. *Circuit City*, 532 U.S. at 123-24.

184. The dissenters argued that the exemptive provision, added to the Act in response to concerns expressed by organized labor, especially in the transportation industry, was intended to make clear that employment agreements were not covered by the Act. *Id.* at 126-28. Thus, at least arguably, Congress was making a concession to labor involved in the transportation industry, but the rest of the exemptive provision was not a concession to labor interests, as there were doubts that Congress could regulate private employment contracts outside of the transportation industry.

185. See also *Citizens Bank v. Alafabco, Inc.*, 539 U.S. 52, 53 (2003) (holding that debt-restructuring agreements executed in Alabama by Alabama residents satisfy the FAA’s “involving commerce” test).

this traditional area of state regulation. The conservative wing of the Court was, ironically, not more sensitive to this concern. This indifference to the states' jurisdiction also reflected in the securities laws cases, makes *Lopez* and *Morrison* seem more like outliers in a judicial agenda of expanding federal power, even at the risk of offending congressional intent.<sup>186</sup>

Support for this view is evident in the Court's 2000 decision in *Geier v. American Honda Motor Co.*<sup>187</sup> This case decided that a state law tort claim was preempted by a regulation adopted by the Department of Transportation mandating the phase-in of airbags by car manufacturers.<sup>188</sup> Although defendant Honda was in compliance with the phase-in requirements, plaintiff claimed that failure to include a driver side airbag in his 1987 Honda constituted negligence under state common law. The Court upheld dismissal of the complaint, reasoning that the plaintiff's claim was in conflict with the DOT standard, despite a savings clause in the federal statute that provided: "Compliance with a motor vehicle safety standard prescribed under this chapter does not exempt a person from liability at common law."<sup>189</sup> This savings clause was the basis for a strong dissent by Justice Stevens, joined by Justices Souter, Ginsburg, and Thomas.<sup>190</sup> Again, with some exceptions, the conservative Justices tend to favor the extension of federal power, with the liberal Justices in dissent. The real fault line, however, at least for most of the Court, may be on the question of whether a state law negligence claim with potentially significant damages should be allowed to go forward when a plausible case for preemption exists.<sup>191</sup> In any case, this Court has been aggressive in finding federal preemption,<sup>192</sup> as

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186. The Court's protective reading of the FAA carried the day in another case from the same term, *PacifiCare Health Systems, Inc. v. Book*, 538 U.S. 401 (2003). In *PacifiCare*, the issue was whether a provision in the arbitration agreement that precluded punitive damages rendered the agreements unenforceable because the plaintiffs claimed relief under the Racketeer Influenced and Corrupt Organization Act (RICO). RICO entitled successful plaintiffs to treble damages, which they argued the arbitrators would be unable to award. Not so, ruled the Supreme Court, as the arbitrator may find that such damages are remedial in nature. *Id.* at 405-06. In any case, the issue was one for the arbitrator and not the courts to resolve. *Id.* at 407. Similarly, in *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 81 (2002), the Court decided that arbitrators should decide whether arbitration was time-barred.

187. 529 U.S. 861 (2000).

188. The regulation was adopted pursuant to the National Traffic and Motor Vehicle Safety Act of 1966, 49 U.S.C. §§ 30101-30127 (2000).

189. 49 U.S.C. § 30103(e) (2000).

190. *Geier*, 529 U.S. at 886.

191. Some commentators have explained that Justices who favor a stronger form of federalism are also committed to deregulation, which is often furthered by a liberal preemption doctrine. See, e.g., Richard H. Fallon, Jr., *The "Conservative" Paths of the Rehnquist Court's Federalism Decisions*, 69 U. CHI. L. REV. 429, 462, 471 (2002); Jonathan D. Varat, *Federalism and Preemption in October Term 1999*, 28 PEPP. L. REV. 757, 767 (2001).

192. See, e.g., Susan Raeker-Jordan, *A Study in Judicial Sleight of Hand: Did Geier v. American Honda Motor Co. Eradicate the Presumption Against Preemption?*, 17 BYU J. PUB. L.

suggested by several other cases from the same term.<sup>193</sup> Abstract notions of federalism and the respect for state law that it entails seem to be far less of an issue, despite the fact that the Court has, on several occasions, embraced a presumption against preemption when state police powers are at issue.<sup>194</sup>

The Court's broad reading of the Constitution is similar to the Court's broad reading of federal statutes, evident in its evolving jurisprudence on the question of punitive damages.<sup>195</sup> Once thought to be the province of state law,<sup>196</sup> in recent

1, 8 (2002) ("Most blatantly, the Supreme Court's five-member majority ignored the long-standing presumption against preemption . . ."); Comment, *Federal Statutes and Regulations*, 114 HARV. L. REV. 339, 339 (2000) ("[In *Geier v. American Honda Motor Co.*], the Court once again chose to disregard the presumption [against preemption].").

193. *E.g.*, *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 371 (2000) (preempting local ordinance requiring boycott of Burma); *Norfolk S. Ry. Co. v. Shanklin*, 529 U.S. 344, 359 (2000) (preempting state tort liability); *United States v. Locke*, 529 U.S. 89, 116 (2000); *see also* *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 571 (2001) (finding that state regulations governing cigarette advertising and sales preempted by Federal Cigarette Labeling and Advertising Act); *Egelhoff v. Egelhoff*, 532 U.S. 141, 150 (2001) (deciding that state law providing that upon divorce beneficiary designations automatically revoked was preempted by the Employee Retirement Income Security Act of 1974); *Buckman Co. v. Plaintiffs' Legal Comm.*, 531 U.S. 341, 353 (2001) (holding that the Federal Food, Drug, and Cosmetic Act preempts state Fraud-on-the-FDA claims). More recent cases also reflect the Court's willingness to preempt state law. *See* *Aetna Health Inc. v. Davila*, 542 U.S. 200 (2004) (finding that ERISA preempts state court suits alleging that defendant HMOs failed to exercise ordinary care under the Texas Health Care Liability Act); *Engine Mfrs. Ass'n v. S. Coast Air Quality Mgmt. Dist.*, 541 U.S. 246, 258 (2004) (holding that California rule requiring fleet purchases to meet certain emissions requirements was preempted by Federal Clean Air Act); *Pierce County, Wash. v. Guillen*, 537 U.S. 129, 148 (2003) (deciding that Federal Hazard Elimination Program's evidentiary privileges apply in state court proceedings as appropriate use of the commerce clause). *But see* *Sprietsma v. Mercury Marine*, 537 U.S. 51, 69 (2002) (finding that state tort action based on boat manufacturers' failure to provide propeller guards was not preempted by Federal Boat Safety Act of 1971).

194. *E.g.*, *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 485 (1996) ("In all pre-emption cases, and particularly in those [where] Congress has 'legislated . . . in a field which the States have traditionally occupied,' we 'start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.'") (citations omitted); *see also* *Engine Mfrs. Ass'n v. S. Coast Air Quality Mgmt. Dist.*, 541 U.S. 246, 259-66 (2004) (Souter, J., dissenting); *Wis. Pub. Intervenor v. Mortier*, 501 U.S. 597, 605 (1991) (applying presumption against preemption to a local regulation).

195. *See* *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559 (1996). The Court's preference for federal solutions is evident in two other lines of recent cases—those dealing with the removal jurisdiction of the federal courts and the spending power. The removal cases, while seemingly a technical procedural issue, reveal the Court's strong preference for dispute resolution in the federal courts as opposed to state courts. In a 2003 case, *Beneficial National Bank v. Anderson*, 539 U.S. 1 (2003), for instance, the Court ruled that defendant National Bank could remove to the federal courts a claim that only sought relief under state law because federal law (the federal National Bank Act, 12 U.S.C. § 85 (2000)) provided an exclusive remedy for usury, the wrong complained of by

years the Supreme Court has created a federal jurisprudence to limit punitive damages in cases arising under state law. In 1991, the Court held that the Due Process Clause of the Fourteenth Amendment barred excessive punitive damage awards.<sup>197</sup> Within a few years, the Court was earnestly seeking to apply this new interpretation of the Fourteenth Amendment,<sup>198</sup> holding in 1993 that an award of punitive damages “526 times greater than the actual damages awarded by the jury”<sup>199</sup> was constitutional and, in 1996, that a 500 to 1 ratio, under the circumstances of the case, violated the Constitution.<sup>200</sup>

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the plaintiff. *Id.* at 3-4. The case represents an exception to the “well-pleaded complaint rule,” under which removal is not permitted unless the complaint expressly alleges a federal claim. *Id.* at 11. *Beneficial* builds and expands on earlier precedent that enlarged removal jurisdiction. *Id.* In short, the majority indicated a distrust for state courts, which ought to dismiss the claim on the basis of federal preemption. *Id.* Apparently fearing that state courts would not act accordingly, the Court established a precedent of removal to the federal courts for resolution of the claim. *Id.*

As to the spending power, see *Sabri v. United States*, 541 U.S. 600 (2004), which upheld under the spending power, a federal statute that proscribed bribery of state and local officials of entities, such as Minneapolis, that received at least \$10,000 in federal funds. The Court held so despite the lack of a connection between the federal funds and the alleged bribe, as an element of liability. *Id.* at 605. See generally Lynn A. Baker & Mitchell N. Berman, *Getting Off the Dole: Why the Court Should Abandon Its Spending Doctrine, and How a Too-Clever Congress Could Provoke It to Do So*, 78 IND. L.J. 459 (2002) (discussing a loophole in the Court’s opinion restricting the spending power that would enable Congress to pass a statute expanding its spending power).

196. *Browning-Ferris Indus. of Vt., Inc. v. Kelco Disposal, Inc.*, 492 U.S. 257 (1989).

197. In *Pacific Mutual Life Insurance Co. v. Haslip*, 499 U.S. 1, 18 (1991), the Court observed that “unlimited jury [or judicial] discretion . . . in the fixing of punitive damages may invite extreme results that jar one’s constitutional sensibilities.” The Court went on to hold that the Due Process Clause would address those sensibilities and guard against unreasonable awards. *Id.* at 17-24.

198. Many commentators have expressed their disagreement with this interpretation of the Fourteenth Amendment. See, e.g., Steven L. Chanenson & John Y. Gotanda, *The Foggy Road for Evaluating Punitive Damages: Lifting the Haze From the BMW/State Farm Guideposts*, 37 U. MICH. J.L. REFORM 441 (2004) (proposing that highest comparable fine should be the presumptive constitutional limit on a punitive damage award); Laura J. Hines, *Due Process Limitations on Punitive Damages: Why State Farm Won’t Be the Last Word*, 37 AKRON L. REV. 779 (2004) (arguing that Court has failed to address several important issues in its punitive damages jurisprudence); Martin H. Redish & Andrew L. Mathews, *Why Punitive Damages Are Unconstitutional*, 53 EMORY L.J. 1 (2004) (arguing that punitive damages as currently structured are unconstitutional); Catherine M. Sharkey, *Punitive Damages as Societal Damages*, 113 YALE L.J. 347 (2003) (arguing for a reformulation of punitive damages as “societal damages”).

199. *TXO Prod. Corp. v. Alliance Res. Corp.*, 509 U.S. 443, 453 (1993).

200. *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559 (1996). The Court established three guideposts for courts reviewing punitive damages to consider: (1) the degree of reprehensibility of the defendant’s misconduct; (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award; and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases. *Id.* at 575-

The Court's most recent pronouncement, its 2003 opinion in *State Farm Mutual Automobile Insurance Co. v. Campbell*,<sup>201</sup> suggests that federal courts will be active participants in determining the appropriateness of state punitive damage awards. Based on criteria developed in its 1996 decision in *BMW of North America, Inc. v. Gore*,<sup>202</sup> the Court decided that punitive damages awarded by the Utah court were excessive.<sup>203</sup> Addressing the question of the appropriate ratio of punitive damages to compensatory damages, the Court suggested that "in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process."<sup>204</sup> In the following paragraph of the opinion, however, the Court further blurred this already fuzzy standard:

Nonetheless, because there are no rigid benchmarks that a punitive damages award may not surpass, ratios greater than those we have previously upheld may comport with due process where "a particularly egregious act has resulted in only a small amount of economic damages." . . . The converse is also true, however. When compensatory damages are substantial, then a lesser ratio, perhaps only equal to compensatory damages, can reach the outermost limit of the due process guarantee. The precise award in any case, of course, must be based upon the facts and circumstances of the defendant's conduct and the harm to the plaintiff.<sup>205</sup>

Not surprisingly, this pronouncement drew some dissent, and Justice Scalia wrote: "I am . . . of the view that the punitive damages jurisprudence which has sprung forth from *BMW v. Gore* is insusceptible of principled application . . ."<sup>206</sup> Given the vague standards that the Court has delineated, Justice Scalia is undoubtedly correct. In any case, the state role in determining punitive damages has been diminished. While this may be a positive for American businesses, at least in the short run, the Court's actions reflect another trend in the preemption of state law, this time based on constitutional principles. Nevertheless, the ability of states to experiment in this area of law, to limit arbitration, or to define fiduciary duties, has been limited by the Court's nationalistic tendencies. Whether these limitations will redound to the benefit of business in the long run is an open question.

### CONCLUSION

The modern securities laws cases, in contrast to cases such as *Santa Fe* and *Blue Chip Stamps*, are nearly bereft of concern for state law. There are, of course,

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201. 538 U.S. 408 (2003).

202. 517 U.S. 559 (1996); *see supra* note 200 for those criteria.

203. *State Farm*, 538 U.S. at 409-11.

204. *Id.* at 425.

205. *Id.*

206. *Id.* at 429 (Scalia, J., dissenting).

qualitative differences between the modern cases and the earlier ones discussed here. Arguably, the modern cases neither result in a preemption of state law nor have the potential of interfering with the allocation of power as among the corporate actors—a chief concern in the Court's earlier opinions. But the modern cases have a different, and no less important consequence: as a practical matter, they preempt areas of law traditionally within the province of state law, and endorse the displacement of states as players in the area of business law. Individually, the encroachment of the modern cases is insignificant; collectively, they fit neatly into a pattern of Supreme Court cases that stretches back to the New Deal era and is unbroken by the decisions in *Lopez* and *Morrison*.<sup>207</sup>

One might ask, what of this? Arguably, there are some real and potential consequences to this preference for a national solution. Imposing a national solution to a problem, such as the misappropriation of confidential information addressed in *O'Hagan*, results in the loss of potentially more efficient and effective state solutions.<sup>208</sup> Allowing the states to craft rules in this area would give rise to competition, and “[s]ubstantial evidence supports the proposition that allowing contracting parties to choose the applicable law can increase efficiency.”<sup>209</sup>

Moreover, as a matter of jurisprudence, conduct that was once regulated by the states now becomes a matter of federal law, even if state law is not directly preempted. If the federal standard is more exacting or provides a longer statute of limitations or greater damages, the state law may become obsolete. Carefully crafted state causes of action are eliminated in favor of a federal claim. A state statute of frauds that, for instance, might have prohibited claims based on oral options would be preempted by *Wharf*. While the promulgation of the Sarbanes-Oxley Act in 2002<sup>210</sup> was met with considerable scholarly comment because it

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207. *United States v. Morrison*, 529 U.S. 598 (2000); see Lynn A. Baker & Ernest A. Young, *Federalism and the Double Standard of Judicial Review*, 51 DUKE L.J. 75 (2001) (noting how the Court vigorously enforces individual rights but applies a different standard when considering states' rights under the Constitution).

208. See generally Ribstein, *supra* note 84, at 155-58 (discussing the court's ambiguity in interpreting the existence of federal insider trading).

209. *Id.* at 156.

210. In passing the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 118, 28, and 29 U.S.C.), Congress adopted a wide-ranging approach to the perceived causes of the financial crises typified by Enron and WorldCom. To the extent that these crises reflected a weakness in the regulation of the accounting profession, for instance, Sarbanes-Oxley created an accounting oversight board. Sarbanes-Oxley Act, §101, 116 Stat. at 750-53. Similarly, perceived weaknesses in the independence of the company's auditors were addressed with new rules to limit non-audit services, to require audit partner rotation, etc. *Id.* §§ 201-204, 116 Stat. at 771-75. The law also addressed corporate governance directly in what might be characterized as two separate sets of initiatives. The first set consists of changes in aspects of corporate governance that were already “federalized.” Examples include a new requirement that the company's chief executive officer and chief financial officer certify the company's periodic filings with the SEC. *Id.* § 302, 116 Stat. at 777-78. This

regulated aspects of corporate governance traditionally regulated under state law, the Court's preemption of state law has received relatively little comment, but is at least as important.

Finally, interpreting federal laws so as to displace state law inevitably results in the arrested development of state law. This was the case for insider trading when litigation under Rule 10b-5 effectively eliminated state claims.<sup>211</sup> With respect to insider trading, for instance, Professor Ribstein observed:

[I]t is unclear whether state law can survive in the shadow of federal law, at least as long as investors can choose among state and federal remedies *ex post*. Investor-plaintiffs plainly have incentives to choose the most stringent remedy. This removes state lawmakers' incentives to compete actively or to innovate regarding remedies that optimize costs as well as benefits.<sup>212</sup>

From a jurisprudential perspective, this may be unfortunate as it spells the end to the common law tradition of developing law to meet changing conditions. Instead, the focus will shift to Congress and the federal courts to deal with an ever-changing legal landscape. All this will have taken place without the full and open debate that ought to accompany such a significant change in the law.

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requirement alters the rules of corporate governance, as the functions and responsibilities of corporate officers are typically matters of state law. However, the federal securities laws have always specified who signs documents to be filed with the SEC, so requiring officer certification to periodic reports did not reflect a significant change in the state-federal relationship.

The second set of initiatives, of greater importance here, are forays into what had been the province of the states. These include forfeiture of certain bonuses and profits and a bar on loans to officers and directors. 15 U.S.C.A. § 7243, §78(m)(k) (2005). Each of these provisions addressed abuses at Enron and other companies, where officers realized substantial bonuses on the basis of fraudulent financial statements and benefited from large loans from the company.

211. WANG & STEINBERG, *supra* note 87, § 16.2.

212. Ribstein, *supra* note 84, at 157.

