SMU | Dedman School of Law

SMU Law Review

Volume 23 | Issue 3 Article 5

January 1969

Federal-State Relations under Rule 10b-5 - Procedural Relations

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COMMENTS

FEDERAL-STATE RELATIONS UNDER RULE 10b-5 — PROCEDURAL RELATIONS

by Rufus S. Scott

With the development of a securities-centered economy in the United States, there has been a concomitant rise in the importance of securities regulation and litigation. A major component of this rise has been the private action against violators of SEC Rule 10b-5.[1] This private right of action, which the federal courts have created by implication from the broad prohibitory language of the rule[2] and section 10(b) of the Securities Exchange Act of 1934,[3] is similar to the common law actions of fraud and deceit, which are the traditional remedies for fraud and misrepresentation in securities transactions.[4] As it has developed, however, the 10b-5 action has acquired an omniscience which has taken federal law into areas of corporate life previously solely within state regulation.[5] As this growth continues, it becomes important to delineate and discern the territorial boundary between federal and state law under 10b-5. The purpose of this Comment is to point out the survey stakes along this boundary.

This boundary begins—and in a sense, ends—with the jurisdictional provisions of the Securities Exchange Act of 1934.[6] Section 27 of the Act provides that federal courts shall have exclusive jurisdiction of violations of the Act and the rules promulgated under it.[7] Section 28 of the Act,

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[1] The leading case is Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947). Professor Loss has collected the subsequent cases. 3 L. Loss, SECURITIES REGULATION 1763 (2d ed. 1961) [hereinafter cited as Loss].

Rule 10b-5 takes on different meanings and serves different purposes in different contexts. Since this Comment is concerned basically with the procedural law surrounding the rule, no attempt is made here to distinguish between its various meanings. Instead, the conduct which may violate the rule is denominated "fraud" or "securities fraud" in the very broadest sense of those terms.

[2] SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1968).

[3] The statute provides, in part:

> It shall be unlawful for any person . . . by the use of any means or instrumentality of interstate commerce . . .
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . in the public interest or for the protection of investors.

15 U.S.C. § 78j (1964). Hereinafter, the Securities Exchange Act will be cited as "Exchange Act" or "SEA."

[4] A. BROMBERG, SECURITIES LAW: FRAUD—S.E.C. RULE 10b-5, § 2.7(1) (1968) [hereinafter cited as BROMBERG]; 3 Loss 1430-44; *see* Derry v. Peek, 14 App. Cas. 337 (1889). *See generally* W. PROSSER, HANDBOOK OF THE LAW OF TORTS §§ 100, 102 (3d ed. 1964).

[5] *See* Fleischer, *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146 (1965); Comment, *The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950).

[6] 15 U.S.C. § 78aa (1964).

[7] The section provides:

> The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by

however, specifically preserves to litigants all rights and remedies available under state common law.[8] Like some other areas of federal regulation,[9] therefore, 10b-5 actions must be brought in federal court, but unlike other areas of federal regulation,[10] Congress has not chosen to preempt the states from dealing with securities fraud. Partly in deference to the prior state regulation in this field,[11] Congress, when it passed the 1934 act, preserved to the states jurisdiction of securities transactions. Although they may not hear actions arising under 10b-5, the states thus can continue to deal with securities fraud and misrepresentation and may give whatever redress they deem appropriate under state law.

Thus the jurisdictional provisions of the Exchange Act authorize *concurrent* federal-state jurisdiction of securities transactions, while conferring *exclusive* jurisdiction on the federal courts for *violations* of the Act.[12] Under the American dual judicial system, this state of affairs inevitably leads to conflicts between federal and state courts.[13] Thus the courts of each judicial system must decide the scope of their jurisdiction under the Act,[14] the law—federal or state—to be applied to securities actions,[15] and the weight to be accorded each other's judgments.[16]

I. JURISDICTION

On the surface, the Exchange Act clearly spells out the jurisdiction of the state and federal courts. But does it? The Act specifies the exclusive and non-exclusive aspects of federal court jurisdiction in sections 27 and 28, but that alone does not foreclose jurisdictional questions. Exclusive jurisdiction of 10b-5 actions is given to the federal courts, but the Act does not indicate the competency of the federal courts to hear securities fraud claims arising under state law. Nor does it indicate the applicability of the broad venue and service of process provisions of the Act to purely

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this chapter or rules and regulations thereunder . . . may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

15 U.S.C. § 78aa (1964).

[8] The section provides in part:

(a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages . . . .

15 U.S.C. § 78bb (1964).

[9] *E.g.*, labor relations, San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236 (1959); patents and copyrights, 28 U.S.C. § 1338 (1964).

[10] *E.g.*, labor relations: San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236 (1959); IAM v. Gonzales, 356 U.S. 617 (1958); Garner v. Teamsters Union, 346 U.S. 485 (1953).

[11] Some states began active securities regulation, partly through blue sky laws and partly as a matter of common law, in the early twentieth century. *See* 1 Loss 23.

[12] Interpreting the exclusive jurisdiction of the SEA, some courts have observed that the exclusive jurisdiction provided in § 27 is exclusive only to the extent that the federal law provides a right of recovery which goes beyond the common law rights. Beury v. Beury, 127 F. Supp. 786 (N.D. Ill. 1954), *appeal dismissed*, 222 F.2d 464 (4th Cir. 1955); *cf.* McCollum v. Billings, 53 Misc. 2d 661, 279 N.Y.S.2d 609, 614 (Sup. Ct. 1967).

[13] *See* Hart, *The Relations Between State and Federal Law*, 54 COLUM. L. REV. 489 (1954).

[14] *See* section I *infra*.

[15] *See* section II *infra*.

[16] *See* section III *infra*.

state matters. At the other extreme the Act does not disclose the competency of state courts to consider 10b-5 questions raised incidentally, or by way of defense or counterclaim in a state court proceeding.

In other fields it is not uncommon for issues within the exclusive jurisdiction of the federal courts to arise incidentally in state court proceedings.[17] For example, questions concerning the validity of patents, a subject within exclusive federal jurisdiction,[18] occasionally are raised in breach of contract actions.[19] When such questions are presented, state courts are ordinarily competent to hear and decide the issues, despite the fact that they could not assume jurisdiction of such issues if they were presented as the plaintiff's cause of action.[20] Likewise, questions of securities law may arise in state courts incidental to some non-securities law action, but they will be dismissed.[21]

Unlike other concepts of exclusive jurisdiction, the jurisdiction provided by the Exchange Act precludes a state court from considering any matters dealing with 10b-5.[22] Probably, this phenomenon is a result of the language of section 27 of the Act, which gives federal courts exclusive jurisdiction of *violations* of the Act.[23] Ordinarily, the statutory basis of exclusive federal court jurisdiction is couched in terms of jurisdiction of actions *arising under* the federal statute.[24] Hence, there is nothing to bar a state court from deciding questions of federal law in state court actions which do not "arise under" the federal statutes. Under the SEA, however, any violation of an Exchange Act provision is within exclusive federal court jurisdiction, so no state court can properly consider any issue which involves a violation of the Act. Although it can be argued that the implied right of action for violation of 10b-5 does not actually "arise under" the Exchange Act,[25] the conduct which gives rise to this right of action is, by definition, conduct which *violates* a rule promulgated under

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[17] 1A J. MOORE, FEDERAL PRACTICE ¶ 0.208[4], at 2325 (1965) [hereinafter cited as MOORE].

[18] 28 U.S.C. § 1338 (1964).

[19] *E.g.*, Adkins v. Lear, Inc., 67 Cal. 2d 882, 435 P.2d 321, 64 Cal. Rptr. 545 (1967) (en banc); Respro Inc. v. Worcester Backing Co., 291 Mass. 467, 197 N.E. 198 (1935).

[20] *Id.*; 1A MOORE ¶¶ 0.208[4], 0.213[2].

[21] Reuben Rose & Co. v. Davon Associates, Ltd., CCH FED. SEC. L. REP. ¶ 92,109 (N.Y. Sup. Ct. Dec. 7, 1967) (defendant's affirmative defenses and counterclaims dismissed because they relied on Exchange Act). *But see* Southern Brokerage Co. v. Cannarsa, 405 S.W.2d 457 (Tex. Civ. App. 1966), *error ref. n.r.e., cert. denied*, 386 U.S. 1004 (1967) (state court, without noting jurisdictional features of Exchange Act, considered the merits of defendant's Exchange Act defenses to breach of contract action).

[22] *E.g.*, Standard Power & Light Corp. v. Investment Associates, 29 Del. Ch. 365, 51 A.2d 572 (Sup. Ct. 1947); Eliasberg v. Standard Oil Co., 23 N.J. Super. 431, 92 A.2d 862 (Ch. 1952); Mitchell v. Bache & Co., 52 Misc. 2d 985, 277 N.Y.S.2d 580 (N.Y. City Court 1966); Gallo v. Mayer, 50 Misc. 2d 385, 270 N.Y.S.2d 295 (Sup. Ct. 1966). *See also* Loss, *The SEC Proxy Rules and State Law*, 73 HARV. L. REV. 1249, 1254-63 (1960).

[23] *See* note 7 *supra*.

[24] *E.g.*, 28 U.S.C. § 1338 (1964) (patents and copyrights).

[25] The 10b-5 action is probably a form of common law tort which arises because a statute (or, more correctly a rule) enacted for the protection of a particular group of persons has been violated. *See* text accompanying note 2 *supra*. Though the rule provides the standards by which the duty owed is measured, the cause of action actually arises under common law tort concepts, not under the statute itself. Thus it is distinguishable from the express civil liability provisions contained in the securities acts, which do "arise under" the statute. *E.g.*, Securities Act of 1933, § 12(2), 15 U.S.C. § 77*l*(2) (1964).

the Exchange Act.[26] Thus the state courts are correct when they refuse to consider 10b-5 questions arising in state court actions.

The drawback to this exclusive jurisdiction lies in the fact that the same conduct may violate both 10b-5 and state law duties prohibiting fraud and misrepresentation.[27] When this occurs, the plaintiff can assert claims under either state law or federal law, but he cannot assert both in a state court because of the exclusive jurisdiction over 10b-5 claims given to the federal courts.[28] Considerations of res judicata and collateral estoppel make it desirable for him to litigate both state and federal claims in the same forum, for an adverse judgment in a state court on his state claims may bar the plaintiff from asserting his federal claims later, and vice versa.[29]

Fortunately, the federal court doctrine of pendent jurisdiction[30] provides the plaintiff with a means of asserting both federal and state claims in the same forum. Although pendent jurisdiction is a matter within the court's discretion,[31] the current trend is toward allowing state claims pendent to federal claims in all areas of federal court jurisdiction, including 10b-5 actions.[32] The fact that both claims arise out of the same transaction, requiring similar proof, and the similarity of common law to the 10b-5 action all suggest that the state claims should be allowed into federal court pendent to the federal claims.[33] However, when the state claims come in, they never lose their character as state claims.[34] State law continues to govern them, even though federal law would require a different result on the same issue.[35] The use of the doctrine of pendent jurisdiction in 10b-5 actions does create at least one federal-state conflict: to what extent should the broad personal jurisdiction and service of process provisions of the Exchange Act allow the plaintiff to assert as pendent claims matters of state law which could not be asserted in a court of the forum state?

Exercising its broad powers over interstate commerce, Congress, in sec-

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[26] If the conduct does not violate the provisions of 10b-5, the duty implied from those provisions is not breached; hence, no cause of action arises.

[27] *E.g.*, Carliner v. Fair Lanes, Inc., 244 F. Supp. 25 (D. Md. 1965).

[28] BROMBERG § 2.7(3), at 57-58; *see* note 7 *supra*.

[29] *See* the discussion of res judicata and collateral estoppel at section III *infra*.

[30] Under this doctrine, when a federal court has properly assumed jurisdiction over federal claims, the court may assume jurisdiction over state claims springing from the same nucleus of operative fact as the federal claims. UMW v. Gibbs, 383 U.S. 715 (1966). In *Gibbs* the Court modified the doctrine of pendent jurisdiction, which had been based on a more restrictive view that the state claims had to be based on the same cause of action as the federal claims. Hurn v. Oursler, 289 U.S. 238 (1933); C. WRIGHT, FEDERAL COURTS § 19 (1963); *see* Annot., 5 A.L.R.3d 1040, 1115-20 (1966).

[31] UMW v. Gibbs, 383 U.S. 715, 726 (1966).

[32] *See* Lowenfels, *Pendent Jurisdiction and the Federal Securities Acts*, 67 COLUM. L. REV. 474 (1967); *cf.* BROMBERG § 2.7(3).

[33] Lowenfels, *supra* note 32, at 486.

[34] *E.g.*, Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964); Note, *Problems of Parallel State & Federal Remedies*, 71 HARV. L. REV. 513, 517 (1958). Although *Erie* is strictly applicable only when the federal court is exercising its diversity jurisdiction, most federal courts apply the concepts developed there to pendent state claims, despite the fact that the court must therefore apply two systems of law in the same lawsuit. *Id. See generally* Friendly, *In Praise of Erie—and of the New Federal Common Law*, 39 N.Y.U.L. REV. 383 (1964).

[35] *See* text accompanying note 109 *infra*; *cf.* Speed v. Transamerica Corp., 135 F. Supp. 176 (D. Del. 1955), *modified*, 235 F.2d 369 (3d Cir. 1956).

tion 27 of the Act, has authorized nation-wide service of process and has afforded very broad venue provisions.[36] Under this section, the defendant may be served wherever he may be found, and venue will lie in any district where any act or transaction constituting the violation occurred, where the defendant is found, is an inhabitant, or transacts business.[37] Applied to federal claims, these broad provisions clearly are appropriate devices to further the national regulatory scheme enacted by Congress.[38] But when they are applied to state claims which are in federal court pendent to 10b-5 claims, these venue and service provisions give the state claims a new reach. Ordinarily, state court jurisdiction is considered territorial in character; a state's courts cannot reach beyond its borders to assert jurisdiction over persons and things outside the state.[39] Today, the concept of state court jurisdiction is actually much broader than this conventional notion suggests; long-arm statutes, the notion of minimum contacts, and non-resident motorist statutes have all combined to expand the old notions of state court jurisdiction.[40] However, probably no one would argue at the present time that any state court could issue process which would reach beyond its borders in all cases, regardless of the connection between the defendant and the state.

Absent some special concept which would enable the state court to obtain jurisdiction over him, a state court hearing a common law claim for securities fraud could not obtain jurisdiction over the person of a non-resident defendant. Therefore, when a common law claim is asserted in a federal court pendent to a 10b-5 claim, should the federal court allow the plaintiff the benefit of the broad jurisdiction and venue provisions of section 27 of the SEA on his state claim? Most courts have said no,[41] but a few[42] have allowed it on the ground that judicial economy and the convenience of the parties are better served if all legal theories arising out of the same set of operative facts are considered in the same action.[43] There is some merit to this argument, but it may work a hardship on the de-

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[36] *Cf.* BROMBERG § 11.3; note 7 *supra.*

[37] *See* Gilson v. Pittsburgh Forgings Co., 284 F. Supp. 569 (S.D.N.Y. 1968); Zorn v. Anderson, 43 F.R.D. 527 (S.D.N.Y. 1966); United Indus. Corp. v. Nuclear Corp. of America, 237 F. Supp. 971 (D. Del. 1964).

[38] *Cf.* Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); Miskin, *The Variousness of "Federal Law": Competence and Discretion in the Choice of National and State Rules for Decision*, 105 U. PA. L. REV. 797, 810 (1957).

[39] *See* H. GOODRICH & E. SCOLES, HANDBOOK OF THE CONFLICT OF LAWS §§ 72, 73 (1964).

[40] *See id.* §§ 73, at 124-30, 76. It should be remembered, however, that the concepts of extra-territorial jurisdiction and service of process are not necessarily the same as those associated with SEA § 27. The idea of "contact" with a particular jurisdiction is not present in § 27 except as it is relevant to the "transacting business" basis for venue. *See* note 7 *supra.* Even there, the quantum of business done is not the same as that under state notions of "doing business" or "minimum contacts." Zorn v. Anderson, 43 F.R.D. 527 (S.D.N.Y. 1966); United Indus. Corp. v. Nuclear Corp. of America, 237 F. Supp. 971 (D. Del. 1964). But the state concepts may be relevant as considerations for the court in determining the standard under SEA § 27. *Cf.* Gilson v. Pittsburgh Forgings Co., 284 F. Supp. 569 (S.D.N.Y. 1968).

[41] BROMBERG § 11.4; *e.g.*, Parker v. Baltimore Paint & Chem. Corp., 244 F. Supp. 267, 271 (D. Colo. 1965); Trussell v. United Underwriters Ltd., 236 F. Supp. 801, 804 (D. Colo. 1965).

[42] BROMBERG § 2.7(4); *e.g.*, Puma v. Marriott, 294 F. Supp. 1116 (D. Del. 1969); Kane v. Central Am. Mining & Oil, Inc., 235 F. Supp. 559, 567-68 (S.D.N.Y. 1964).

[43] Puma v. Marriott, 294 F. Supp. 1116, 1121 (D. Del. 1969).

fendant, and it can be argued that it constitutes an improper use of the jurisdictional features of the Exchange Act.[44]

If there is no concept in state law under which the plaintiff could obtain jurisdiction over the defendant on the state claims, extension of the broad jurisdictional provisions of the Exchange Act to the pendent state claims subjects the defendant to liability which the state courts could not impose. If the federal court is really acting as a court of the state on the pendent claims,[45] the federal court should not utilize special federal jurisdictional provisions to give relief on claims which a state court could not entertain. In allowing extraterritorial jurisdiction on the pendent state claims, the court actually creates a hybrid sort of claim, which is really neither state nor federal in character. Though arising under state law, the claim cannot be called a state claim, for it can be enforced only in conjunction with federal jurisdictional provisions. It cannot be called a federal claim either, for it does not arise under federal law. Although this extraterritorial reach given the state claims by coupling them with federal jurisdictional powers may not be inherently evil, creation of these hybrid claims is judicial legislation of the sort which federal courts ordinarily disdain.[46]

II. The Law Applied in 10b-5 Actions

After these jurisdictional conflicts are resolved, a more fundamental question remains: what shall be the relationship between federal and state law in actions for securities fraud?[47] Because Congress chose not to preempt state court jurisdiction of fraudulent securities transactions, there exists a viable and fairly complete body of state procedural and substantive law in this field. The federal statutory provisions, however, are far less complete. Partly because of the nature of federal legislation and partly because 10b-5 was not designed to afford a private right of action, federal courts, when considering 10b-5 actions, must look outside the statute and rule to find the procedural, and some of the substantive, rules applicable to the case. Ordinarily, Congress legislates against a background of state law, and federal courts often look to established state rules to fill the interstices left in federal legislation.[48] However, when that legislation involves a complete national scheme of regulation, the federal court must

[44] *See* text accompanying note 123 *infra*.

[45] *See* note 34 *supra*.

[46] As concepts of extraterritorial jurisdiction by state courts expand, this concern becomes less important. Even now, many fraudulent activities carried out within a state would subject the nonresident defendant to the jurisdiction of the state's courts by virtue of the state long-arm statute.

There is still a danger, however, that the defendant will be put to undue inconvenience by a plaintiff using SEA § 27, and this inconvenience comes long before it has been determined by the court that the defendant wears a black hat. As Lewis Lowenfels notes, the use of pendent jurisdiction as a device to obtain personal jurisdiction over a nonresident defendant on pendent state claims is subject to abuse and should be scrutinized carefully by the court. Lowenfels, *supra* note 32, at 492.

[47] *See generally* Friendly, *In Praise of Erie—and of the New Federal Common Law*, 39 N.Y.U.L. Rev. 383 (1964); Miskin, *supra* note 38.

[48] Miskin, *supra* note 38, at 811.

also consider whether a better approach would be to formulate a separate federal rule to fill out the national scheme.[49]

Thus a dilemma presents itself for the federal court in choosing the law applicable to a 10b-5 action. A principal explanation for the creation and rapid expansion of the private right of action under 10b-5 is that investors need an action free from the substantive and procedural restrictions which have grown like a shell around state court securities fraud actions.[50] Suggesting that 10b-5 actions should not be encrusted with this shell, Congress has deprived state courts of jurisdiction of 10b-5 violations; yet blind adherence to prevailing state rules in filling the interstices of 10b-5 would engraft these restrictions on the federal action. Because the fifty states differ in their own rules on these matters, adoption of state rules also encourages forum shopping, for the broad personal jurisdiction and venue provisions of the Exchange Act often permit suit in federal courts sitting in several states.[51] If the federal court adopts the law of the state in which it sits, the law applicable to 10b-5 actions varies among the federal district courts, and litigants seek the forum state with rules most favorable to them.

At the other extreme, too much judicial creation by the federal courts produces confusion and hardship for those who must conduct their business affairs under this creation.[52] Uniformity of federal rules may be achieved, but the price may be a disparity between state and federal law applicable to the citizens of a state. While this disparity is irrelevant if the need for national uniformity is strong, the citizen perhaps should not be put to the burden of having his conduct governed by two differing standards where the only reason for a separate federal rule is a desire for symmetry of abstract legal principles. The states, too, have an interest in having their law applied in federal actions. That law reflects state policies as to permissible conduct. If the federal courts formulate their own rules, overriding state concepts in the federal action, the state rules may be vitiated.

In view of these competing considerations, common sense suggests that the choice of federal or state law cannot be determined in one simple formula. Unquestionably, Congress does not expect or desire the federal courts to create new federal rules whenever an issue arises which is not expressly provided for in 10b-5. Rather, the courts must consider the relationship of each issue which arises to the national program.[53] Where there is no need for a uniform rule among the federal courts and where the state courts have already devised a just and workable procedure, there is no reason to create a separate federal approach. Making this determination, however, is easier said in the abstract than done in reality. Fortunately, the United States Supreme Court has provided the lower courts with some guidance in choosing the applicable law. By way of dictum in

[49] Miskin, *supra* note 38, at 800, 810-14; Friendly, *supra* note 47, at 410.
[50] BROMBERG § 2.7(1).
[51] *See* text accompanying note 36 *supra*; *cf.* note 7 *supra*.
[52] Friendly, *supra* note 47, at 410; Miskin, *supra* note 38, at 822.
[53] Friendly, *supra* note 47, at 410.

J.I. Case Co. v. Borak,[54] the Supreme Court recognized the power of the federal courts to fashion new federal rules in actions based on Exchange Act violations, even to the extent of overriding provisions of state law.[55] There is nothing unique in this approach; the Court has recognized the same power to fashion federal rules in other areas of federal legislation.[56] However, *Borak* has served as the base upon which federal courts have built a body of federal law governing private 10b-5 actions. Although resort to state law has not been eliminated, the federal law formulated in this process has departed sufficiently from the conventional state rules that the 10b-5 action probably can now be called a unique type of action for securities fraud, not just a federal court extension of the common law actions of fraud and deceit.[57]

Remedies. The question involved in *Borak* was the remedy which the federal courts can give for Exchange Act violations.[58] Where a federal right is invaded, the Court reasoned, it is necessary to provide appropriate remedies to effectuate the congressional purpose.[59] In providing these remedies, the court may use any available remedy and, in addition, may fashion federal remedies.[60] Unquestionably, this dictum is sound from the standpoint of federal-state relations. If federal courts could not fashion appropriate remedies, the rights created by federal legislation would be hollow indeed.[61] The national scheme of securities regulation reflected by the Exchange Act would also suffer, for a toothless act probably would have little deterrent effect on the fraudulent activities prohibited by 10b-5.[62] It seems, therefore, that the remedies provided in the 10b-5 action actually lie at the heart of the national scheme, and this scheme can be effectuated fully only if those remedies are under federal control.

Even if it is assumed that federal law should determine the mode of redress given, there remains the more philosophical question of what those remedies should be. In *Borak* the Court found it unnecessary to indicate what relief would be appropriate.[63] However, the usual legal and equitable devices for securing redress of private injuries seem appropriate models for redress under federal law.[64] In utilizing these traditional devices, the federal courts usually run into no conflicts with the states, for

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[54] 377 U.S. 426, 434 (1964).

[55] *Id.*

[56] *E.g.*, Textile Workers Union v. Lincoln Mills, 353 U.S. 448 (1957); *cf.* Friendly, *supra* note 47, at 413. Writing before the Supreme Court opinion in *Borak*, Judge Friendly foresaw *Lincoln Mills* as portending that the federal courts would "fashion a corpus of law on the responsibility of officers and directors consistent with federal securities legislation; and this, like the federal common law of labor, would have supremacy over state law." *Id.*

[57] *See* Fleischer, *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146 (1965).

[58] J.I. Case Co. v. Borak, 377 U.S. 426, 434 (1964).

[59] *Id.*

[60] *Id.*; Miller v. Steinbach, 268 F. Supp. 255, 268 (S.D.N.Y. 1967); Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369, 375 (D. Del. 1965); Eagle v. Horvath, 241 F. Supp. 341, 344 (S.D.N.Y. 1965).

[61] *Cf.* Harris v. Palm Springs Alpine Estates, Inc., 329 F.2d 909 (9th Cir. 1964).

[62] *Cf.* Securities Exchange Act of 1934, § 2, 15 U.S.C. § 78b (1964).

[63] J.I. Case Co. v. Borak, 377 U.S. 426, 434 (1964).

[64] *See* Comment, *Private Remedies Available Under Rule 10b-5*, 20 SW. L.J. 620 (1966); *cf.* BROMBERG §§ 9.1-9.3.

state courts would give the same remedy or relief if the action had been commenced before them as a common law action. However, suppose the state court provides an exclusive remedy in a particular situation. How far *should* the federal courts go in awarding a remedy forbidden by the state courts?

Mergers. It is now clear that 10b-5 does apply to fraud in connection with mergers which involve securities transactions.[65] Thus if 10b-5 is violated in a merger, anyone injured by the violation may commence a 10b-5 action in federal court. Most often, these actions are begun by disgruntled shareholders suing either for their own injury or for that allegedly done to the corporation. State law has attempted to provide for these disgruntled shareholders through the right to appraisal, whereby dissenting shareholders can have the value of their stock appraised and can receive cash from the corporation in exchange for it.[66] Although appraisal provides necessary relief where the stock has no market value, this relief is rarely what the disgruntled shareholder desires.[67] Appraisal provides no device for stopping or remedying the consequences of a fraudulent merger transaction. The shareholder who sees fraud in the merger thus has no means of asserting it through the appraisal device; yet, under state law, appraisal may be his exclusive remedy.[68]

When the disgruntled shareholder bases his complaint on a violation of 10b-5 and brings his action in federal court, the court must decide whether to limit the plaintiff's remedies to appraisal or to fashion some other relief, such as enjoining or unscrambling the merger. If the plaintiff is one whom state law would limit to appraisal rights, the questions of federal-state relations become pertinent for the federal court in choosing the proper relief. Restricting a plaintiff to appraisal as his exclusive remedy reflects a strong state policy on mergers and the extent to which dissenting shareholders should be able to interfere with merger transactions. To allow other relief, such as an injunction against the merger, in federal court vitiates this state scheme and leads to disunity between federal and state law, thus encouraging forum shopping.[69] In addition, the fact that so many states have made appraisal the dissenting shareholder's exclusive relief[70] indicates that the policy is a strong one in corporate law and

[65] SEC v. National Sec., Inc., 393 U.S. 453 (1969); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied sub nom.* Bard v. Dasho, 389 U.S. 977 (1967).

[66] H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS § 349 (1961).

[67] If the stock has a market value, the shareholder who objects to the merger usually can sell in the market without resort to his judicial remedies if all he wants is out of the corporation. Usually, however, the shareholder who complains of a merger wants to stay in the corporation as a stockholder; he just wants to keep it from merging.

[68] H. HENN, *supra* note 66, § 349, at 553.

[69] When the federal courts look to state law, it is ordinarily the law of the forum state. Thus any differences between state rules are accentuated, for plaintiffs seek to bring their actions in the federal district court which will apply the state law most favorable to them. The breadth of the jurisdictional provisions contained in § 27 usually allows plaintiffs a variety of states in which to file 10b-5 actions. The effect is to allow the plaintiffs to select the forum with little concern for the convenience of the parties. Even if the action is later transferred under 28 U.S.C. § 1404(a) (1964), the law of the forum state in which the action is originally brought may still apply. H. L. Green Co. v. MacMahon, 312 F.2d 650 (2d Cir. 1962), *cert. denied*, 372 U.S. 928 (1963).

[70] *See* text accompanying note 68 *supra.*

should not be lightly set aside. This uniformity among the states also vitiates the argument for uniformity of redress, which is frequently advanced as a reason for fashioning a separate rule.[71] Because most states would confine the shareholder to his appraisal remedy, uniformity of the redress given by the federal district courts on 10b-5 violations would be little less uniform if the state appraisal remedy were utilized in lieu of a separate federal remedy.

Nevertheless, the federal circuits which have considered the question so far have rejected the state remedy of appraisal as the exclusive remedy for mergers.[72] The reasoning behind these cases and that of several district court opinions[73] has been that the overriding federal law governs the appropriateness of the redress. While it is an accurate parroting of *Borak*,[74] this reasoning is not helpful in deciding whether to apply exclusively appraisal in a 10b-5 action. Certainly, the federal court must determine the appropriateness of the redress, but that does not mean that the court must always fashion a separate federal rule; it may choose the state rule as the appropriate redress.[75] What the courts are really getting at in these opinions is a view that appraisal is not the appropriate relief for a violation of 10b-5. To apply appraisal, therefore, would impede the congressional purpose behind the federal statute, and any state remedy or other rule which impedes that purpose must give way to another rule.[76]

Perhaps the question comes into sharper focus if less stress is placed on the exclusiveness of the remedy of appraisal in state court proceedings. For the shareholder who merely dissents from a merger, appraisal *is* the exclusive remedy, but where fraud is involved in the merger, many, if not all, states would allow other forms of redress.[77] Although 10b-5 may make fraudulent some activities which state fraud law would condone,[78] the 10b-5 action can be looked upon as similar to a state court action for fraud in connection with the merger. Thus the plaintiff is not a shareholder who merely dissents from the merger; he is complaining that the transaction itself involves some species of fraud. Hence appraisal would not be the plaintiff's exclusive remedy if the fraud were actionable in state court, so there is no conflict with state law when the federal court applies a remedy other than appraisal.

Application of the *Borak* notions of federal-state relations is also reflected in several cases dealing with other aspects of the remedy given in 10b-5 actions. Thus the effect of a release given in a state action upon the plaintiff's rights in a subsequent 10b-5 action is a question of federal

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[71] *Cf.* Miskin, *supra* note 38, at 812-13.

[72] Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied sub nom.* Bard v. Dasho, 389 U.S. 977 (1967).

[73] Miller v. Steinbach, 268 F. Supp. 255 (S.D.N.Y. 1967); Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369 (D. Del. 1965); Eagle v. Horvath, 241 F. Supp. 341 (S.D.N.Y. 1965).

[74] J.I. Case Co. v. Borak, 377 U.S. 426, 434 (1964).

[75] Miskin, *supra* note 38, at 805.

[76] Fleischer, *supra* note 57, at 1170.

[77] *E.g.*, Miller v. Steinbach, 268 F. Supp. 255 (S.D.N.Y. 1967) (dictum); Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369 (D. Del. 1965) (dictum).

[78] *See generally* 3 Loss 1430-44.

law.[79] Likewise, whether the plaintiff is entitled to prejudgment interest on his 10b-5 claim[80] and whether an attorney is entitled to a fee from the corporation for his role in prosecuting a derivative action under the Exchange Act[81] are questions to be decided according to federal law. These cases, however, point out the ongoing role which state law must play in fashioning remedies for 10b-5 actions. Although deciding these questions for themselves without being required to follow state law, the courts have observed by way of dictum that the rules generally followed by state courts are relevant considerations for the federal courts in fashioning federal law.[82]

Security for Expenses. One area in which federal courts have rejected a state procedural requirement is the security for expenses imposed by some states in derivative actions. Because of the abuses inherent in derivative suits, a number of states have sought to deter such suits through a variety of procedural restrictions.[83] These devices have served as effective deterrents in state court actions, and defendants in federal court derivative actions based on 10b-5 violations have sought to impose similar requirements in the federal forum.[84] As in *Borak*, the federal courts have refused to engraft these restrictions on 10b-5 actions.[85]

Although decided prior to *Borak*, one of the leading cases for this proposition is *McClure v. Borne Chemical Co.*[86] The defendant asserted three grounds for applying the state security for expenses requirement in the 10b-5 action:[87] (1) state law rather than federal law controls this issue, (2) even if federal law applies, security for expenses may be required under the principles of "general federal equity law," and (3) a security for expenses requirement should be implied from section 10b-5 by analogy to other provisions of the Act which authorize security for expenses when a private right of action is expressly authorized. These three assertions cover the range of contentions which have been advanced in 10b-5 actions as reasons for applying state rather than federal law.

The first of these assertions was complicated by the fact that the federal court was sitting in Pennsylvania and dealing with a corporation which was incorporated in New Jersey and had its principal place of business in New Jersey. Both states have security for expenses require-

[79] Stella v. Kaiser, 221 F.2d 115 (2d Cir.), *cert. denied*, 350 U.S. 835 (1955).

[80] Ross v. Licht, 263 F. Supp. 395, 411 (S.D.N.Y. 1967); Speed v. Transamerica Corp., 135 F. Supp. 176, 198 (D. Del. 1955), *modified*, 235 F.2d 369 (3d Cir. 1956).

[81] Gilson v. Chock Full O'Nuts Corp., 331 F.2d 107 (2d Cir. 1964) (SEA § 16(b)).

[82] *Id.* at 109; *cf.* Estate Counseling Serv., Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962) (utilized state law on election of remedies). *But see* Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963): "State court decisions involving fraud and misrepresentation are applicable only indirectly as supplementary aids in establishing standards of diligence."

[83] H. HENN, *supra* note 66, §§ 352, 360-62, 374.

[84] *See generally* Note, *Shareholder Derivative Suits Under Sections 10(b) and 14(a) of the Securities Exchange Act*, 18 STAN. L. REV. 1339 (1966).

[85] *E.g.*, Levine v. Bradlee, 378 F.2d 620 (3d Cir. 1967); Weitzen v. Kearns, 262 F. Supp. 931 (S.D.N.Y. 1966), *aff'd sub nom.* Epstein v. Solitron Devices, Inc., 388 F.2d 310 (2d Cir. 1968); Kane v. Central Am. Mining & Oil, Inc., 235 F. Supp. 559 (S.D.N.Y. 1964); *see* cases cited in BROMBERG § 2.5(2) n.109.

[86] 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961).

[87] *Id.* at 827.

ments, so there was an additional question of which state law would be applied. In resolving this issue the court, without realizing it, was forced to make the two-stage determination of (a) whether the applicability of security for expenses is a federal question and (b) if so, whether the federal court should apply state law or a separate federal rule.

The principal argument for applying the Pennsylvania security for expenses requirement was that under *Erie* the law of the forum state applied.[88] Since the action arose under a federal statute which expressly confers jurisdiction on the federal courts, the Third Circuit easily disposed of the *Erie* rationale, for special federal question jurisdiction like that conferred by section 27 of the Exchange Act[89] is not subject to the dictates of *Erie*.[90]

The defendants also sought to have the federal court apply the Pennsylvania security for expenses requirement by analogy to the cases in which federal courts have presumed that congressional silence on a fundamental principle of law indicates that Congress intended the courts to look to state law on that matter.[91] Going to the question of whether the courts should look to state law as a matter of federal law, this contention was easily rejected as inapposite.[92] When Congress fails to provide a statutory rule on a fundamental and universally accepted principle of law, the federal courts will presume that Congress intended state law to govern.[93] However, security for expenses requirements are neither fundamental nor universally accepted,[94] so there is no basis for inferring a congressional intention to apply state provisions.[95]

The Third Circuit found the question of whether to apply the New Jersey security for expenses requirement more difficult.[96] As the state of incorporation and the principal place of business, New Jersey had a substantial interest in the shareholder's rights and in the relationship between the corporation and its shareholders. This relationship, as well as the very existence, rights, and powers of the corporation, was a creation of New Jersey corporate law and reflected strong New Jersey public policies on a shareholder's rights and powers *vis-á-vis* the corporation. In enacting its security for expenses requirement, New Jersey had indicated a policy of limiting the shareholder's right to sue on behalf of the corporation.

When federal courts allow shareholders to sue without posting security, they are overriding state policy. In addition, the federal courts encourage forum shopping, for the plaintiff who cannot bring his action in state court without posting security for expenses will choose the federal forum,

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[88] *Id.* at 830.

[89] *See* note 15 *supra.*

[90] *E.g.*, in diversity jurisdiction and on state claims in federal court pendent to federal claims. *See* note 34 *supra.*

[91] 292 F.2d at 830; *cf.* discussion of this point as it relates to statutes of limitations at note 116 *infra.*

[92] *Id.*

[93] *See* text accompanying note 116 *infra.*

[94] *Cf.* BROMBERG § 2.5(2) nn.108-09; 2 MODEL BUS. CORP. ACT ANN. § 43A (1960).

[95] Also, at the time Congress enacted § 10(b) of the Exchange Act, no security for expenses requirement had been enacted. 292 F.2d at 830.

[96] *Id.* at 831.

not so much for its broader substantive rules as for its procedural advantages. These procedural advantages are not, however, the reason for allowing actions under 10b-5; the private right of action is designed to provide investors with additional substantive rights, not just to make it easier for them to get into court.

To avoid these effects, the federal courts could hold that the question of a shareholder's right to sue on behalf of the corporation is to be determined by reference to the law of the state of incorporation. Thus the shareholder's rights to bring a suit on behalf of the corporation would be identical in both the state and the federal forum. Since the right being asserted is that of the corporation and not the individual shareholder, the substantive rights afforded by 10b-5 would not be affected by this approach, for the reference to state law would not affect the merits of the corporation's claim. All that would be affected is the question of who shall raise that claim and what must be done to raise it. Because the security for costs requirements differ among the states, there of course would be a lack of uniformity among the federal district courts. This lack of uniformity, however, would not be serious, for the rule applicable to suits on behalf of a particular corporation would be the same regardless of the court in which the action were brought. Since the rule would be tied to the state of incorporation (of which most corporations have only one),[97] a shareholder suing on behalf of the corporation would face the same requirements wherever he brought his suit.[98]

In *McClure*, however, the Third Circuit refused to make this reference to state law,[99] and that result has been followed in subsequent actions.[100] Instead of viewing the shareholder's rights to maintain a derivative suit as flowing from state corporate law, the court quoted extensively from a Second Circuit opinion involving a derivative suit under the Interstate Commerce Act, which took the view that the shareholder's right to maintain suit on behalf of the corporation is a federally conferred right and is not subject to the peculiarities of state law.[101] The federal provisions, the *McClure* court reasoned, "are a part of a statutory scheme which had as its purpose the creation of a new federal law of management-stockholder relations . . . ."[102] If the state policies of management-shareholder relationships reflected by the security for expenses requirements were engrafted upon the 10b-5 action, those policies would cut across the simi-

[97] For the comparatively small number of corporations which are incorporated in more than one state, this approach might not necessarily be helpful.

[98] This approach would be in conformity with the usual conflict of laws rule applicable to derivative suits. When a shareholder seeks to enforce a right on behalf of the corporation, the forum will look to the law of the state of incorporation to determine the shareholder's standing to sue. *See* Rosenfeld v. Schwitzer Corp., 251 F. Supp. 758 (S.D.N.Y. 1966). *Contra*, Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965).

[99] 292 F.2d at 831-36.

[100] Levine v. Bradlee, 378 F.2d 620 (3d Cir. 1967); Weitzen v. Kearns, 262 F. Supp. 931 (S.D.N.Y. 1966), *aff'd sub nom.* Epstein v. Solitron Devices, Inc., 388 F.2d 310 (2d Cir. 1968); Kane v. Central Am. Mining & Oil, Inc., 235 F. Supp. 559, 569 (S.D.N.Y. 1964).

[101] Fielding v. Allen, 181 F.2d 163 (2d Cir.), *cert. denied sub nom.* Ogden Corp. v. Fielding, 340 U.S. 817 (1950).

[102] McClure v. Borne Chem. Co., 292 F.2d 824, 834 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961).

lar federal interests embodied in the securities acts and would thus "severely limit" the scope of 10b-5 in the federal regulatory scheme.[103] "Thus state interest in the present suit must be subordinated to the federal policy occupying the same field."[104]

Even if state law is inapplicable, the defendants in *McClure* argued, security for expenses should be required either under general federal equity law or by implication from the express liability provisions of the securities laws which impose such requirements.[105] The court, however, rejected this argument, principally upon the ground that such an extraordinary requirement should not be imposed without express statutory authority.[106] After reviewing the security for expenses required by other provisions in the securities acts,[107] the court concluded that the acts did not "manifest [a] sufficiently clear or uniform policy favoring security for expenses to allow us to imply such a limitation from Section 10(b)."[108]

Even though security for expenses is not required on 10b-5 claims, the *McClure* reasoning does not mean that security for expenses is never required in federal actions. If the plaintiff asserts claims arising under state law pendent to his 10b-5 claims, any security for expenses requirements imposed by state courts will also be imposed in the federal court.[109] Thus the plaintiff who asserts too many claims may find that his attempt to avoid state security for expenses requirements by going to federal court was useless, for he will have to meet the state requirements on his state claims just as he would if he had not alleged the 10b-5 violation. As master of the action, however, the plaintiff can easily avoid this result by failing to allege his claims under state law.[110] Of course, if he does this and then loses on his 10b-5 claims, the plaintiff may be unable to assert his state claims in a subsequent state court action.[111]

Although security for expenses is the most notable example, the states which have sought to deter derivative suits have used several different devices for this purpose.[112] As might be expected, these devices also are inapplicable to derivative actions brought in federal court under 10b-5. Thus the extent of the demand which a shareholder must make on the officers, directors, and other shareholders prior to instituting suit is a question of federal law, and failure to satisfy state requirements does not defeat the plaintiff's right.[113] However, it should be noted that denominating a specific matter a federal question still does not require the federal

[103] *Id.* at 835.
[104] *Id.*
[105] *Id.*
[106] *Id.* at 835-37.
[107] Securities Act § 11(e), 15 U.S.C. § 77k(e) (1964); SEA § 9(e), 15 U.S.C. § 78i (1964); SEA § 18(a), 15 U.S.C. § 78r (1964).
[108] 292 F.2d at 837.
[109] *E.g.*, Weitzen v. Kearns, 262 F. Supp. 931 (S.D.N.Y. 1966), *aff'd sub nom.* Epstein v. Solitron Devices, Inc., 388 F.2d 310 (2d Cir. 1968); Kane v. Central Am. Mining & Oil, Inc., 235 F. Supp. 559, 569 (S.D.N.Y. 1964); BROMBERG § 2.5(2) n.109.
[110] Eagle v. Horvath, 241 F. Supp. 341, 345 (S.D.N.Y. 1965); *cf.* Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961).
[111] *See* the discussion of res judicata and collateral estoppel at section III *infra.*
[112] H. HENN, *supra* note 66, §§ 360-62.
[113] Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965) (Investment Company Act of 1940).

court to reach a result favorable to the plaintiff. Any state requirement which the federal court desires to impose in 10b-5 actions may still be imposed. All that the doctrine which has developed around 10b-5 means is that a federal court has discretion to decide the shareholder's right to bring the suit as a matter of federal law. Thus the federal court is not *bound* to follow state law, as it would be in situations within the *Erie* doctrine,[114] but the federal court, in its *discretion* to choose the proper federal rule, may reach the same result as a state court would.

Statute of Limitations. Like all good things, a cause of action arising under 10b-5 must come to an end. However, because it was not intended as a foundation for a private cause of action, the statutory basis for this action affords no period of limitations applicable to actions arising under the rule.[115] Unless the cause of action is to run forever, the federal courts must find some device for applying a statute of limitations to the 10b-5 action. Fortunately—or unfortunately—the Supreme Court has evolved a rule applicable to this situation. When Congress creates a right of action but fails to provide an applicable period of limitations, the courts presume that the congressional silence means that the state statute of limitations is to apply, for it is unlikely that Congress intended to create a right not subject to limitations, and there is no general federal statute of limitations to fill the void.[116] Thus, a federal court must look to state law to determine the statute of limitations applicable to the 10b-5 action.[117] But what state's statute should be applied? That of the forum, or should some conflict of laws rule be utilized to choose among the statutes of several states? And after the state is determined, what limitation period of that state should be utilized? Furthermore, when does the statute begin to run, and when is it tolled? And finally, does the equitable doctrine of laches apply, and, if so, is it determined by state or federal law?

The possibilities for confusion are almost limitless. Reflecting this fact, a good deal of litigation has arisen involving these questions. Interestingly, the courts have clung tenaciously to the Supreme Court's notion that state law should apply when no express limitations period is prescribed in the statute, but in all other areas under 10b-5 in which conflicts have arisen between federal and state law, the federal courts have been quick to reject the state rules on the ground that a separate federal rule is necessary to provide uniformity in the enforcement of the federal right.[118] Apparently, it is critical to the national regulatory scheme to have a federal rule on the important issue of whether a plaintiff can recover prejudgment in-

[114] *See* Mishkin, *supra* note 38, at 798-808.

[115] *See* BROMBERG § 2.5(1); *cf.* Lorenz v. Watson, 258 F. Supp. 724 (E.D. Pa. 1966); 3 Loss 1773-74.

[116] UAW v. Hoosier Cardinal Corp., 383 U.S. 696 (1966); Cope v. Anderson, 331 U.S. 461 (1947); Holmberg v. Armbrecht, 327 U.S. 392 (1946); Campbell v. Haverhill, 155 U.S. 610 (1895); *cf.* Guaranty Trust Co. v. York, 326 U.S. 99 (1945); Rules of Decision Act, 28 U.S.C. § 1652 (1964); 3 Loss 1771-77; Annot., 90 A.L.R.2d 265 (1963). *See also* Note, *Federal Statutes Without Limitations Provisions*, 53 COLUM. L. REV. 68 (1953).

[117] *See* Schulman, *Statutes of Limitation in 10b-5 Actions: Complication Added to Confusion*, 13 WAYNE L. REV. 635 (1967).

[118] *E.g.*, remedies, note 60 *supra*; security for expenses, note 85 *supra*; *cf.* note 82 *supra*.

terest,[119] but it is unnecessary to have uniformity on such a mundane issue as whether the plaintiff can assert his cause of action.

Choice of States. When a defense of limitations is raised in a 10b-5 action, one of the initial problems for the district court is the question of which state's limitations period is to be applied. Under the Supreme Court doctrine requiring the court to look to the state period, it is the statute of limitations of the state in which the federal district court is sitting which governs.[120] Because federal district judges usually are familiar with the law of the forum state, this approach ensures that the court will have little difficulty applying the limitations period correctly. However, the presupposition underlying federal court jurisdiction under the Exchange Act is that the transaction under consideration has some interstate connections.[121] To confer jurisdiction under the Act, these interstate connections may be trifling, but many fraudulent schemes or acts have substantial relations with several states. Because of the breadth of the personal jurisdiction and venue provisions in the Act,[122] the plaintiff may be able to use any of these states as the forum for his 10b-5 action. Due to the great diversity among the states on the time in which the plaintiff must bring his action, the plaintiff's action may be barred under the limitations period of some of the states yet still be viable under the period of other states. Thus the tardy plaintiff may forum shop among the federal district courts in order to find a forum state law which will allow him to maintain his 10b-5 action.[123] Not only does this situation underscore the lack of uniformity created by resort to state law, but it constitutes an improper use of 10b-5 as well. When used in this manner, 10b-5 becomes no more than a procedural trick to get the plaintiff into a court. The broad substantive rights afforded investors by the implied right of action are secondary here to the slippery jurisdictional features of the Exchange Act. In allowing the plaintiff to pick and choose the applicable statute of limitations by hinging that choice on the state in which the court happens to sit, the courts have turned these jurisdictional features into little erasers by which plaintiffs can wipe out the consequences of their own inefficiency.

One technique for avoiding this misuse is resort to some conflict of laws rule whereby a given cause of action would be governed by one statute of limitations regardless of the forum state of the federal court hearing the suit. For example, the federal court, like a state court applying a conflict of laws rule in a tort action,[124] could determine the federal district having the most significant relationship with the action and could then apply the statute of limitations which that district court would ap-

[119] *See* note 80 *supra.*

[120] Holmberg v. Armbrecht, 327 U.S. 392 (1946); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964); *cf.* Trussell v. United Underwriters, Ltd., 236 F. Supp. 801 (D. Colo. 1964).

[121] *See* note 3 *supra.*

[122] *See* note 7 *supra.*

[123] *See* note 69 *supra.*

[124] *See, e.g.*, Babcock v. Jackson, 12 N.Y.2d 473, 191 N.E.2d 279 (1963).

ply. This approach would insure that, no matter where the plaintiff chooses to file his suit, the period of limitations applicable to his 10b-5 action would be the same.[125]

A result similar to this was recently suggested in dictum by a Colorado federal district court.[126] There the alleged misrepresentation had occurred in Kansas, where the sale of securities was made. Concluding that the cause of action thus arose in Kansas, the federal court nevertheless looked to Colorado law to determine the applicable statute of limitations. However, Colorado has a "borrowing statute" which precludes maintenance of actions arising in another state when the action would be barred in that other state,[127] and the court reasoned that the Kansas period of limitations therefore would apply.[128] This latter approach has been sanctioned by the United States Supreme Court in a case involving the National Banking Act but which presented the same problems as 10b-5.[129]

Choice of Time Period. After the court has determined which state's statute of limitations governs, the next question is which limitations period of that state applies. To determine this, the court must delve rather deeply into policy considerations, both federal and state, for any limitations period merely reflects a policy determination of how long the plaintiff may wait before commencing his action. Reflecting differing policies toward different types of actions, all states have more than one period of limitations; yet the doctrine by which the federal courts refer to state law for the applicable statute of limitations provides no device for determining which of the various periods applies.[130] Clearly, it would be inappropriate for a court to apply a statute such as a twenty-year statute applicable to adverse possession of land in the 10b-5 action, but the choice among the various tort and commercial periods is not always easy. Because the question is a federal one, it is up to the federal courts to pick and choose among the provisions and to try to find the period most appropriate in effectuating the national policies behind 10b-5.[131] Thus the federal court is taking state statutes, reflecting state policies, and applying them so as to further federal policies. The result often is not blessed with clarity.

The choice of limitations problem which has arisen most frequently has been whether to apply a state limitations period for actions based on fraud or a period for actions based on statutory liability. Because the private right of action based on 10b-5 is quite similar to common law concepts of fraud and deceit,[132] the state limitations period for fraud actions may reflect state policy considerations most closely analagous to those underlying 10b-5.[133] On the other hand, the liability imposed under 10b-5 fre-

[125] *See also* text accompanying note 97 *supra.*
[126] Trussell v. United Underwriters, Ltd., 236 F. Supp. 801 (D. Colo. 1964).
[127] COLO. REV. STAT. ANN. § 87-1-19 (1963).
[128] 236 F. Supp. at 803.
[129] Cope v. Anderson, 331 U.S. 461 (1947).
[130] *See* cases cited note 116 *supra.*
[131] Charney v. Thomas, 372 F.2d 97, 100 (6th Cir. 1967); Vanderboom v. Sexton, 294 F. Supp. 1178 (D. Ark. 1969); Schulman, *supra* note 117, at 640.
[132] *See* BROMBERG § 2.7(1).
[133] *But see id.* § 2.5(1) n.105.

quently would not exist except for its statutory basis.[134] In this situation, therefore, it can be argued that the limitations period for liability created by statute should govern. Actually, neither analysis holds up completely, for 10b-5 simply does not fit the neat little slots constructed by state law.

If, however, a slot must be found, the fraud analogy is probably the better approach, and that is the choice made by most federal courts.[135] The rule prohibits employing devices, schemes or artifices to defraud, making untrue or misleading statements, and engaging in practices which operate as a fraud or deceit.[136] By this language, the Commission apparently sought to prohibit the sort of conduct already recognized under state law as fraud or misrepresentation. Thus when the rule is violated, the conduct involved is the sort to which a state court probably would apply its statute of limitations applicable to fraud or misrepresentation. This close connection between conduct which violates 10b-5 and common law fraud led the Ninth Circuit, in *Fratt v. Robinson*,[137] to hold that the 10b-5 action was one "for relief upon the ground of fraud" and thus came within the Washington six-year limitations period rather than a two-year period which applies to actions "for relief not hereinbefore provided for."[138] Although the defendant argued that the action arose from a statute, the court, relying on several decisions of the Washington supreme court, reasoned that it was the fraud which offended the statute.[139]

> Here is not a governmental statutory denouncement of a human action heretofore undenounced, such as a violation of a wartime price for a commodity. Fraud is denounced in all its phases by federal and state and the common law. There are statutes with restrictions and limitations as to actions under it, but such actions do not arise out of nor upon a statute . . . .[140]

Fratt now seems ensconced as authority for the proposition that state limitations periods applicable to fraud govern the 10b-5 action.[141] In fact, it has now achieved that somewhat dubious role as authority which can be cited by the court without any further discussion of the point or the applicability of the reasoning.[142] Since *Fratt* was based on an interpretation

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[134] *I.e.*, 10b-5 may make illegal conduct which would be sanctioned at common law. Therefore, the liability which is being imposed would not exist except for 10b-5. *Cf.* Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Connelly v. Balkwill, 174 F. Supp. 49 (N.D. Ohio 1959), *aff'd*, 279 F.2d 685 (6th Cir. 1960).

[135] Azalea Meats, Inc. v. Muscat, 386 F.2d 5 (5th Cir. 1967); Charney v. Thomas, 372 F.2d 97 (6th Cir. 1967); Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Hecht v. Harris Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968); Connelly v. Balkwill, 174 F. Supp. 49 (N.D. Ohio 1959), *aff'd*, 279 F.2d 685 (6th Cir. 1960); *cf.* Schulman, *supra* note 117, at 641-42, and cases cited therein.

[136] *Cf.* note 3 *supra*.

[137] 203 F.2d 627 (9th Cir. 1953).

[138] *Id.* at 635.

[139] *Id.*

[140] *Id.*; *cf.* Connelly v. Balkwill, 174 F. Supp. 49, 63-64 (N.D. Ohio 1959): "[T]he incorporation of a common-law right of action into a statute or rule . . . does not create a liability that would not exist except for the statute."

[141] Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951), is also commonly cited for this proposition. However, the one-paragraph consideration given there to the choice of the applicable limitations period was rather cursory. *Id.* at 787; *cf.* Errion v. Connell, 236 F.2d 447 (9th Cir. 1956).

[142] *E.g.*, Hecht v. Harris Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968).

of a Washington statute, however, it would seem that any decision on which limitation period should govern requires a consideration of the specific language of the state statutes of limitations. Without such an analysis of the limitations question, it is impossible to be certain what criteria the court is utilizing to choose the fraud statute. For example, in *Azalea Meats, Inc. v. Muscat*, a recent case arising in the Fifth Circuit, the district court[143] rejected *Fratt* and its train of following cases[144] because under Florida law an action brought under a statute is governed by the limitation period applicable to liability created by statute, even though the action is similar to one existing at common law.[145] On appeal, the court[146] rejected this notion, reasoning that the gravamen of a 10b-5 action is fraud.[147] "[A] state statute of limitations should not be permitted to narrow the filing time available under a broadly remedial federal act to a period less than the one available for commencing a similar common-law action."[148] To support this reasoning, the court quoted, somewhat irrelevantly, from a Supreme Court opinion[149] to the effect that the purpose behind the federal securities laws is to substitute a philosophy of full disclosure for that of *caveat emptor*.[150] By this approach, the Fifth Circuit seems to say that state law provisions are irrelevant; the applicable limitations period is always at least that which the state would apply to a fraud action at common law. This goes one step beyond what the courts have done in previous 10b-5 actions. Though acknowledging that the choice of the applicable limitations period is a matter of federal law, most courts, in looking to state law have been willing to follow the language of the state statutes in deciding which period is applicable.[151] *Azalea Meats*,[152] however, suggests that the Fifth Circuit, having concluded as a matter of federal law that 10b-5 is a fraud action, will look to state law only for the length of time applicable to fraud actions and without regard for any other periods prescribed by state law.[153]

Blue Sky Limitation Periods. Most states now have a blue sky law, many of which prohibit the same types of conduct condemned by 10b-5, and some of which expressly authorize a private action for investors injured by that conduct.[154] Where such actions are provided, it may be appropriate for the federal court to consider the limitation period contained in the state blue sky law as the period governing 10b-5 actions.[155] Since the pe-

[143] Azalea Meats, Inc. v. Muscat, 246 F. Supp. 780 (S.D. Fla. 1965).

[144] Cases cited note 135 *supra*.

[145] 246 F. Supp. at 782. However, the point was largely academic, for the limitations period both for the common law fraud statute and for liability created by statute is three years.

[146] Azalea Meats, Inc. v. Muscat, 386 F.2d 5 (5th Cir. 1967).

[147] *Id.* at 8.

[148] *Id.*

[149] SEC v. Capital Gains Bureau, 375 U.S. 180, 186 (1963).

[150] 386 F.2d at 8.

[151] Schulman, *supra* note 117, at 642.

[152] Azalea Meats, Inc. v. Muscat, 386 F.2d 5 (5th Cir. 1967), *rev'g* 246 F. Supp. 780 (S.D. Fla. 1965).

[153] This ignores the question of whether 10b-5 is really similar to a common law fraud action. *See* text accompanying note 161 *infra*.

[154] *See generally* L. Loss & E. Cowett, Blue Sky Law 138-42 (1958).

[155] *See* Bromberg § 2.5(1) n.105.

riods contained in these statutes are usually shorter than those applicable to common law fraud actions, some defendants have urged that they be applied by the federal court. The first two cases to consider this contention[156] rejected the blue sky limitations periods. In *Charney v. Thomas*[157] the Sixth Circuit rejected the statute of limitations in the Michigan blue sky law on the ground that the act contained no provision similar to section 10(b) of the Exchange Act. Similarly, the period in the Colorado blue law was rejected by a district court in *Trussell v. United Underwriters, Ltd.*[158] because the liability imposed in that act is more analogous to the civil liability imposed by section 12 of the Securities Act of 1933[159] than to liability imposed under 10b-5. These cases in effect say that the policies underlying the express liability provided by state blue sky laws are not the same as the policies underlying the 10b-5 action, which is in reality some sort of federal common law fraud action. In *Charney*, however, the court did not foreclose the possibility of using the blue sky limitations period.[160]

Recently, a district court sitting in Arkansas adopted the blue sky provision of that state.[161] In doing so, the court distinguished both *Charney* and *Trussell*, though the basis for these distinctions is somewhat obscure. Correctly, the court recognized that in choosing the proper limitations period it should select the period "which best effectuates the federal policy."[162] In choosing the shorter blue sky limitations period over that applicable to common law fraud, the court was impressed by the difference between the elements of the 10b-5 action and common law fraud actions in Arkansas courts.[163] In *Myzel v. Fields*[164] the Eighth Circuit, which Arkansas courts must follow, held that scienter is not an essential element of proof in 10b-5 actions. Abolition of this element, which is at the heart of the traditional common law action, the court noted,[165] gives 10b-5 actions a substantially different character from state court actions which still require proof of scienter. This difference, the court reasoned, is sufficient to make the state limitations period for common law fraud inapplicable.[166] *Trussell*[167] was distinguishable because the district court there

[156] Charney v. Thomas, 372 F.2d 97 (6th Cir. 1967); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964).

[157] 372 F.2d 97 (6th Cir. 1967).

[158] 228 F. Supp. 757 (D. Colo. 1964).

[159] *Id.* at 776.

[160] "[I]n some cases the local Blue Sky Law might be the more appropriate point of reference . . . ." Charney v. Thomas, 372 F.2d 97, 100 (6th Cir. 1967).

[161] Vanderboom v. Sexton, 294 F. Supp. 1178 (D. Ark. 1969). Arkansas has adopted the Uniform Securities Act, ARK. STAT. ANN. §§ 67-1235 to -1262 (Repl. 1966), so the limitation period was that applicable to actions under § 410 of the Uniform Securities Act. When the Uniform Act was drawn, the commissioners specifically rejected the idea that an implied right of action would be available under § 101 of the Act, which embodies the same language as rule 10b-5. Uniform Securities Act § 410(h), *Official Comment*. Thus, the only civil liability available under the Act is that under § 410, which is analogous to the express liability provided in § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l* (1964). *See generally* L. Loss & E. COWETT, BLUE SKY LAW 128-79, 250-51 (1958).

[162] 294 F. Supp. at 1188.

[163] *Id.* at 1191-92.

[164] 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

[165] 294 F. Supp. at 1192.

[166] *Id.*

[167] 228 F. Supp. 757 (D. Colo. 1964).

was following a Tenth Circuit opinion[168] which required proof of scienter in 10b-5 actions, thus making the 10b-5 action analogous to common law fraud.[169]

Even if the absence of the scienter element in 10b-5 actions makes the fraud limitations period inapplicable, that does not make the blue sky limitations period applicable—except by default. By seemingly circuitous reasoning, however, the court concluded that 10b-5 and the express liability provision in the blue sky law were similar.[170] The blue sky provision, which is virtually identical to section 12(2) of the Securities Act of 1933,[171] is actually the same as the second clause of rule 10b-5.[172] Therefore, the court concluded that the short limitations period which is applicable to blue sky remedies, which are analogous to liability imposed by section 12(2), is appropriate in the 10b-5 action.[173]

Tolling. Like a straight line, the period of limitations, once its length has been determined, runs from one point to another. In deciding whether an action is barred by limitations, therefore, the court must decide from what point in time the period runs. Determining this point is a matter of federal law, which the federal courts decide by reference to federal policies without particular regard for state tolling rules, even though the state rules would affect the period of limitations chosen by the court.[174] When fraud is involved in a federal action, the statute of limitations does not begin to run until either the fraud has been actually discovered or should have been discovered by the plaintiff.[175] In a 10b-5 action, because fraud is involved, this federal tolling doctrine comes into play.[176] Thus, if the applicable state period of limitations is two years, that period does not run until the plaintiff diligently should have discovered the fraud, even though it might take active concealment on the part of the defendant to toll the same limitations period in a state court action.[177]

From the standpoint of effecting federal policies, this use of a federal tolling doctrine clearly is appropriate. Without it, the antifraud policies of the federal law could be frustrated by short state limitations periods which would run even though the plaintiff had no knowledge of the fraud.

However, use of a separate federal tolling doctrine is not completely

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[168] Rice v. United States, 149 F.2d 601 (10th Cir. 1945).

[169] 294 F. Supp. at 1189-90.

[170] *Id.*

[171] 15 U.S.C. § 77*l* (1964).

[172] 294 F. Supp. at 1190; *see* note 3 *supra.*

[173] *Id.*; *cf.* Dack v. Shanman, 227 F. Supp. 26 (S.D.N.Y. 1964).

[174] Holmberg v. Armbrecht, 327 U.S. 392 (1946); Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). *But see* Butterman v. Steiner, 343 F.2d 519 (7th Cir. 1965), and Errion v. Connell, 236 F.2d 447 (9th Cir. 1956), which looked to state law on the tolling question.

[175] Bailey v. Glover, 88 U.S. 342 (1875); Moviecolor Ltd. v. Eastman Kodak Co., 288 F.2d 80 (2d Cir.), *cert. denied*, 368 U.S. 821 (1961); *see* Schulman, *supra* note 117, at 639.

[176] Saylor v. Lindsley, 391 F.2d 965, 970 (2d Cir. 1968); Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); Annot., 90 A.L.R.2d 265, 275 (1963); *cf.* Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

[177] Janigan v. Taylor, 344 F.2d 781, 784 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). For a discussion of due diligence, see Azalea Meats, Inc. v. Muscat, 386 F.2d 5, 8 (5th Cir. 1967).

satisfactory. In using the state limitations period, the court is adopting a set of state policies reflecting the length of time in which an action should be brought. However, the policies behind the state tolling provisions are at least as important as those behind the time period. A state may pass an exceptionally short statute of limitations but allow it to be freely tolled and achieve a result roughly similar to a long time period which is not so freely tolled. When the federal courts utilize their own tolling doctrine, they reject the latter part of the state policies behind the limitation period and thus may achieve an overall result much different from that of the state court. If the rationale behind resort to state law is that Congress presumably intended the state statute of limitations to apply,[178] it would seem that the federal courts should look to the total policy behind the state law, including tolling provisions, so that the federal court application of the state statute of limitations would reach the same substantive result as that of a state court.[179]

Laches. The choice of the appropriate statute of limitations is important when the action is purely legal in character, but when some form of equitable relief is sought, the limitation of that aspect of the plaintiff's action is governed by the equitable doctrine of laches.[180] In *Holmberg v. Armbrecht*[181] Justice Frankfurter observed that statutes of limitations do not control equitable relief and are "drawn upon by equity solely for the light they may shed" in determining whether the plaintiff has slept on his rights.[182] Although laches has been held inapplicable to some civil liability actions under the Securities Act of 1933,[183] the courts have held this equitable doctrine applicable to 10b-5 actions because the rights accruing under the rule "are enforceable at law and in equity."[184] In 10b-5 actions, however, the courts have not yet indicated whether this doctrine is that of the forum state or a federal concept of laches. In the one case which has raised this question,[185] the district court judge concluded that both federal and state doctrines were the same, so the question was academic. From Justice Frankfurter's language in *Holmberg*, however, it seems that federal doctrine should apply.[186] When the equity jurisdiction of the court is invoked in aid of its legal jurisdiction, the equitable action should not survive the legal right, since equity follows the law.[187] But when the equitable jurisdiction of the court can be invoked independently, as the cases

[178] *See* text accompanying notes 116-17 *supra.*

[179] Of course, because tolling here is a federal question, there is no requirement that the federal court reach the same substantive result as that of a state court, which would be the case if the *Erie* doctrine applied. *See* text accompanying notes 47-49 *supra*; note 34 *supra.*

[180] Holmberg v. Armbrecht, 327 U.S. 392 (1946).

[181] *Id.*

[182] *Id.* at 396.

[183] *E.g.*, Straley v. Universal Uranium & Milling Corp., 289 F.2d 370 (9th Cir. 1961); *cf.* Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962).

[184] Tobacco & Allied Stocks v. Transamerica Corp., 143 F. Supp. 323, 327 (D. Del. 1956), *aff'd*, 244 F.2d 902 (3d Cir. 1957); *see* Shapiro v. Schwamm, 279 F. Supp. 798 (S.D.N.Y. 1968); Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962).

[185] Baumel v. Rosen, 283 F. Supp. 128 (D. Md. 1968).

[186] Holmberg v. Armbrecht, 327 U.S. 392, 395 (1946).

[187] Cope v. Anderson, 331 U.S. 461 (1947); Tobacco & Allied Stocks v. Transamerica Corp., 143 F. Supp. 323 (D. Del. 1956), *aff'd*, 244 F.2d 902 (3d Cir. 1957).

suggest it can be in 10b-5 actions,[188] the federal court must make its own determination of whether to follow state law.

III. Res Judicata and Collateral Estoppel

After a state or federal court has entered a judgment in a securities fraud action, a new question of federal-state relations arises: what is the effect of that judgment upon an action pending in another forum? In general, this situation invokes the well-developed concepts of res judicata and collateral estoppel, which serve to preclude litigation of matters already decided.[189]

Res Judicata. The federal courts have split over the question of whether a prior state court action is res judicata as to a subsequent 10b-5 action.[190] Since the res judicata effect attaches only if the prior adjudication was on the same cause of action, the central question in these cases is whether the state proceeding involved the same cause of action as the federal court proceeding under 10b-5. If the prior action was unrelated to securities fraud, naturally the causes of action are different.[191] However, if the state suit was a common law action for misrepresentation in the securities transaction, it is much more difficult to decide whether 10b-5 is a separate cause of action from the state proceeding or is merely a different theory of recovery on the same cause of action.

Determining what constitutes a cause of action is a difficult question for the courts in all areas,[192] and securities fraud cases are no exception. In the earliest case clearly in point, *Connelly v. Balkwill*,[193] a district court in Ohio concluded that a prior fraud action in Ohio was res judicata as to the 10b-5 action before it—or at least that collateral estoppel precluded relitigation of the subject matter of the suit. The court based its reasoning concerning the res judicata point on the similarity between the duty imposed by Ohio law and the duty under 10b-5.[194] Concluding that the Ohio fraud standards were as stringent as the 10b-5 standards, the court held that the 10b-5 action was based on a cause of action no different from that in the prior state action.[195]

In *Connelly* the court apparently viewed the standard of duty imposed as the talisman for defining "cause of action." In a recent case,[196] however, the Second Circuit suggested that a state action based on a breach of fiduciary duty would not be res judicata in the 10b-5 action. The Second Circuit's reasoning, though dictum, was based on the fact that the state

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[188] *See* cases cited at note 184 *supra*.

[189] *See generally* 3 Loss 1796; Note, *Res Judicata: Exclusive Federal Jurisdiction and the Effect of Prior State-Court Determinations*, 53 Va. L. Rev. 1360 (1967).

[190] *Compare, e.g.*, Connelly v. Balkwill, 174 F. Supp. 49 (E.D. Ohio 1959), *aff'd*, 279 F.2d 685 (6th Cir. 1960), *with* Abramson v. Pennwood Invest. Corp., 392 F.2d 759 (2d Cir. 1968).

[191] Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954, 957-59 (N.D. Ill. 1952).

[192] 1B Moore ¶ 0.410[1].

[193] 174 F. Supp. 49 (E.D. Ohio 1959), *aff'd*, 279 F.2d 685 (6th Cir. 1960); *see* Note, *supra* note 189, at 1370-71.

[194] 174 F. Supp. at 55-60.

[195] *Id.* at 60.

[196] Abramson v. Pennwood Investment Corp., 392 F.2d 759 (2d Cir. 1968).

court could not hear the 10b-5 claims.[197] Since those claims are cognizable only in federal court, the court concluded that the 10b-5 claims represented a different cause of action, which the outcome of the state proceedings could not bar as res judicata.[198]

If this jurisdictional test employed by the Second Circuit is correct, a state determination can never be res judicata in a 10b-5 action, for a state court can never hear the 10b-5 claims.[199] Other cases, however, have not utilized such a mechanical test and have found that res judicata applies despite the fact that the 10b-5 claims could not be raised in the state action.[200]

In *Dembitzer v. First Republic Corp. of America*[201] Judge Metzner distinguished between the wrong done and the theory of recovery advanced. Characterizing 10b-5 as merely a different theory of recovery from the breach of fiduciary duty alleged in the state action, he reasoned that "res judicata applies if the legal wrong done by the impact of the same facts was the same in the two cases."[202] In most cases this characterization of the right infringed is accurate. In both the federal and the state actions the plaintiff is complaining of the same fraudulent conduct in connection with a securities transaction. Ordinarily, the only difference between the contentions in the two actions is the basis on which the plaintiff seeks to recover. In the state action he alleges that a duty owed to him under common law has been breached; in the federal court he contends a rule prohibiting this sort of conduct has been violated. In this context, therefore, the 10b-5 action looks very much like nothing more than a statutory version of common law fraud.

The "right infringed" theory of what constitutes a cause of action conforms to that utilized in some non-securities cases, where the focus has been on the right infringed rather than the form of the action,[203] but it apparently is based on notions of procedure which are inapplicable in securities fraud situations. In making "cause of action" hinge on the right infringed rather than on the theory of recovery, the courts assume that modern procedural devices permit the parties to advance all of their theories in the same proceeding.[204] In most actions, joinder of pleadings and compulsory counterclaims require the litigants to assert all of their claims in one proceeding, and fairness to the parties dictates that matters not raised there should not be advanced later. Under the older notions of forms of action, however, the definition of cause of action was of necessity much narrower.[205] If all of the theories of recovery could not be advanced in the first proceeding, res judicata would not preclude subsequent litiga-

[197] *Id.* at 762; *cf.* text accompanying note 22 *supra.*

[198] 392 F.2d at 762.

[199] *See* text accompanying note 22 *supra.*

[200] Boothe v. Baker Indus., Inc., 262 F. Supp. 168 (D. Del. 1966); Dembitzer v. First Republic Corp. of America, CCH FED. SEC. L. REP. ¶ 91,566 (S.D.N.Y. July 30, 1965).

[201] CCH FED. SEC. L. REP. ¶ 91,566 (S.D.N.Y. July 30, 1965).

[202] *Id.*

[203] 1B MOORE ¶ 0.410[1], at 1157.

[204] *Id.* at 1151.

[205] *Id.* at 1161.

tion between the parties.[206] The jurisdictional provisions of the SEA suggest that this older view is more applicable to securities actions than the modern approach.[207] Since the plaintiff cannot raise his 10b-5 claims in a state court, the modern procedural devices promoting joinder are irrelevant; he cannot have his day in court on his federal claims without going into federal court.

Collateral Estoppel. If res judicata does not attach to a prior state fraud action, the question remains whether its sister doctrine of collateral estoppel may prevent relitigation of the matters litigated in the state court.[208] When both federal and state actions are based on the same transaction, collateral estoppel should apply. Recognizing this, several courts, when invoking res judicata to bar 10b-5 actions, have suggested that the narrower doctrine of collateral estoppel would also apply so as to defeat the federal action.[209] Since both federal and state actions are concerned with the fraud or misrepresentation of the defendants, the issues raised and the proof offered will be virtually the same in both actions. If for no other reason, the simple dictates of judicial economy require that once the evidence is presented on these issues and the facts are determined, there is no need to make another determination.[210]

Applied in the cases which have invoked res judicata, however, collateral estoppel probably would not have precluded the 10b-5 litigation. The rationale behind the doctrine is that the issues have been subjected to the adversary process of resolution in a prior action. Thus, according to Professor Moore, default judgments, consent judgments, and judgments upon stipulations should not be given effect under collateral estoppel, for the issues determined there lack the test of judicial inquiry (*i.e.*, the issues in reality have not been litigated).[211] The recent securities cases raising the question of res judicata all represent attempts by shareholders to prosecute derivative suits under 10b-5 when prior state derivative suits had been settled.[212] If Moore is correct, collateral estoppel should not attach to the issues involved in these settlements, so the plaintiffs would not be estopped from raising them in the 10b-5 actions. If res judicata can be applied, however, even the settlements will preclude subsequent actions, for res judicata attaches finality to all such judgments.[213] Although this distinction betwen res judicata and collateral estoppel may be somewhat artificial, the courts apparently felt constrained to find that the prior state proceedings were res judicata in order to prevent relitigation of the issues

[206] *See* Williamson v. Columbia Gas & Elec. Corp., 186 F.2d 464, 469-70 (3d Cir. 1950), *cert. denied*, 341 U.S. 921 (1951).

[207] *I.e.*, a state court could not require joinder of the 10b-5 claims with common law claims. *See* note 22 *supra.*

[208] 1B MOORE ¶ 0.441.

[209] Abramson v. Pennwood Invest. Corp., 392 F.2d 759 (2d Cir. 1968); Boothe v. Baker Indus., Inc., 262 F. Supp. 168 (D. Del. 1966); Connelly v. Balkwill, 174 F. Supp. 49 (E.D. Ohio 1959), *aff'd*, 279 F.2d 685 (6th Cir. 1960).

[210] 1B MOORE ¶ 0.444.

[211] *Id.* ¶ 0.442[1].

[212] Saylor v. Lindsley, 391 F.2d 965 (2d Cir. 1968); Dembitzer v. First Republic Corp. of America, CCH FED. SEC. L. REP. ¶ 91,566 (S.D.N.Y. 1965); cases cited note 209 *supra.*

[213] 1B MOORE ¶ 0.409.

raised in the state courts. In these cases, however, there were strong grounds for precluding relitigation. In several, the plaintiffs either had an opportunity to intervene in the state proceeding but declined or actually participated in the state court action.[214] In none of the cases had the derivative action failed on its merits. Therefore, it can be argued that only the *Connelly*[215] decision stands as a case in which a 10b-5 action was dismissed because a prior state action had resolved the fraud issues on the merits. The question of whether a prior state action is res judicata on the 10b-5 claims, therefore, is probably still open.

IV. Conclusion

The Supreme Court dictum in *Borak*,[216] now backed by a number of lower court opinions, clearly establishes the overriding importance of federal law in 10b-5 actions. When a question of procedure arises, therefore, the adoption of the proper rule is a matter of federal law. Of less certainty is the extent to which the federal courts will look to state law in deciding these federal questions. Arthur Fleischer has observed that state law is inapplicable only when it "impedes the congressional purpose,"[217] and some cases have rejected state law which "cuts across" the federal rights.[218] Determining when state law does "cut across" the federal right is of course the critical question. To a large extent this determination hinges on the substantive make up of the federal rights. Before deciding whether the congressional purpose would be impeded or the federal right "cut across," the court must decide what that congressional purpose or those federal rights are.

The cases which have been decided, however, do indicate the power of the federal law to override state procedural requirements. In rejecting appraisal as the exclusive remedy for shareholders who dissent from a merger,[219] the cases suggest that even very strong state policies are irrelevant. In making appraisal the exclusive relief for shareholders, the states have indicated a strong policy against shareholder interference with merger transactions, except as authorized by statute. The willingness of the federal courts to ignore this exclusive relief suggests that state policies toward shareholders are relevant only if they happen to conform to federal policies. From the results of the cases, it is apparent that this means that state policies designed to restrict the rights of shareholders and other investors will be rejected, whereas those designed for the protection of that group probably will be adopted.

The rejection of state procedural requirements for derivative suits is a further indication of the unwillingness of the federal courts to follow

[214] Cases cited note 212 *supra*; *cf.* Moran v. Paine, Webber, Jackson & Curtis, 279 F. Supp. 573, (W.D. Pa. 1966), *aff'd*, 389 F.2d 242 (3d Cir. 1968).

[215] Connelly v. Balkwill, 174 F. Supp. 49 (E.D. Ohio 1959), *aff'd*, 279 F.2d 685 (6th Cir. 1960).

[216] J.I. Case Co. v. Borak, 377 U.S. 426, 434 (1964).

[217] Fleischer, *"Federal Corporation Law": An Assessment*, 78 Harv. L. Rev. 1146, 1170 (1965).

[218] *E.g.*, McClure v. Borne Chem. Co., 292 F.2d 824, 835 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961).

[219] *See* text accompanying note 65 *supra*.

state policies which restrict the rights of investors.[220] In *McClure v. Borne Chemical Co.*[221] the Third Circuit carried this notion one step further when it stated that the shareholder's right to sue under 10b-5 in behalf of the corporation arises independently of state law. It perhaps would have been reasonable to conclude that a shareholder's right to sue on behalf of the corporation is a question of state law since the relationship of the shareholder to the corporation is ordinarily a creation of the law of the state of incorporation. In rejecting this argument, the court thus indicated that even on this fundamental question of corporation-shareholder relations, federal law is supreme.

The notable exception to this rejection of state law concepts in 10b-5 actions is the choice of the applicable limitations period of the state where the federal court is sitting.[222] With federal courts sitting in fifty different states, each with a somewhat different policy toward limitation of actions, this resort to state law is an approach highly unlikely to produce uniformity in any sense of that term. Nevertheless, the doctrine is a venerable one, and the Supreme Court recently affirmed it in the field of labor relations,[223] which seems indistinguishable on this point from 10b-5 actions. The rationale behind this resort to state law is partly that there is no need for uniformity on this issue and partly that the failure of Congress to provide a limitations period applicable to the 10b-5 action indicates that Congress intended for the state periods to apply. When considered against the background of the exceptionally short limitations periods expressly provided in the securities laws, this second rationale seems unlikely. A more plausible explanation for the failure of Congress to provide an express limitation period for 10b-5 actions is that Congress did not anticipate that section 10(b) of the Act (or a rule promulgated under it) would serve as a foundation for a private right of action.[224] Thus a much better approach would be to fashion a separate federal period of limitations applicable to 10b-5 actions which would better reflect the policy of limitation of actions suggested by the short limitations periods contained in other provisions of the securities laws.[225] Because of the venerable nature of the Supreme Court doctrine requiring resort to state limitations periods, however, there is little possibility that a federal limitations period properly could be fashioned by the courts. Thus legislation probably is required to eliminate the presumption.

The absence of a need for uniformity on the limitations period applicable to 10b-5 actions is also a questionable reason for resort to state law. Although it is true that the question of limitations actually does not go to

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[220] *See* text accompanying note 83 *supra.*

[221] 292 F.2d 824, 832-35 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961); *cf.* Levitt v. Johnson, 334 F.2d 815, 819 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965) (Investment Company Act of 1940).

[222] *See* text accompanying note 115 *supra.*

[223] UAW v. Hoosier Cardinal Corp., 383 U.S. 696 (1966); *see* cases cited note 116 *supra.*

[224] Schulman, *Statutes of Limitation in 10b-5 Actions: Complication Added to Confusion*, 13 WAYNE L. REV. 635, 649 (1967).

[225] *Id.*; Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 685-86 (1965).

the right created by federal law,[226] the federal right has not been affected in other areas in which the federal courts have rejected state rules in favor of fashioning separate federal rules.[227] The federal right involved is the protection of investors from fraudulent activities, and the limitation of the investor's action is not necessarily involved in that right. Nevertheless, the possibilities for confusion associated with choosing and applying the applicable state law[228] and the possibility of injustice associated with forum shopping by virtue of section 27 of the Act[229] indicate that the question of limitations has become inseparably tied up with the federal rights created by 10b-5. Thus the absence of a federal rule on this subject actually impairs the federal right just as much as would application of state security for expenses requirements. In short, this area is one in which a uniform national rule both would produce a more just result for the parties and would be easier to apply.

Determining where res judicata and collateral estoppel fit into this map of federal-state relations is still a somewhat ambiguous question. The willingness of the federal courts to disregard state law concepts which impede the plaintiff in bringing his 10b-5 action suggests that a prior state adjudication should not bar the plaintiff's 10b-5 action. However, the cases which have rejected state law have involved procedural questions arising prior to judgment.[230] Once a judgment is rendered, somewhat different considerations, based primarily on the need for finality in litigation, become applicable. Once the plaintiff has had his day in court, he should not be allowed to relitigate his action by finding another forum and another theory of recovery. Nevertheless, a prior state adjudication probably should not bar the plaintiff in asserting his 10b-5 claims, for the exclusive jurisdiction of the federal courts over those claims means that the plaintiff can never have his day in court on them until he is in federal court. The doctrine of pendent jurisdiction of course may be available to permit the plaintiff to litigate both his federal and state claims in the same forum if he files suit in federal court initially,[231] but his failure to utilize this aproach should not preclude him from asserting his federal claims.[232] Section 28 of the Exchange Act preserves the plaintiff's rights under state law,[233] and the fact that he chooses to assert those rights in a separate state action should not prejudice his rights under federal law.

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[226] UAW v. Hoosier Cardinal Corp., 383 U.S. 696, 702 (1966).
[227] *E.g.*, security for expenses. *See* text accompanying note 83 *supra.*
[228] *See, e.g.*, text accompanying note 154 *supra.*
[229] *See* text accompanying note 121 *supra.*
[230] *E.g.*, security for expenses, appraisal.
[231] *See* text accompanying note 30 *supra.*
[232] *But see* 1B MOORE ¶ 0.410[2] n.38, at 1183.
[233] *See* note 8 *supra.*