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ACTION UNDER STATE LAW: FLORIDA'S BLUE SKY AND COMMON LAW ALTERNATIVES TO RULE 10b-5 FOR RELIEF IN SECURITIES FRAUD

INTRODUCTION

The Securities Exchange Act of 1934[1] [the Act] has, since its enactment,[2] been the primary source of relief for securities fraud while state law has been relegated to an ancillary status.[3] The circuit courts of appeal had dramatically expanded the narrow language of section 10-b and rule 10b-5[4] until they eclipsed all other sources of relief for securities manipulation and deception. However, recent Supreme Court rulings have just as dramatically restricted the scope of these provisions[5] and a plaintiff can no longer invoke the Act and be confident of sympathetic judicial interpretation and lenient elements of action.[6]

1. Securities Exchange Act of 1934, §10, 15 U.S.C. §78 (1976). As originally promulgated, §10-b makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Securities and Exchange Commission may prescribe as necessary or appropriate in the public interest or protection of investors. *Id.* §78j.

2. *See* S. REP. No. 792, 73d Cong., 2d Sess. (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 18 (Ellenberger & Mahar 1973). One of the most important policies behind the Act was to curb misuse of inside information in the trading of securities. The Act was designed to substitute the philosophy of full disclosure for that of caveat emptor and to protect the investing public from the abuses of insiders. For judicial articulation of this policy *see, e.g.*, Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2nd Cir. 1969). The federal law was so successful that most state legislation and judicial interpretation has tracked federal law. The Uniform Securities Act's antifraud provision follows rule 10b-5 even to the extent of omitting authorization of civil relief and requiring judicial interpretation on that point. Ratner, *Federal and State Roles In The Regulation of Insider Trading*, 31 BUS. LAW. 947, 950-51 (1976).

3. As long as the Act was able to grant relief, all other alternatives have been largely ignored. When state law has been considered in this context, it has been mainly as an ancillary action for the purpose of increasing damages. Punitive damages are not authorized under the Act, but are available in common law fraud actions. This is made possible by provisions of the Act which allow state law remedies as long as they do not run counter to the federal law. Note, *The Availability of Variant State Remedies for Pendent State Fraud Claims Actionable Under the Federal Securities Act*, 47 S. CAL. L. REV. 1213, 1230-34 (1974).

4. 15 U.S.C. §78j (1976). Rule 10b-5 was promulgated pursuant to the authority granted by §78w for the protection of investors. 17 C.F.R. §240.10b-5 (1979).

5. The trend of the recent Supreme Court decisions interpreting the Act has been very restrictive, reversing what had been an expansive trend by the Circuit Courts of Appeals. Between 1975 and 1977, the Supreme Court added the element of scienter to the cause of action, refused standing except to a purchaser or seller, and held that corporate mismanagement was not actionable under the Act. *See* Santa Fe Indus. Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). See note 83 and accompanying text, *infra*.

6. Prior to the Supreme Court's restrictions of the Act, many circuit courts were willing to grant wide latitude in its use. Scienter was often not an element of action, privity was not

The plaintiff can now expect elements of action and problems of proof as stringent and difficult as the most difficult action under common law.[7] In effect, this will often bar an action under the Act forcing the plaintiff to seek relief under state law.[8] Fortunately, the state statutory and common law, long neglected as a primary source of relief for securities fraud, offer surprisingly effective alternatives to the federal law. The plaintiff should be aware, however, that while a state cause of action can often circumvent the difficulties of action under the Act, state action also presents unique problems that may defeat the unwary.

The recent case, *Cameron v. Outdoor Resorts of America Inc.*,[9] illustrates the need for a plaintiff defrauded in a securities transaction to consider bringing an action under state law. The plaintiffs in *Cameron* originally brought an action[10] pursuant to rule 10b-5 against Outdoor Resorts of America Inc., a recreational land developer that sold recreational vehicle lots on a condominium plan.[11] Outdoor Resorts presented this offer to the plaintiffs with optimistic projections of occupancy, expense, and income which were not realized.[12] The plaintiffs' action under the Act for fraudulent representation in the sale of a security was upheld by the lower court. The Fifth Circuit Court of Appeal reversed,[13] finding that the plaintiffs had only shown negligent misrepresentation and had not met the requirement of scienter.[14] Although it denied action under the Act, the Fifth Circuit did not leave the plaintiff without a remedy, but remanded the case for consideration under Florida's common law of negligent misrepresentation.[15]

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required, and many went so far as to grant relief to plaintiffs who had not even traded. In many of these courts there was a judicial policy of intense protection of a securities investor, and the most difficult task for a plaintiff was to show a deception. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2nd Cir.), *cert. denied*, 404 U.S. 1005 (1971).

7. The effect of the recent restrictive trend has been to supplement the Act with elements of action that are almost as stringent as those under common law fraud, one of the most difficult common law actions to maintain. The element of scienter is now required in both, and while privity is slighty more lenient under the Act, elements of privity have been imposed. In cases of nondisclosure, the Act is even more stringent than a common law action for fraud, requiring a fiduciary relationship; fraud requires a duty to disclose, a somewhat wider standard. See notes 231-235 and accompanying text, *infra*.

8. The federal law has always allowed state action in this area, and has never specifically prohibited it. The effectiveness of the federal rules has usually relegated state action to a pendent role in the federal courts, leaving the developments of federal law judicially unconsidered in the state courts. *See* 15 U.S.C. §78 bb(ä) (1976). *See also* 2 S. GOLDBERG, FRAUDULENT BROKER-DEALER PRACTICES, ch. 10 at 16 (1978).

9. 608 F.2d 187 (5th Cir. 1979), *modified* 611 F.2d 105 (5th Cir. 1980).

10. *Id.* at 192 n.1.

11. *Id.* at 191.

12. *Id.* Outdoor Resorts Inc. projected an 80% occupancy rate with a return of five dollars per night to the owner. It further projected that each lot would cover the debt payments for a block of 20 campsites. These overly optimistic projections induced the plaintiffs to purchase 45 lots at $6,000 each. *Id.*

13. *Id.* at 194.

14. *Id.* The plaintiffs had failed to allege scienter on the part of Outdoor Resorts Inc. Scienter in this context is a "mental state embracing intent to deceive, manipulate, or defraud." SEC v. Blatt, 583 F.2d 1325, 1333-34 (5th Cir. 1978).

15. The case was remanded after rehearing, 611 F.2d 105, 107 (5th Cir. 1980). While the

Florida's common law of negligent misrepresentation not only allowed the plaintiffs in *Cameron* to circumvent the federal scienter requirement, but it also imposed elements of action not present in federal law.[16] If the plaintiffs are not aware of these elements of action, such as privity, the state cause of action, which has the potential of providing relief, may also fail. Thus in *Cameron* the plaintiffs were left not only with an alternative to federal action, but also with an alternative set of standards, some of which have not been developed in relation to securities fraud,[17] and which, if ignored, could make relief unavailable. This note outlines the possibilities and problems of the state action under Florida law for securities fraud, which is destined to become a major avenue of relief for defrauded Florida plaintiffs.

ACTION UNDER THE ACT, SECTION 10-b AND RULE 10b-5

An appreciation of the possibilities and problems of the Florida law of securities fraud requires a review and comparison of the federal provisions, including the Securities Exchange Act of 1934.[18] Prior to 1934, a defrauded purchaser or seller of securities was limited either to state common law[19] or state securities statutes.[20] Neither alternative was adequate.[21] The complexity

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Fifth Circuit used the language of fraud, it apparently meant negligent misrepresentation. The court felt the defendant's actions fulfilled the elements of common law fraud: a false representation of a material fact, knowledge of the falsity or a negligent representation, intent to induce action, and damage resulting from justifiable reliance on the representations. 608 F.2d at 195-96. If the defendants had actual knowledge of the falsity of their representations then they would have had the requisite scienter to make action under the Act possible. It is clear, therefore, that the court was remanding this action for consideration under negligent misrepresentation because it had previously found scienter not to be present.

16. The plaintiffs escaped the scienter requirement of action under the Act, but they incurred the burdens of establishing jurisdiction and privity under state law. Fortunately for them, the representations were made within Florida and were made directly by the selling party, fulfilling both elements not present in the Act. *Id.* at 191.

17. See note 8 *supra.*

18. 15 U.S.C. §78j (1976).

19. The common law at this time offered only erratic relief. In Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933), a director misused inside information to purchase shares through a broker from several shareholders. In finding no liability the court stated "[t]he fact that the defendants were directors created no fiduciary relation between them and the plaintiff in the matter of the sale of his stock." *Id.* at 361, 186 N.E. at 660. In Thompson v. Walker, 253 Mich. 126, 234 N.W. 144 (1931), however, the court, in imposing liability, found that the directors and officers had a duty to act in the utmost good faith to see that their statements to prospective shareholders were true. *Id.* at 136, 234 N.E. at 147. Generally, the majority took the *Goodwin* view and refused to extend a fiduciary duty from an insider to a shareholder with whom he had traded. *See* R. FROME & V. ROSENZWEIG, SALES OF SECURITIES BY CORPORATE INSIDERS 234-35 (2d ed. 1975).

20. *See* Washburn & Steig, *Control of Securities Selling*, 31 MICH. L. REV. 768 (1933). At the time the exchange act was passed, 43 states had blue sky laws. *Id.* at 769. Of these only three had any antifraud provisions, while the rest required only licensing of seller and a merit determination by the state securities board. The three states with antifraud provisions allowed the attorney general to prosecute criminally for fraudulent transactions, but no state offered any civil remedy. Every state had separate criminal statutes for fraud, but in practice they were ineffective for fraud on a large scale and could not cope with the organized secur-

of the national securities market and the faceless interstate transactions consummated through the exchange destroyed the privity[22] necessary for common law action and usually prevented the forum from gaining jurisdiction even if a cause of action existed.[23] This relative inability of state law to control securities fraud resulted in rampant abuse of inside information[24] and widespread manipulation of the securities market. Congress responded with Section 10-b of the Act[25] which was expanded by the Securities and Exchange Commission through rule 10b-5.[26] Congress intended to substitute a policy of full disclosure for caveat emptor and to protect persons trading in securities.[27] Section 10b and rule 10b-5 were inforceable by the SEC through both criminal and injunctive action[28] and were to regulate those interstate transactions that state law had been unable to control.[29] As originally envisioned the SEC, acting

ities manipulation common at that time. *Id. See also* Bartell, *Federal State Relations Under the Federal Securities Code,* 32 VAND. L. REV. 457, 463 n.32 (1979).

21. The many states that had blue sky laws in 1933, including those with rigid standards and antifraud provisions, were dissatisfied with their effectiveness. Washburn & Steig, *supra* note 20, at 768-69. Congress also considered state law inadequate in this area. S. REP. No. 792, 73d Cong., 2d Sess. (1934), *reprinted in* LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 12 (Ellenberger & Mahar 1973). *See also* Note, *supra* note 3, at 1229.

22. The largely interstate nature of securities transactions was beyond the reach of most state laws at a time when long arm statutes were unknown. Even if jurisdiction could be established, the use of brokers negated the privity requirement, while the requirement of scienter remained as difficult probatively as it is today.

23. Fraud was actionable at this time in all jurisdictions, but the elements of the action were very stringent. *See* Comment, *Fraud-Right of Buyer to Rely on Seller's Representations as to Value of Stock,* 19 VA. L. REV. 299 (1933). A plaintiff's action was limited to misrepresntation of fact and not opinion, and he must have exercised reasonable care in his own behalf. If the plaintiff had freedom to investigate no cause of action would lie, despite what the investigation failed to reveal. Nonsuit would also result if there was no fiduciary relationship and the subject matter was equally available to both parties. *Id.* at 300-01. *See also* Note, *The Liability of Directors and Officers For Misrepresentation in the Sale of Securities,* 34 COLUM. L. REV. 1090, 1094-97 (1934).

24. *See* Stock Exchange Practices, Letter from the Counsel for Senate Committee on Banking and Currency (to Senate Banking and Currency Committee), Under S. Rep. 84, 72d Cong. (Feb. 18, 1933), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 3 (Ellenberger & Mahar 1973). See note 2 *supra.*

25. See note 1 and accompanying text, *supra.*

26. 17 C.F.R. §240.10b-5 (1979). Rule 10b-5 makes any use of a device or scheme to defraud unlawful, and does not differentiate between violations of ommission or commission. *Id.* §a. It also specifically prohibits an omission which makes other statements misleading, calling for full disclosure if anything is said. *Id.* §b.

27. "It is clear that the statute was intended to create a form of fiduciary relationship between so-called corporate insiders and outsiders with whom they deal in company securities which places upon the insiders duties more exacting than mere abstention from what generally is thought to be fraudulent practices." Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963).

28. Securities and Exchange Act of 1934 §21 (e), 15 U.S.C. §78u(e) (1976).

29. S. REP. No. 792, 73rd Cong. 2d Sess. 1-5 (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (Ellenberger & Mahar 1973). One of the main deficiencies of state laws at this time was their being limited to criminal sanction. None provided for civil relief which was considered far more effective in controlling abuse. *Id.*

pursuant to the authority of the Act, was to be the primary check on securities abuse while private action under state law occupied a secondary position.

Following the liberal policy of full disclosure,[30] the courts dramatically expanded the Act to afford generous relief.[31] The courts relaxed the elements of action, and expanded the use of section 10b by opening its provisions to private plaintiffs as well as the SEC.[32] Initially, only plaintiffs defrauded by actual misrepresentation could obtain relief, but the section was judicially extended to cases of nondisclosure[33] where the information not disclosed would be considered important by a reasonable investor.[34] The class of potential plaintiffs was also expanded by the judicial interpretation of rule 10b-5 to negate the requirement of privity of contract between buyer and seller.[35] The courts allowed plaintiffs who had never directly traded with the defendant, but who had used the medium of the exchange, to bring action under the Act.[36] Early

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30. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). "The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks, including risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital." *Id.* at 851-52.

31. *See, e.g.*, Financial Indus. Fund Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973); A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

32. The most potent protection for investors is the ability to bring a civil action for damages. The profit motive was considered to be more effective than sole reliance on governmental action. *See, e.g.*, Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). The judiciary viewed §10b of the Exchange Act as having the purpose of making the guilty party answerable in civil damages, apart from any action the commission might take. This implied provision for damages was, according to some courts, the essence of the deterrent force of the act. Fratt v. Robinson, 203 F.2d 627, 631 (9th Cir. 1953).

33. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Mills v. Electric Autolite Co., 396 U.S. 375 (1970); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 796 (1969).

34. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972). This test is substituted for ordinary causal links in cases of misrepresentation. Without some form of implied causation, liability in cases of non-disclosure would be difficult, if not impossible to prove. *See generally* Keeton, *Fraud-Concealment and Non-Disclosure* 15 TEX. L. REV. 1 (1936).

35. *See* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971). Here plaintiffs had sold through an exchange and had no privity with the purchasers who had perpetrated the misrepresentations. The action was upheld, but the element of causation was added. See note 81 and accompanying text, *infra*. *Accord*, Heit v. Weitzen, 402 F.2d 909 (2d Cir.), *cert. denied*, 395 U.S. 903 (1968).

36. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969); McManus v. Jessup & Moore Paper Co., 3 S.E.C. 1864 (E.D. Pa. 1948). *But see* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952). An exception to the purchase or sale requirement has always been found if the plaintiff is only seeking to obtain injunctive relief and not damages. Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967). This has remained true even after the later more restrictive decisions imposed a strict requirement for a purchase or sale.

cases went so far as to afford relief to parties that had not traded, but were damaged by not having done so.[37]

The courts also expanded the application of rule 10b-5 to the more peripheral areas of the securities market. For example, the courts used the rule to qualitatively review the actions of corporate insiders.[38] Where action had been previously allowed for an insider's manipulation of an investor's ignorance, it became possible to obtain relief under rule 10b-5 for an insider's breach of fiduciary duty.[39] This became a potent ground for action,[40] and in some cases was applied to corporate mismanagement and insider negligence.[41] The judicial application of rule 10b-5 to corporate mismanagement, coupled with the policy of granting relief in the absence of a trade, gave indications, that if unchecked, rule 10b-5 had the potential of becoming an omnibus provision for federal regulation of corporate action.[42]

As the courts expanded the class of plaintiffs and application of rule 10b-5, they also expanded the class of potential defendants.[43] Initially, only insiders[44]

37. *Id.*

38. There is a long history of state actions enforcing fiduciary duties of corporate insiders to the corporation and its shareholders. *See* Flight Equip. & Eng. Corp. v. Shelton, 103 So. 2d 615, 626-27 (Fla. 1958); Citizens State Bank v. Adams, 140 Fla. 578, 583, 193 So. 281, 283 (1939); Renpack, Inc. v. Oppenheimer, 104 So. 2d 642, 644 (Fla. 2d D.C.A. 1958); Etheredge v. Barrow, 102 So. 2d 660, 662 (Fla. 2d D.C.A. 1958); Diamond v. Oreamuno, 24 N.Y.2d 494, 496 (N.Y. 1969). While rule 10b-5 does not expressly address the problem of breach of corporate fiduciary duty it can, by implication, be applicable. Since most breaches of corporate fiduciary duty involve securities in some form and are accompanied by fraud, deceit or nondisclosure, 10b-5 was found to be applicable. *See, e.g.*, Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971). This case held that rule 10b must be read flexibly and that disregard of a trust relationship (here that of a controlling shareholder to the corporation) is the same seamless web as manipulation and investor's ignorance. *Id.* at 12.

39. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

40. See note 38 *supra.*

41. Early cases under rule 10b-5 were split regarding the requirement of scienter. Thus in a jurisdiction that did not require scienter, negligent breach of fiduciary duty could often be an implied cause of action under rule 10b-5 in the same manner as a fraudulent breach of fiduciary duty. *See* White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir.), *cert. denied,* 419 U.S. 873 (1974); Lanza v. Drexel 479 F.2d 1277, 1306 (2d Cir. 1973). Since Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), a civil action for damages now requires scienter. See also note 117 *infra.*

42. *See, e.g.,* Affiliated Ute Citizens v. United States, 406 U.S. 128, (1972); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971); Kardon v. National Gypsum Corp., 73 F. Supp. 798 (E.D. Pa. 1947).

43. Both §10b and rule 10b-5 only narrow the class of potential defendants to persons who violate the law by means of the use of an instrumentality of interstate commerce or mail or of a facility of a national securities exchange. Specificity in this area was deliberately left to judicial interpretation. See 15 U.S.C. 78j (1976); 17 C.F.R. §240.10b-5 (1979).

44. Although an insider is usually involved in a trade, this need not be so. A plaintiff who has traded was able to bring action against insiders who, although not trading, had misused inside information to defraud the plaintiff. Generally, the following types of abuse are actionable: concealment of a material fact, use of misleading statement, use of a fraudulent device, preparation of misleading statements, and withholding information from minority shareholders. *See* Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953).

who actually made a purchase or sale[45] were liable under the rule. The courts soon enlarged the concept of "insider" to include anyone who possessed inside information of value to a reasonably speculative investor.[46] They used this expanded concept to impose liability on third parties who did not take part in a trade,[47] such as brokers,[48] controlling persons,[49] and accountants.[50] The courts

45. This narrow application of the Act soon expanded as rapidly as the inventiveness of plaintiffs' attorneys would allow. Now the purchase or sale requirement is a restriction on the class of plaintiffs that have standing, but has nothing to do with determination of the class of defendants.

46. The term "insider" originally referred to corporate officers and directors who were privy to significant non-public information concerning the corporation in which they served. This abuse of information by officers and directors was one of the primary motivations for enacting the Act. See notes 1 & 2 *supra*. *See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.), *cert. denied*, 304 U.S. 796 (1969). *See generally* R. FROME & M. ROSENZWEIG, *supra* note 19.

This concept was expanded to impose vicarious liability on corporations and control persons for the acts of their agents and employees. There is no doctrine of respondeat superior in the Act, vicarious liability is imposed by statute. 15 U.S.C. §78t(a) (1976). The courts have interpreted this statute to impose liability on corporations for the acts of their agents, but have exempted officers and directors from liability unless they participated personally. Cameron v. Outdoor Resorts of America, Inc., 611 F.2d 105, 107 (5th Cir. 1980); Hudak v. Economic Research Analysts, Inc., 499 F.2d 996, 1002 (5th Cir. 1974); Lanza v. Drexel, 479 F.2d 1277, 1289 (2d Cir. 1973). The common law doctrine of respondeat superior has no application under the Act. *See* SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973); Note, *Securities Regulation-Vicarious Liability for Securities Acts Violations By Common Law or By Statute*, 54 N.C. L. REV. 488, 488-89 (1976). *See also* Kerbs v. Fall River Indus., Inc., 502 F.2d 731 (10th Cir. 1974); SEC v. Geon Indus. 381 F. Supp. 1063 (S.D.N.Y. 1974).

47. Any nontrading party, such as an insider who becomes a tipper but not a trader, can be considered an aider and abettor upon whom liability can be imposed. The early use of rule 10b-5 facilitated actions against such parties, often allowing an imputation of scienter. This imputation of scienter for aider and abettor was crucial since proof of intent is even more difficult than in the case of a principal to the trade. The early law required that the principal must have violated rule 10b-5 and that the aider must be aware that he is rendering assistance, but scienter as to the violation of the securities act could be imputed if the assistance was not normal activity for the aider. If the assistance was regular activity for the aider, an intent on the aider's part to violate the securities laws was required. Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94-97 (5th Cir. 1975). *See* Comment, *Establishment of Liability for Aiding and Abetting Under Rule 10b-5 and the Common Law*, 25 U.C.L.A. L. REV. 862, 865-73 (1978).

The federal cause of action was far superior to the common law remedies against aiders and abettors. Under common law there was no liability in nondisclosure cases unless there was first a duty to disclose. Since this often could not be found absent a fiduciary relationship, it was seldom that common law afforded a remedy against aiders in nondisclosure cases. If there was active misrepresentations common law was not much better. Scienter could not be imputed as it could under the federal law and therefore it was necessary to show that the aider had knowledge of the fraudulent character of the principal's acts and intended to further them. *Id.* at 885-87. *See* 3A H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW §§9.19 [2], .20 [1]-[2] (1979). This advantage of the federal over the common law was only under the early cases. After Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) the situation is changed. See note 117 *infra*.

48. Under early interpretation of rule 10b-5, brokers were considered insiders and scienter was imputed to their actions if such actions were outside the normal range of their activities. *See* Shapiro v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974);

also imposed liability on parties far removed from what was traditionally considered to be a corporate insider, such as tippees[51] who received their information from insiders and tippees of those tippees, liability[52] coming to rest on a party remote from the initial source.[53] The expansion of the classes of defendants, plaintiffs, and application of rule 10b-5 resulted in the Act being applied to virtually any corporate activity that affected the value of securities as long as the elements of action under the rule could be met.

The elements of an action under section 10b and rule 10b-5 were much less

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SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973). *See generally* D. BRODSKY, BROKER-DEALER LIABILITY 287 (1978); 2 S. GOLDBERG, *supra* note 10.

49. 15 U.S.C. §78t(a) (1979). Control persons are liable for violations of securities laws pursuant to the provisions of federal statutes, not the common law doctrine of respondeat superior. The federal acts impose liability only if the control person authorized or ratified the employee's acts. This, of course, does not apply if the control person is a corporate entity. Because a corporate entity can only act through its agents, liability is imposed as long as the agent acts within the scope of his authority, regardless of whether the corporation specifically authorized or ratified the violation. *See* Gordan v. Burr, 506 F.2d 1080 (2d Cir. 1974); SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973).

50. Accountants could be found liable under rule 10b-5 if they certified a false financial statement or if they failed to disclose that a statement, while true as to its included facts, omitted material information. The courts neither required an intent to deceive investors nor limited the action to plaintiffs in a special relationship with the accountants. This resulted in broad liability for accountants who were merely negligent to plaintiffs with whom they had no direct relationship. This most often occurred where an accountant could be charged with negligently omitting material information from a prospectus which the plaintiff claimed would have induced him to act differently had it been included in the prospectus. *See* Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967); Fisher v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

51. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852-56 (2d Cir. 1968), *cert. denied*, 394 U.S. 796 (1969).

52. Liability has been imposed to the extent of out of pocket expenses or benefit of bargain depending upon the relationship of the parties and the egregiousness of the defendant's violation. Draconian damages, the benefit of the bargain for all parties who traded in the particular security, whether they relied upon the misrepresentation or not, have not been imposed. In all cases, however, the defendants are required to forfeit any profits they may have made. *Compare* SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.) (where the benefit of bargain rule was applied), *cert. denied*, 404 U.S. 1005 (1971) *with* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971) (where out of pocket damages was applied), *cert. denied*, 404 U.S. 1004 (1971).

53. Early cases held remote tippees to a negligence standard based upon the circumstances of each case. If the tippees knew or should have known of the nonpublic nature of the information, they could be held liable in an action for damages. This standard looked to such factors as the nature of the information received, the confidentiality of the source and the likelihood that the source would have inside information, and the circumstances under which the information was received. Materiality was also important in the sense that the information was a factor in the decision to trade. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). Materiality was often found, however, by the satisfaction of the *Affiliated Ute* test. All this test required for a finding of materiality was that the information would be material in the sense that a reasonable investor might have considered it important. This was an objective test which helped overcome the difficulty of showing subjective materiality in a remote tippee's decision to trade. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972). See note 54 *infra*.

restrictive than the elements of a common law action for fraud.[54] Initially the courts required neither privity of contract nor scienter.[55] Because both privity and scienter are usually difficult to prove in securities fraud, the federal action, which did not require either, was far superior to action under common law[56] from the plaintiff's perspective.

The applicability of rule 10b-5[57] depends on the use of an instrumentality of interstate commerce[58] by the defendant to manipulate or deceive.[59] This element of action has not proved to be an obstacle with the expansion of the constitutional concept of interstate commerce.[60] The language of the rule not only prohibits the use of manipulative or deceptive devices in the interstate context,[61] but has been extended to cover negligently prepared financial state-

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54. Several elements of action are required to be shown in an action against a nontrading tipper. Foremost, there must be a trading tippee that violated §10b and rule 10b-5 by an illegal use of the tip. Second, the information must have been material inside information. While it was possible that negligent tippiing could result in tipper liability in early cases, today scienter would be required. See text accompanying note 106 *infra.* Nontrading tipper cases today most often arise against brokers, and the requirement of scienter and the requisite knowledge of the nonpublic nature of the information makes this a difficult action. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852-56 (2d Cir. 1968), *cert. denied,* 394 U.S. 796 (1969). *See generally* 2 S. GOLDBERG, *supra* note 8; M. BRODSKY, *supra* note 48, at 287.

55. *See* Kutner v. Kalish, 173 So. 2d 763 (Fla. 3d D.C.A. 1965). Florida recognized five essential elements in common law fraud: misrepresentation of a material fact, scienter, intent to induce action, justifiable reliance, and damages. *Id.* at 764-65. *See* W. PROSSER, THE LAW OF TORTS, 686-97 (4th ed. 1971).

56. See text accompanying note 231 *infra.*

57. 15 U.S.C. §78bb(a) (1976). Section 28(a) of the Securities Exchange Act of 1934 provides that the federal remedies are only in the alternative and are not to be considered as preempting any state action also available. State action is only precluded if it conflicts with the federal provisions; it is allowed in all other instances, even where it will grant relief unavailable under federal law. Cameron v. Outdoor Resorts of America, Inc., 608 F.2d 187, 196 (5th Cir. 1979) (assumed *sub silentio*). *See also* Note, *Securities Fraud Under State Common Law:* Schein v. Chasen — *Expanding Liability for the Tippor and Tippee,* 45 U. COLO. L. REV. 519, 527 (1974); 2 S. GOLDBERG, *supra* note 8, §10.2 [b].

58. 15 U.S.C. §78j (1976); 17 C.F.R. 240.10b (1979). The use of any means of interstate communication, including telephone has been held to support invocation of the federal law. It is doubtful whether anything more than face to face communication could escape the provisions of rule 10b-5.

59. See note 41 *supra.* The attempt to manipulate or deceive can be either intentional or negligent, and can be by misrepresentation or nondisclosure. The courts initially interpreted this clause liberally in order to effect as wide relief as possible. Later decisions restricting the use of federal law have centered on the elements of action necessary to establish an attempt to manipulate or deceive. See text accompanying note 83 *infra.*

60. U.S. CONST. art. 1, §8, cl.3. *See, e.g.,* Barrett v. United States, 423 U.S. 212 (1976); Heart of Atlanta Motel, Inc. v. United States, 379 U.S. 241, 252-53 (1964); Katzenbach v. McClung, 379 U.S. 294, 301 (1964).

61. 17 C.F.R. 240.10b-5 (1979). The language of the rule is fairly narrow, and certainly narrower than the extensive application the rule was to experience in the hands of the judiciary. It grew to become almost the omnibus provision for securities protection. This wide expansion beyond the anticipation of the drafters of the rule was a primary factor motivating the later judicially imposed restrictions.

ments,[62] actions by agents,[63] and even aid given to those who violate the rule.[64] The extension of the rule to cover negligent conduct,[65] while not universal,[66] was nonetheless significant in that the common law requirement of scienter was frequently an insurmountable barrier to an action for securities fraud.

Privity of contract, another major obstacle to relief under common law,[67] is not an element of action under rule 10b-5.[68] Where the common law required the plaintiff to have traded directly with the defendant, the federal action does not even require a contemporaneous trade,[69] with some circuit courts allowing action by a plaintiff who had not traded at all.[70] These courts only required a trade by either the defendant[71] or a third party[72] with whom the defendant was

62. Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967); Fisher v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

63. See notes 47-50 *supra*.

64. *Id.*

65. *See, e.g.*, SEC v. Management Dynamic Inc., 515 F.2d 801 (2d Cir. 1975); Ernst & Ernst v. Hochfelder, 503 F.2d 1100 (7th Cir. 1974), *rev'd*, 425 U.S. 185 (1976); Hochfelder v. Midwest Stock Exchange, 503 F.2d 364, 374 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974); SEC v. Spectrum, Ltd., 489 F.2d 535, 541 (2d Cir. 1973); Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

66. This split has been resolved by Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). See note 89 and accompanying text, *infra*. During the early development of the rule, however, the circuit courts were divided regarding the need for scienter in a private action for intentional violations while others used the rule to encompass negligence as well. This uncertainty in the law led to forum shopping, especially as applied to corporate officers and directors because the courts that allowed action for negligent violations of the Act held corporate officers to the higher standard of negligence rather than the business judgment rule used by some circuit courts. *See, e.g.*, Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), 404 U.S. 1004 (1971).

67. See text accompanying note 199 *infra*.

68. The early cases required only that a trade had been made and considered contact with the defendant irrelevant. The absence of a privity requirement was a tremendous advantage in a securities system where trades were made through brokers and specific connections between buyer and seller often could not be made. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Sargent v. Genesco, Inc., 492 F.2d 750 (5th Cir. 1974); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 796 (1969).

69. See note 68 *supra*.

70. *Compare* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952) (where the court required a plaintiff to have made a purchase or sale in order to have standing), *cert. denied*, 343 U.S. 956 (1952) *with* Blue Chip Stamps v. Manor Drug Stores, 492 F.2d 136 (9th Cir. 1973) (where the circuit court allowed a nontrading plaintiff to have standing), *rev'd*, 421 U.S. 723 (1975). In both of these circuit court cases the plaintiff had not traded although the defendant had. They illustrate the split in the circuit courts prior to the Supreme Court intervention, in that one court allowed plaintiff to have standing, although he had not traded, while the other court held the opposite. The permissive approach allowed a plaintiff who refrained from trading in reliance on a misrepresentation to pursue redress under rule 10b-5. The restrictive circuits left this plaintiff without a federal remedy.

71. *See, e.g.*, Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971), Bailes v. Colonial Press, Inc., 444 F.2d 1241 (5th Cir. 1971).

72. A trade by a third party can be enough to impose liability on a nontrading defendant if there is a close connection between the third party and the defendant. In addition

connected. Even though some courts would not go this far, all jurisdictions allowed action by a plaintiff who traded, but could not show a contemporaneous trade with the defendant.[73]

The requirement of privity between the plaintiff and defendant was replaced with the elements of materiality[74] and causality.[75] The information misrepresented or withheld was required to have been material,[76] defined as in-

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the defendant must have influenced the third party to trade, and in doing so, must have caused damage to the plaintiff. This is different from an agency or control person concept since the third party need not have been in the defendant's employ or acting for his benefit. All that is necessary is that the third party, connected by more than a causal relationship, be influenced to trade by the defendant.

73. *See* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). Even under the most strict standing requirements of any circuit, those articulated in *Birnbaum*, a plaintiff need not have traded contemporaneously with the defendant. Privity of trade was replaced with the elements of materiality and causality. See notes 74 & 75 *infra*. Otherwise the action would have been almost useless since it is often impossible to trace a connection between parties to a trade through an exchange.

74. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). In what has become known as the *Affiliated Ute* test, the Supreme Court defined materiality as being facts which a reasonable investor might have considered important in making a decision. In *Affiliated Ute* the action was for failure to disclose, but the test has since been applied both to nondisclosure and misrepresentation. In practice, this test replaces privity with the requirement that the plaintiff show the deception was concerned with reasonably important information. *See also* List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965). In *List* the court used the language of materiality, but also looked at the causal link between the violation and the damages. The plaintiff could not show that he would have acted any differently had there been full disclosure, therefore, the court denied relief. The court wanted a showing that in effect the deception caused plaintiff's damages. If the plaintiff cannot show that his actions would have changed, in follows that the deception was not responsible for his damages, he would have suffered them in any event. *Accord*, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

Often cases use a synthesis of both tests and require that the information misrepresented or undisclosed must be reasonably important and that the plaintiff would have acted differently had full disclosure been made. *See, e.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

75. If the plaintiff is a corporation and the action is in the nature of a derivative suit, the causality requirement consists of the necessity to show damage to the corporate entity. This is separate from damage to the shareholders. It is not enough that the shareholders lost money; the corporation itself must have been damaged in order for a derivative suit to be brought. *See* Polakoff v. The Delaware Steeplechase & Race Ass'n, 254 F. Supp. 574 (D.C. Del. 1966); Hoover v. Allen, 241 F. Supp. 213 (S.D. N.Y. 1965). Once the element of damage to the corporation is shown, security for expenses is not a requirement for a derivative action for violation of rule 10b-5. McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961). *But see* Schein v. Chasen, 313 So. 2d 739, 746 (Fla. 1975) (the Florida supreme court followed the federal rule and required that damage to the corporation be shown as a prerequisite to a derivativesuit).

76. In case of misrepresentation, reliance and materiality are separate issues. If the defendant misrepresented a fact to the plaintiff, the plaintiff must show reliance on the misrepresentation. This is not true, however, of cases of nondisclosure. If the violation is one of failure to disclose, the materiality and reliance elements are combined. If the information withheld is found to have been material, there is a presumption that the plaintiff would have relied on it had it been disclosed. This rule recognizes that the only way a plaintiff in a nondisclosure case could show reliance would be to show that the information withheld was important enough to support the inference that it would have changed his actions. *See* Affiliated

formation which would be of importance to a reasonably speculative investor.[77] Once the plaintiff had shown materiality, he then had to establish a causal link between the information and the damage alleged. If the violation was one of misrepresentation the plaintiff had to show reliance on the erroneous information,[78] and if the violation was one of nondisclosure, he had to convince the court that he would have acted differently had the omitted information been disclosed.[79]

Because elements of action under rule 10b-5 did not require privity of contract or scienter on the part of the defendant, the federal action often applied where the common law would not support relief.[80] The federal action was limited however, by the requirements of the use of an interstate instrumentality, the completion of a trade by the defendant, and informational causality and materiality.[81] These limits were flexible enough to allow a substantial expansion of rule 10b-5 beyond what the legislature had envisioned.[82]

Recent cases have severely restricted the initial expansiveness of rule 10b-5 and have wide application to securities regulation.[83] Some aspects of privity,[84] scienter, and a relationship between plaintiff and defendant have been added to the elements of action, making the plaintiff's burden heavier than initially imposed by early judicial interpretations.[85] The net result has often been to

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Ute Citizens v. United States, 406 U.S. 128 (1978); Shapiro v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). *Cf.* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.) (where, in a case of misrepresentation, the separate issue of reliance had to be addressed by plaintiff), *cert. denied*, 44 U. S. 1004 (1971).

77. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

78. See note 76 *supra.*

79. *Id.*

80. Without this liberalization, an action under the Act would be no more advantageous in most respects than an action under common law. *See* Note, *supra* note 23, at 1094; Comment, *supra* note 47, at 863.

81. See notes 74 & 75 *supra.*

82. The legislative intent behind the Act was to curb knowing misuse of inside information by insiders who themselves traded. *See Report to the Secretary of Commerce of the Committee on Stock Exchange Regulation*, S. REP. 792 73rd CONG., 2nd SESS. 18 (1934). The use of the act by the judiciary quickly encompassed more than just knowing violations by traders. For an exposition of the flexible policy applied by the courts, see Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

83. The circuit courts expanded the use of the Act until the Supreme Court reacted and reimposed restrictions in the form of adding elements of action formerly not required by the circuit courts. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Court stated that rule 10b-5 bore a relationship to misrepresentation and deceit in tort law. *Id.* at 744-45. The Court further stated that because the action had departed from its tort background the best way to limit its growth was to reimpose elements of tort action. *Id. See generally* Note, *The Reach of the S.E.C. Under Rule 10b-5 Is Further Restricted: Negligent Conduct Is Insufficient to Warrant Commission Instigated Injunctive Relief*, 31 U. MIAMI L. REV. 1524 (1977).

84. Privity per se, a traceable, face to face trade between plaintiff and defendant, is still not required under rule 10b-5. A semi-privity requirement has been established, where the plaintiff must show his involvement in a trade even if he cannot trace it to the defendant. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975).

85. *Compare* Cameron v. Outdoor Resorts of America Inc., 608 F.2d 187, 194 (5th Cir. 1979) (where the new elements of action denied the plaintiff a cause of action under the Act)

deny plaintiffs a federal cause of action through an inability of the plaintiffs to meet the elements of action[86] and to force them to seek relief under state law.[87]

While the courts do not require privity per se, the class of potential plaintiffs has been greatly reduced by the imposition of some of the elements of privity.[88] In *Blue Chip Stamps v. Manor Drug Stores*[89] the Supreme Court held that a plaintiff must be a purchaser or seller in order to have standing.[90] In *Blue Chip Stamps* the plaintiff had not made a purchase or sale, but was damaged by his failure to act.[91] In denying relief, the Supreme Court admitted that its decision prevented three classes of plaintiffs from obtaining relief under rule 10b-5.[92] Potential purchasers who had been dissuaded from purchasing by the misrepresentation,[93] actual shareholders who did not sell,[94] and parties whose interests were devalued,[95] all are now foreclosed from action under rule 10b-5 even though their damages result from violations of the rule. The Court recognized this, but felt justified by the need to restrict the heretofore unchecked growth of the rule.[96]

Other elements of privity have been imposed by later decisions in cases of nondisclosure. These cases hold that while privity is not necessary in instances

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with Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc., 495 F.2d 228, 235 (2d Cir. 1974) (the plaintiff was granted relief under the more relaxed elements of action previously used for the Act).

86. 608 F.2d at 194.

87. *Id.* at 196.

88. The Supreme Court decision imposing some of the elements of privity was a case of misrepresentation, not nondisclosure. This principle has recently been applied by a circuit court to nondisclosure, restricting action in that case to an even greater degree than in misrepresentation. Fridrich v. Bradford, 542 F.2d 307, 312 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977). The court held there was no duty to disclose absent a trade between the plaintiff and defendant. *Id.* The court took a very restrictive stand, finding that even a trade between the plaintiff and a third party would not support liability, but required an actual plaintiff-defendant connection. *Id.* See text accompanying notes 76-79 *supra*.

89. 421 U.S. 723 (1975).

90. *Id.* at 731.

91. *Id.* at 730. The plaintiff had a right to buy the defendant's stock, but passed up the opportunity based on the very negative picture the defendant presented in its prospectus. *Id.* When later it was discovered that the prospectus contained misrepresentations and that the stock had been offered at a very good price, the plaintiff brought action under the Act. Because the plaintiff had not traded, however, he was denied standing even though the defendant was guilty of misrepresentation in its prospectus. *Id.* at 731.

92. *Id.* This was a reaffirmation of the doctrine found in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). This doctrine required a plaintiff to be either a purchaser or seller in order to have standing under the Act. An exception to this rule has always been allowed where the plaintiff seeks injunctive relief rather than damages. *See, e.g.*, Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967).

93. 421 U.S. at 748.

94. *Id.*

95. *Id.*

96. *Id.* at 731. The Court was also concerned about plaintiff abuse of rule 10b-5 in "strike suits." There was a very real danger that the lenient elements of action under the Act and the liberal discovery procedures were being used to extract settlements from corporations in cases of doubtful merit. The corporations were settling just to protect themselves from exposure of business documents. This and other abuses of rule 10b-5 by plaintiffs comprised part of the motivation for the court to restrict the rule.

of misrepresentation,[97] when the misrepresentation is only a failure to disclose, the plaintiff must show a relationship to the defendant that imposes a duty to disclose.[98] The recent case of *Chiarella v. United States,*[99] however, held that absent a fiduciary relationship between the parties,[100] a purchaser has no duty to disclose to a seller.[101] The defendant in *Chiarella* was a corporate outsider who traded on the basis of inside information which he did not disclose to the parties with whom he dealt.[102] Prior judicial use of rule 10b-5 would have allowed action in this case, but the Supreme Court denied relief, finding the necessary fiduciary relationship was not present.[103] By denying relief, this decision has precluded action against many tippees and nontrading tippers in the ordinary course of exchange transactions.[104]

Scienter, the intent of the defendant,[105] has been reimposed to an even greater degree than privity, and the courts have departed from early cases allowing action for negligent conduct.[106] In *Ernst & Ernst v. Hochfelder,*[107] an action for negligent violation of rule 10b-5, the Supreme Court held that scienter was an essential element of action under the rule.[108] This decision has

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97. See note 93 *supra.*

98. Flight Equip. & Eng'r Corp. v. Shelton, 103 So. 2d 615 (Fla. 1958). Traditionally, a duty to disclose has been supported by the relationship of an officer or director to the corporate shareholders. *Id.* at 626. It has also been found where the parties are not at an arm's length, one has a great advantage over the other, and acts egregiously. Vokes v. Arthur Murray Inc., 212 So. 2d 906, 908-09 (Fla. 2d D.C.A. 1968).

99. 100 S. Ct. 1108 (1980).

100. The defendant was a printer who used information gathered from printing corporate documents to trade in securities. He had no relationship with the stockholders of the corporation and was working for an independent contractor. *Id.* at 1112.

101. *Id.* at 1115.

102. *Id.* at 1112.

103. *Cf.* SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.) (where purchasers made some of their trades on the basis of nondisclosure), *cert. denied,* 404 U.S. 1004 (1971). In *Texas Gulf Sulphur,* although the defendants did later misrepresent, early violations were nondisclosures. While a fiduciary relationship could be established with the defendants who were directors, other defendants did not hold positions traditionally thought to be fiduciary in character. Under the *Texas Gulf Sulphur* analysis, the facts of *Chiarella* would have probably supported liability because that analysis did not require a fiduciary relationship and the facts included knowing abuse of obviously inside information. 100 S. Ct. at 1112.

104. Because most tippees are outside the corporation, they hold no fiduciary duty to the shareholders and after *Chiarella,* can trade without fear of civil liability to the defrauded parties. If their nontrading tippers can be ascertained, they might be subject to liability, but the problems of proof and the other restrictive elements of atcion make this unlikely. *See* 100 S. Ct. at 1117.

105. See note 80 *supra.*

106. Prior to the Supreme Court settling the law in this area the lower courts were split and in confusion over the ability of negligence to support liability under the Act. *See* Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir.), *cert. denied,* 419 U.S. 873 (1974). Even the courts that allowed negligence to support liability were uncomfortable with ordinary negligence and tended to impose liability only where more than mere negligence was found. *Id.*

107. 425 U.S. 185 (1976).

108. The Court required scienter, but only addressed the situation where a plaintiff sought relief in a private action for damages. The Court left unanswered the standard to be applied in SEC actions or an action for injunctive relief. The Court also specifically did not

created serious difficulties for the plaintiff,[109] especially in an action against corporate insiders or traders whom the plaintiff has never met.[110] Corporate mismanagement[111] and breach of fiduciary duty,[112] earlier actionable, are now beyond the scope of rule 10b-5 unless intentional fraud can be shown.[113] If the defendant is insulated from the plaintiff by third parties, scienter becomes even more of a barrier. Defendants such as controlling persons,[114] remote tippees,[115] nontrading tippers,[116] and aiders[117] may now claim their acts were merely negligent and defy plaintiffs to show otherwise.[118]

The reimposition of the elements of scienter and a form of privity have precluded many potential plaintiffs from bringing actions under federal law.[119]

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address the question regarding reckless conduct. At this time, the ability of reckless conduct, short of scienter, to support an action for damages remains unsettled. It is probable that the circuit courts will remain split on this issue, with the more plaintiff minded circuits using it as an avenue to grant relief. *Id.* at 193 n.12. *See also* Note, *supra* note 83.

109. 425 U.S. at 188-90. The plaintiffs suffered damages as the result of the negligence of the accounting firm that performed the corporation's audits. The plaintiffs won in the lower courts which applied the old standard, allowing an action for negligent conduct. *Id.* at 191. The SEC argued that this standard was proper since the effect of the securities violation on the plaintiff was the same whether the violation was negligent or intentional. *Id.* at 198. The Supreme Court rejected this argument and required scienter. *Id.* at 199. The court interpreted the history of rule 10b-5 as being nonexpansive. They, in effect, reversed the earlier judicial trend of expansion under the Act and set a more restrictive attitude of statutory construction. *Id.* at 201.

110. *See* Comment, *supra* note 47, at 863 (1978). *See also* Note, *supra* note 23, at 1095. The difficulty of proving intent in the corporate setting, which was necessary under common law fraud, was one of the gross defects in state law that led to the enactment of the Act. *Id.*

111. The business judgment rule will insulate officers and directors from the proof of intentional mismanagement unless evidence to the contrary is overwhelming. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

112. *See* Santa Fe Indus., Inc., v. Green, 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977). In the *Green* case there was no manipulation or deception, only a breach of fiduciary duty. Using the old standard, the lower court gave relief under the Act, but was reversed by the Supreme Court.

113. *See* Campbell, *Elements of Recovery Under Rule 10b-5: Scienter, Reliance, and Plaintiff's Reasonable Conduct Requirement*, 26 S.C. L. REV. 653, 653-74 (1975). Under the present state of the law, the plaintiff must show scienter, reliance, materiality and damage just as in common law fraud. In addition, he must show justifiable reliance and that he acted reasonably in his reliance on the misrepresentation. *Id.* at 674 n.100.

114. See note 49 *supra.*

115. See note 53 and accompanying text, *supra.*

116. See note 47 *supra.*

117. An action against an aider is an action under the Act, yet common law principles have been grafted on to make the action more difficult than one against a principal. There are two elements of action against an aider that are unique. The aider must have knowledge of the wrongfulness of the principal's action and must then render substantial assistance. *See* Woodward v. Metro. Bank of Dallas, 522 F.2d 84, 97 (5th Cir. 1975). *See also* RESTATEMENT (SECOND) OF TORTS §876 (1965); Note, *Rule of 10b-5: Liability for Aiding and Abetting After Ernst & Ernst v. Hochfelder*, 28 U. FLA. L. REV. 999, 1004 (1976).

118. *See, e.g.*, Cameron v. Outdoor Resorts of America, Inc., 608 F.2d 187, 194 (1979). The defense of negligence is even more effective when conducted from behind the corporate shield. See note 110 *supra.*

119. The Supreme Court recognized this, but reasoned that the loss in effectiveness of the

The plaintiff must show scienter and then establish the fact that he traded, and in cases of nondisclosure, he must go farther and establish a fiduciary relationship to the defendant. The result is that instead of being able to use federal law tailored for securities violations, plaintiffs now are often forced to seek alternate remedies under state law.[120]

ACTION UNDER FLORIDA'S BLUE SKY LAW

If a plaintiff is precluded from bringing federal action for securities fraud, relief must then come from either common law or state statutory provisions. Called "blue sky laws,"[121] state statutory provisions regulating securities transactions are so pervasive that they are the next logical source of relief.[122] The Florida securities statutes are wider in scope than the federal law which was enacted solely to ensure full disclosure. Florida's law, in addition to anti-fraud provisions, has merit provisions[123] which allow the state to judge the relative financial merit of the security and to use that judgment as a criterion for disqualification.[124] The plaintiff should be aware that the policy underlying the Florida statute is not only to mandate full disclosure, but also to prevent unfair practices in general, even if there is full disclosure.[125] The policy behind

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Act is worth the restrictions set on it in furtherence of proper statutory interpretation. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975).

120. *See, e.g.*, Cameron v. Outdoor Resorts of America Inc., 608 F.2d 187, 196 (1979).

121. *See* 1 L. LOSS, SECURITIES REGULATION 27 (2d ed. 1961). "Blue Sky Laws" is the name given to state statutes which regulate securities matters within the state. These acts fall into three general types: anti-fraud, broker registration and securities registration. The anti-fraud types are aimed at preventing fraudulent sales or purchases of securities and are generally similar to rule 10b-5. *Id.* at 33. The broker and securities' registration types register brokers and securities respectively, but may not have anti-fraud provisions as such. *Id.* Florida has elements of all three types and cannot be categorized as any, but is an amalgam. *Id.* at 42-43. *See also* H. BLOOMENTHAL & S. WING, SECURITIES LAW ch. 9 at 3-4 (1973).

122. Florida's provisions very closely parallel the Act in the anti-fraud sections. FLA. STAT. §517.301(1)(b) (1979). The Florida anti-fraud section makes it unlawful "to employ any device, scheme or artifice to defraud." *Id.* This is a reflection of the legislative intent to allow relief under Florida law for fraud in the sale of securities. *See* NATIONAL CONFERENCE ON UNIFORM STATE LAW, HANDBOOK AND PROCEEDINGS 17 (1929). Florida adopted the 1929 Uniform Securities Act, 1931 Fla. Laws ch. 14899, §22.

123. FLA. STAT. §517.07 (1979). Merit provisions are provisions allowing the state government to pass on the financial merits of the security. Florida requires this before the security can be offered for sale within the state. This is more stringent than the federal law which makes no such judgment, but only requires disclosure of the data behind an offering. The basic intent of Florida's merit provision, to be a prophylactic and prevent high risk securities from entering the market. *See* Data Lease Financial Corp. v. Barad, 291 So. 2d 608, 612 (Fla. 1974). *See generally* Goodkind, *Blue Sky Law: Is There Merit In The Merit Requirement*, 76 WIS. L. REV. 79 (1976).

124. FLA. STAT. §517.07 (1979).

125. The intent of the federal law was to establish full disclosure in securities transactions. See note 27 and accompanying text, *supra*. Florida's policy subsumes this in the overall goal of protection of investors. Florida's provisions will apply whether there is full disclosure or not as long as there is a basic unfairness to the transaction. *See* Data Lease Financial Corp. v. Barad, 291 So. 2d 608, 612 (Fla. 1974). This policy encourages a more liberal judicial application of Florida's provisions on a parallel with the federal courts and rule 10b-5.

the Florida provisions is more liberal than that behind the Securities Act of 1934 and supports a more liberal relief for fraudulent actions.[126]

While Florida did not adopt the Uniform Securities Act of 1956,[127] the two schemes are similar in several respects,[128] most notably concerning fraud.[129] Both Florida and the Uniform Act follow rule 10b-5[130] and prohibit fraudulent practices in conjunction with the sale or purchase of securities.[131] It is significant that, although similar to rule 10b-5, the Florida anti-fraud provisions have not been subjected to a similar restrictive interpretation by state courts.[132] Recent action has been expansive, as exemplified by the 1978 amendment of section 517.211 to allow action by defrauded sellers as well as purchasers.[133]

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126. *Id.* This liberal policy is further evidenced by the use of the Florida statutes to supplement rather than exclude common law actions. FLA. STAT. §517.241(2) (1979). This section not only allows a statutory right of action under the Florida Blue Sky Law, but statutorily articulates the policy that statutory relief is in addition to common law and does not abrogate any existing rights. *Id. See* 2 L. Loss, *supra* note 121, at 1123-32.

127. *See* NATIONAL CONFERENCE OF COMMISSION ON UNIFORM STATE LAW, HANDBOOK AND PROCEEDINGS 134-35 (1956). The Uniform Securities Act of 1956 included an anti-fraud provision patterned somewhat after rule 10b-5. *Id.* at 183. The anti-fraud provisions made it unlawful to engage in an act or course of business which would result in a fraud. *Id.* at 182. *See also* Uniform Securities Act §§101(3), 410(a).

128. *See* Uniform Securities Act §410(a). This section of the act creates a statutory right of civil action against a seller who perpetrates a fraud. The effect of this section is limited however, by following subparagraphs which limit civil action to action against a buyer. *Id.* §401(h). This leaves a fraudulent buyer covered only by §101 of the act which does not provide for civil damages. *Id.* §101(3). A fraudulent buyer, therefore is not under the reach of the portions of the civil penalties of the act and can only be sanctioned by other state provisions such as common law or by criminal action. *See* L. LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT, 151 (1976).

Florida has not adopted the Uniform Securities Act, choosing instead provisions for civil relief that are more liberal. FLA. STAT. §517.211(2) (1979). This section was amended in 1978 to allow action against both a purchaser or seller, removing one of the biggest statuatory deficiencies. 1978 Fla. Laws ch. 78-435. In addition, this section allows a private right of damages which had to be judicially imposed under rule 10b-5. FLA. STAT. §517.211(2) (1979). This concrete expression of the legislature's intent to allow liberal relief gives less room for judicial restriction than under the federal act.

129. *Compare* Uniform Securities Act §410 (allowing action only against a fraudulent seller) *with* FLA. STAT. 517.211(2) (1979) (which allows action against both a fraudulent seller and buyer).

130. *See* FLA. STAT. §517.211 (1979); Uniform Securities Act, §§101,410; 17 C.F.R. 240.10b-5 (1979). Florida's provisions more closely parallel the language of rule 10b-5 than does the Uniform Securities Act. All three make deception in the sale of securities actionable, but only rule 10b-5 and Florida's provisions give a cause of action to both defrauded sellers and purchasers. *See generally* Goodkind, *supra* note 123, at 79 n.2; Ratner, *supra* note 2, at 951.

131. Only Florida gives a private right of damages to both a seller and a purchaser. The Uniform Securities Act forces a seller to rely on either common law or criminal action. *See* Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946); Loss, *supra* note 143, at 151. *See also* H. SOWARDS & N. HIRSCH, BUSINESS ORGANIZATIONS, BLUE SKY REGULATIONS ch. 6 at 52 (1979).

132. See notes 88-106 and accompanying text, *supra*.

133. See note 128 *supra*. Although the legislature acted to alleviate some deficiencies of the Florida law, faults still exist. The largest of these, procedurally, is the lack of jurisdiction over many potential defendants. This is inherent in state blue sky laws because they are limited to the reach of their long arm statutes. Often the defendants have had less than the minimum

This amendment eliminated what had been a major fault in Florida's statutes, and illustrates the legislature's intent to expand this area. This intent is also illustrated by the legislature's retention of common law actions as an alternative to the statute.[134] The liberal policy of fair practice in security transactions and the expansive attitude of the legislature support the view that the Florida blue sky laws augment the common law and seek to provide investors with additional protection.

Florida's blue sky laws avoid the restrictions of scienter found in both common law fraud and rule 10b-5,[135] and remain a viable action against defendants protected from proof of intent such as corporate insiders or remote tippees.[136] The Florida blue sky provisions offer the plaintiff an excellent alternative when action under rule 10b-5 is precluded by a lack of scienter, but the plaintiff must remain aware of elements of action which are peculiar to the Florida statute.

Florida's law is, on its face, more conducive to private action than rule 10b-5.[137] While the private remedy under federal law is a creation of the judiciary, the private right of action in Florida law is based on a statutory mandate.[138] Although based on a statutory rather than a judicial base, the

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contact required in order to gain jurisdiction, forcing the plaintiff to litigate in a foreign forum. *See* Bartell, *supra* note 20, at 463 n.32. Substantively, the most critical defect remaining in the Florida law is the privity requirement. See note 182 and accompanying text, *infra*. This defect should be corrected to conform to the liberal policy behind the statutes.

134. FLA. STAT. §517.211(2) (1979). Florida's blue sky law follows rule 10b-5 and does not preclude common law action, but allows it as both alternative and supplement. *See also* 15 U.S.C. §78bb(a) (1976); Note, *supra* note 62, at 523.

135. See note 108 *supra*. Originally, Florida's law followed rule 10b-5 which permitted, at least according to many circuit courts, action for negligent violation. See text accompanying note 117 *supra*. Recent Supreme Court decisions have restricted rule 10b-5, while Florida's law remained consistent with earlier federal liberality.

136. *See* FLA. STAT. §517.301(1) (1979). The language of this section has two very expansive clauses. It is introduced by making unlawful any action done "in connection with" a sale or purchase of a security, and ends with an inclusion of both direct and indirect violations. *Id. Cf.* 17 C.F.R. 240.10b-5 (1979) (where the same clauses are used). This language, especially the "in connection with" phrase, is the language used expansively by the federal courts in applying rule 10b-5. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 796 (1970). The language, used in Florida's statute, although similar to rule 10b-5, would be unaffected by the recent cases restricting rule 10b-5 and could easily cover nontrading tippers and remote tippees in the same manner as early federal cases.

137. *Compare* 15 U.S.C. §78a (1976) (which leaves the question of the right to a private action unanswered) *with* FLA. STAT. §517.211(1) (1979) (which statutorily grants the right). Similarly, the type of damages authorized is statutorily implied in Florida, while it had to be judicially imposed on the federal law. *Id.* Punitive damages are not generally awarded in either, and both allow for recission. Monetary damages are out of pocket and not benefit of bargain. The defendant usually receives the difference of what he could replace the security for had he acted within a reasonable time. *See* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971). One advantage of action under Florida's law is the statutory provision of attorney's fees in addition to the judgment, a provision not present under rule 10b-5. FLA. STAT. §517.211(6) (1979). This is in keeping with the protective policy of the blue sky law and will allow investors with small claims to afford to bring action.

138. FLA. STAT. §517.211(2) (1979).

Florida law followed the federal law in its expansive phase.[139] As the federal law expanded to include tippers and remote tippees, the Florida law, by its prohibition of indirect attempts to violate the statute, also included defendants other than trading insiders.[140] Similar to rule 10b-5, the Florida law would apply to aiders and abettors, controlling persons and tippees.[141] While the Florida statutory law mirrors the earlier expansive judicial interpretation of the federal law, it has not yet changed direction and followed the recent judicially imposed restrictions of the federal law.[142] Accordingly, the only restrictions on the Florida law are those statutorily imposed by its own elements of action[143] and it is more immune from judicial restriction than was rule 10b-5. In addition, only a broad interpretation of the restrictions that are imposed on Florida's law will effectuate the liberal legislative intent to insure fairness in securities transactions.[144]

Section 517.211 of the Florida statutes[145] is an example of restrictions placed on the blue sky law which are more broadly interpreted than comparable federal law.[146] Section 517.211 gives a cause of action to a purchaser or seller[147] and the Florida courts have interpreted this similarly to the federal decision in *Blue Chip Stamps*,[148] by requiring a plaintiff to be either a purchaser or seller to have standing. Within these limits, the Florida courts have acted more ex-

139. See note 130 and accompanying text, *supra*. The language of the Florida anti-fraud provisions followed rule 10b-5. The federal cases provided analagous precedent for any elements not codified by state law because the language of the federal and state statutes closely resembled each other. The precedential value of federal law and its statutory similarity was tacitly recognized in Florida's blue sky law by a provision which approved federal civil remedies. FLA. STAT. §517.241(3) (1979). This provision authorizes remedies developed under federal law to be brought in state court. This section is, in effect, a codification of federal law as an addition to state law. It is another example of the expansive intent of the Florida statute because federal law, added to state law in this manner, insures that the state provision will always protect investors to the limit of federal development. At this time, the state law is broader than the federal, but when the statute was drafted, the federal was still in its expansive phase.

140. FLA. STAT. §517.301(1) (1979).

141. See notes 50 and 136 *supra*. This comparison applies to earlier actions under rule 10b-5. Now, after the restriction of rule 10b-5 actions, state law is actually better against these parties than action under the Act.

142. See note 119 and accompanying text, *supra*.

143. See notes 169 and 177 *infra*.

144. This intent is to provide protection, not just disclosure, for investors in Florida. *See* Data Lease Financial Corp. v. Barad, 291 So. 2d 608, 612 (Fla. 1974). *See also* 1931 Fla. Laws ch. 14899, §22.

145. FLA. STAT. §517.211 (1979). This section authorizes the remedies available for the anti-fraud provisions. *See* FLA. STAT. §517.301 (1979). It restricts the blue sky law in the sense that remedies are allowed only under its provisions. If the plaintiff cannot comply, he is forced to rely on the common law.

146. The purchase and sale requirement, which is comparable to §517.211 has been interpreted strictly in the federal law. *See* 421 U.S. at 731.

147. FLA. STAT. §517.211(2) (1979). The statute provides that violators shall be liable "to the person selling the security to or purchasing the security from such person. . . ." This language mandates the purchase or sale requirement that was judicially imposed on rule 10b-5, following the trend of the Florida legislature to codify federal case law.

148. *See* 421 U.S. at 731. See text accompanying note 88 *supra*.

pansively than their federal counterparts and will allow action for a violation of the statute even absent a trade by the defendant.[149] In *Merrill Lynch, Pierce, Fenner & Smith v. Byrne,*[150] the Florida Third District Court of Appeal held a broker liable for accepting a client's stop order at a time when stop orders in the security could not be placed.[151] The plaintiff had standing because he had made a trade and the court went on to hold the broker liable under section 517.301(b) even though he was not a purchaser or seller himself.[152] This result would not have been possible under rule 10b-5.[153]

Merrill Lynch v. Byrne[154] illustrates another advantage of Florida's blue sky law, the absence of the scienter requirement[155] which is now an element of an action under rule 10b-5 after *Ernst & Ernst v. Hochfelder.*[156] The court in *Merrill Lynch v. Byrne*[157] held that while scienter is an element of action under Florida's common law of fraud,[158] it is not required for liability under the statute.[159] This only applies to an action against a principal[160] however, and Florida still requires scienter for persons other than the principal, such as aiders and abettors.[161] Under this analysis, corporations are considered principals and

149. *See* FLA. STAT. §517.211(2) (1979). The statute speaks in terms of liability being imposed upon fraudulent purchasers or sellers, but the courts have implied an action against mere violators who have not sold. This expansion under the act was done implicitly; the courts glossed over this issue and assumed that §517.211 allowed action against violators as well as traders. See note 167 *infra.*

150. 320 So. 2d 436 (Fla. 3d D.C.A. 1975).

151. *Id.* at 437-38. The broker agreed to enter the plaintiff's stop orders but failed to check the computer which would have informed him that stop orders could no longer be placed on that security. The plaintiff brought action for a negligent violation of §517.301(b). *Id.* at 440.

152. *Id.* The broker never made a purchase or sale; he merely negligently assisted the plaintiff in making one.

153. See note 72 *supra.* Action under rule 10b-5 required either a trade by the defendant, a third party influenced by the defendant, or that the action be against an aider and abettor. In *Merrill v. Byrne* the defendant was neither a trader not an aider and abettor, and so would have been immune from federal action. In the state action the broker was held liable as a principal, not an aider, and was held liable even though he had neither traded nor influenced another to do so in his place. 320 So. 2d at 437-38.

154. 320 So. 2d at 440.

155. *Id.* The court held that while scienter may be a requirement for common law fraud, it is not necessary for recovery under Florida's blue sky law. *Id.* It is significant that the Florida court relied on several federal decisions to interpret Florida's security law. *Id.* This illustrates the Florida tendency to follow federal law when it is expansively interpreted.

156. 425 U.S. at 193. See text accompanying note 120 *supra.*

157. 320 So. 2d 436 (Fla. 3d D.C.A. 1975).

158. *Id.* at 440.

159. *Id.* The requirement of scienter is also not a necessity for actions prosecuted by the state. *See* State v. Houghtaling, 181 So. 2d 636 (Fla. 1965).

160. 320 So. 2d at 437. In this case the defendants were all principals who participated personally in the violations. *See also* State v. Houghtaling, 181 So. 2d 636, 637 (Fla. 1965).

161. *See* Woodward v. Metro Bank of Dallas, 522 F.2d 84 (5th Cir. 1975). Plaintiff brought action against defendant bank for aiding and abetting a violation of the Florida blue sky law. *Id.* 87-88. The court denied liability because of the lack of scienter on the part of the aider, even though the principal could have been held liable for mere negligence. *Id.* at 97. The holding required scienter on the part of the aider if the aider's activity constituted no more

are held liable without scienter for the acts of their agents.[162] Corporate officers and directors are not considered principals when acting for the corporation, and cannot be held liable for negligent violations of the blue sky law.[163] The plaintiff in Florida must be satisfied with an action against the corporate entity unless scienter can be shown in which case the individual agents can be liable.[164] Except for defendants other than principals, the Florida blue sky law remains more liberal than action under rule 10b-5. Scienter is only necessary in an action against aiders and abettors, corporate officers and other secondary parties, unlike rule 10b-5 where it is required in all cases.[165]

While the Florida law is more liberal than the federal law in its requirements for scienter, Florida law is more restrictive regarding privity. The federal cases have added some aspects of privity to the action under rule 10b-5, but as yet have not required privity per se.[166] A survey of Florida cases shows that liability has been imposed under Florida blue sky law only where there was a face to face transaction between the plaintiff and defendant.[167] Although it is true that Florida law will support liability where the defendant has not actually

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than its regular practices. In addition, the court required a violation by the principal and knowing assistance by an aider who was generally aware of his role. *Id.*

162. *See* Hudak v. Economic Research Analysts, Inc., 499 F.2d 996 (5th Cir. 1974), *cert. denied,* 419 U.S. 1122 (1975). The corporate entity is as vulnerable as an individual in this context and can be held liable for the negligent securities violations of its officers and directors. *Id.* at 1002. This is because the corporation is seen as being able to act only through its agents. This case is also significant because the plaintiff brought action under rule 10b-5, but the court was forced to apply Florida's blue sky law to determine the applicable statute of limitations. *Id.* at 999. The court applied Florida blue sky law, recognizing that it was a mirror of rule 10b-5. *Id.* at 1000. *But see* Connely v. Special Road & Bridge Dist. No. 5, 99 Fla. 456, 126 So. 794 (Fla. 1930). Here the court applied agency law to disallow the imputation of an agent's criminal act to the principal on the theory that the agent's authority did not contemplate illegal activity. *Id.* at 473-74, 126 So. at 800.

163. Hudak v. Economic Research Analysts, Inc., 499 F.2d 996 (5th Cir. 1974), *cert. denied,* 419 U.S. 1122 (1975). The imputation of negligence does not flow in both directions. While the corporation can be held for negligent acts of its officers and directors, they, as individuals, can only be held liable for violations with scienter. *Id.* at 1002. Thus an individual, who could normally be liable for a negligent violation of the statute, will have immunity because he was acting in the name of a corporation. This is in keeping with the common law business judgment rule which does not impose liability on directors or officers for negligent conduct that is arguably within their sound business judgment.

164. *Id.* If the officers or directors of a corporation act with scienter, then they can be liable as individuals and are not shielded by the corporate veil.

165. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

166. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975); Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053 (1977).

167. *See* Schein v. Chasen, 313 So. 2d 739 (Fla. 1975). *Schein* illustrates the connection between most Florida blue sky cases. The defendants were investors and a broker which had no face to face contact with the plaintiff shareholders. Although other factors were given as supporting the decision denying liability, it is significant that privity was lacking. *Id.* at 744. *Accord,* Hudak v. Economic Research Analysts, Inc., 499 F.2d 996, 1002 (5th Cir. 1974); Merrill Lynch, Pierce, Fenner & Smith v. Byrne, 320 So. 2d 436, 437-38 (Fla. 3d D.C.A. 1975). In both of these cases, liability conformed to the absence or presence of face to face transactions between the plaintiff and defendant. *See generally* Comment, *Corporations: Florida Common Law Liability of Tippees In a Shareholder Derivative Suit,* 28 U. FLA. L. REV. 223, 224-35 (1975).

traded, and has merely violated the statute,[168] the cases that have done so have all had the element of face to face contact between plaintiff and defendant.[169]

The strict requirement of privity has been one of the major faults of most blue sky laws including Florida's, and the resultant inability to afford a remedy when a transaction is consummated through an exchange was one of the motivating factors for enactment of the Securities Act of 1934.[170] This debility caused by the element of privity could be overcome by the liberal trend of Florida courts.[171] Not only does the language of section 517.301(1)[172] closely parallel rule 10b-5, but section 517.301(3)[173] specifically imposes liability for knowingly making a false or fictitious statement. The similarity of section 517.301(1) to rule 10b-5 and the trend of Florida courts to interpret the blue sky law expansively could result in Florida adopting the federal elements of materiality and causality in lieu of privity.[174] This is further supported by section 517.301(3), which imposes liability for intentional deception. This provision, interpreted in the light of *Merrill Lynch v. Byrne*[175] which imposed liability on a nontrading defendant, would argue for the adoption of privity requirements similar to federal law. If so, it is also likely that Florida courts,

168. *See* Merrill Lynch, Pierce, Fenner & Smith v. Byrne, 320 So. 2d 436, 437-38 (Fla. 3d D.C.A. 1975). See note 149 *supra.*

169. *See, e.g.,* Data Lease Financial Corp. v. Barad, 291 So. 2d 608, 613 (Fla. 1974). See note 167 *supra.*

170. Privity is the main problem with both common law and blue sky actions and has been so since the inception of securities exchanges. The face to face contact necessary under Florida's provisions is totally lacking in the normal broker consummated transaction where not only are the parties without contact, they are completely unknown and often untraceable. This remains the one great advantage of action under rule 10b-5, the ability to pierce the veil of the exchange and impose liability without strict privity. The best solution for this problem would be either judicial expansion of Florida's blue sky law or legislation to abrogate the privity requirement. It would be within the general liberal intent of the statute to expand Florida's law to a more complete mirror of rule 10b-5. An argument could be made from §517.241(3) which provides federal civil remedies for Florida investors. This section could be used for support that the state law was intended to be at least as expansive as the federal, relaxing the privity requirement. *See* FLA. STAT. §517.241(3) (1979). *See also* Ratner, *supra* note 2, at 947-48.

171. See note 170 *supra.*

172. FLA. STAT. §517.301(1) (1979). This section, similarly to rule 10b-5, sanctions violations in connection with the sale or purchase of a security, directly or indirectly, and further specifically enumerates device, schemes or artifices to defraud. It further follows rule 10b-5 by making illegal any course of business that would operate as a fraud or deceit. *Id.*

173. *Id.* §517.301(3) (1979). This statute specifically makes intentional deception actionable. The strong legislative intent, evinced by reiterating conduct already covered by a previous statute, argues for an abrogation of the privity requirement in order to effectuate its provisions. It can also be argued that action under this section is not tied to a relationship but to an act, intentional deception in a securities transaction. Violations under this section should therefore be sanctioned because of their nature and not become immune because of a technicality of relationship.

174. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

175. 320 So. 2d 436, 440 (Fla. 3d D.C.A. 1975). The court was willing to read beyond the language of the statute to provide relief. This judicial favor for the statute could just as easily allow the privity requirement to be circumvented. The privity requirement is not required by the language of §517 and is as easily subject to judicial expansion as were the principles in *Merrill Lynch v. Byrne.*

following the federal trend, would impose liability without privity in circumstances of misrepresentation, but would not impose liability for failure to disclose unless a fiduciary relationship could be established.[176] This could result in privity being replaced by materiality and causality in cases of misrepresentation, but being retained in cases of nondisclosure.[177]

Other than privity, the only serious obstacle to action under Florida's blue sky law is that of jurisdiction. Rule 10b-5 requires the use of an instrumentality of interstate commerce, and the Florida law parallels it in the sense that a violation must take place within its jurisdiction in order to be actionable.[178] This is the most serious obstacle for a securities action since jurisdiction will often not lie for an extrastate transaction effectuated through the exchange.[179] Even if Florida can gain jurisdiction, the long arm statutes may not be sufficient to gain in personam jurisdiction over all the defendants.[180] This in turn may necessitate either an alternate forum where jurisdiction can be obtained over all the parties or the inconvenience of separate state actions.

Despite the shortcomings of privity and jurisdictions, the Florida blue sky law offers a more extensive remedy than rule 10b-5 in circumstances of negligence or a nontrading defendant. The plaintiff must remain alert, however, to obstacles peculiar to the Florida blue sky law, especially the privity and jurisdictional problems. Privity, while potentially amenable to judicial waiver, is still an element of the Florida action and jurisdiction will remain an immediate threshold concern. Once these obstacles are surmounted, the plaintiff will have a cause of action as powerful as rule 10b-5 before it was restricted.

ACTION UNDER FLORIDA COMMON LAW

The other alternative to an action under rule 10b-5 is an action under common law, and the most efficacious action under Florida common law in this context is an action for negligent misrepresentation. This is primarily due to the elements of action for negligent misrepresentation, which allow the plaintiff

176. *See* Chiarella v. United States, 100 S. Ct. 1108, 1115 (1980). If the Florida courts followed the federal trend in relaxing privity, it is unlikely that they would go beyond the present state of the law. The Florida courts have already taken this position in derivative suits and held that there is no cause of action absent a breach of a fiduciary duty. *See* Schein v. Chasen, 313 So. 2d 739, 744 (Fla. 1975). *Cf.* Twomey v. Mitchum, 262 Cal. App. 2d 690, 711 (1968) (California court applying California blue sky law held the defendant liable in a case of nondisclosure because a fiduciary relationship existed). Florida courts have found fiduciary relationships that would support liability. *See* Etheredge v. Barrow, 102 So. 2d 660, 662 (Fla. 1958); Flight Equip. & Eng'r Corp. v. Shelton, 103 So. 2d 615, 626-27 (Fla. 1958); Citizen's State Bank v. Adams, 140 Fla. 578, 583, 193 So. 281, 283 (1939); Renpack Inc. v. Oppenheimer, 104 So. 2d 642, 644 (Fla. 2d D.C.A. 1958).

177. Chiarella v. United States, 100 S. Ct. 1108, 1115 (1980).

178. *See* 17 C.F.R. §240.10b-5 (1979). The federal rule has jurisdiction only over those defendants engaging in interstate commerce. Florida's blue sky law, like all its statutes, can extend only to the limit of its long arm statutes.

179. *See* Bartell, *supra* note 20. Jurisdictional problems are extremely severe in the context of an exchange. Because the exchange and the opposite party are usually both outside the state and have no contact with it, most state long arm statutes are insufficient to gain jurisdiction. *Id.* at 463 n.32.

180. *Id.* at 463. The problems are accentuated if there are multiple defendants.

to circumvent many of the problems that prevent action under federal law. As was true of an action under Florida's blue sky law, however, an action for negligent misrepresentation, while advantageous, also presents challenges not present in rule 10b-5.

An action for negligent misrepresentation may prove extremely useful where a lack of scienter prevents the plaintiff from bringing action under federal law.[181] While federal law requires that the defendant have knowledge of the falsity of his representation, an action for negligent misrepresentation does not require actual knowledge, only that the defendant should have known.[182] This negligence standard is advantageous in a corporate setting where it may be difficult to prove an insider actually knew his representation was false, but circumstances may support an inference that regardless of his actual knowledge, he was negligent in making the representation.[183] In *Cameron v. Outdoor Resorts of America Inc.*,[184] the Fifth Circuit pointed out to the plaintiffs that this action would provide them with a viable state law alternative to the federal acion. Having been unable to prove scienter on the part of the defendants, an action for negligent misrepresentation would present a much lighter burden. If the plaintiffs could show that under the circumstances the defendants should have known their representations were false, they could meet that burden in the state action.[185] The action for negligent misrepresentation, therefore, presents a noteworthy alternative to the plaintiff shut out of federal court by the scienter requirement.

Though the plaintiff is relieved of the burden of showing an intent to defraud on the part of the defendant, he will have to establish that the defendant intended to induce the plaintiff to act.[186] The intent to induce action does not fall under the negligence standard that applies to the intent to defraud, and the

181. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). Florida's common law takes a minority position and allows negligent misrepresentation to be actionable. *See* Kutner v. Kalish, 173 So. 2d 763, 765 (Fla. 3d D.C.A. 1965). Florida's position rejects the majority view which requires scienter for any form of misrepresentation to be actionable. *See* Derry v. Peek, 14 A.C. 337 (1889). *See generally* W. PROSSER, *supra* note 55, at 705.

182. *See* Ostreyko v. Morton Org. Inc., 310 So. 2d 316, 318 (Fla. 3d D.C.A. 1975). The courts applying Florida law have held negligent misrepresentation to be tantamount to actionable fraud. *Id. Accord,* Bobby Jones Garden Apts. Inc. v. Suleski, 391 F.2d 172, 177 (5th Cir. 1968).

183. *See* Kutner v. Kalish, 173 So. 2d 763 (Fla. 3d D.C.A. 1965). There are five elements of action required for negligent misrepresentation that are recognized by courts applying Florida law. They are misrepresentation (or nondisclosure) of a material fact, misrepresentation where the defendant should have known of its falsity, intention to induce the plaintiff to act, justifiable reliance by the plaintiff and resultant injury. *Id.* at 765. *See also* Watson v. Jones, 41 Fla. 241, 25 So. 678, 682 (1899); Wheeler v. Baars, 33 Fla. 696, 15 So. 584, 588 (1894). These elements are identical to the elements of action for common law fraud except that fraud requires actual knowledge of falsity by the defendant.

184. 608 F.2d 187 (5th Cir. 1979).

185. *Id.* at 194. The circuit court used the language of fraud, but it was subsuming negligent misrepresentation to be under the law of fraud in Florida. The court recognized that while the plaintiffs could not show scienter and were precluded from action under rule 10b-5, they could meet the standards for Florida's common law. *Id.* at 195.

186. *See* Kutner v. Kalish, 173 So. 2d 763, 765 (Fla. 3d D.C.A. 1965). *See generally* W. PROSSER, *supra* note 54, at 686.

plaintiff can only meet this burden by showing the defendant had "actual" intent.[187] In practice this is not a heavy burden; it is reasonable to conclude that most representations in the securities field are more than mere off-hand remarks.[188] Moreover, while the intent to induce action element does present a burden for the plaintiff, it is much easier to prove by inference than the intent to defraud.[189] The different burdens presented by the scienter and the intent to induce action elements weigh decidedly in favor of the state cause of action.[190]

A more difficult situation may exist, however, where the case is one of failure to disclose rather than misrepresentation. Even if the defendant's intent to induce plaintiff's action can be shown, the courts will not generally impose liability unless there was a close relationship between the parties. In *Logan v. Arnold*,[191] for example, the plaintiff was defrauded by defendant's failure to disclose the full value of the stock which he had purchased from the plaintiff.[192] Because the parties were in a close relationship and not at arm's length, the court held the defendant liable.[193] Later cases have relied on *Logan* to disallow liability where the parties did not have a close relationship.[194] This has led to a general rule that the plaintiff must show there was a fiduciary relationship between the parties before there will be recovery for damages resulting from nondisclosure.[195]

187. *See* Poliakoff v. National Emblem Ins. Co., 249 So. 2d 477 (Fla. 3d D.C.A. 1971). Whereas the intent to defraud can be fulfilled by a showing of negligence, the intent to induce action remains a strict element of action. *Id.* at 478. The defendant may not have known his representation was false, but he must have made it with the purpose of inducing the plaintiff to act. A mere negligent inducement will not suffice.

188. *See, e.g.*, Cameron v. Outdoor Resorts of America Inc., 608 F.2d 187, 192 (5th Cir. 1979). The representations made here are fairly typical; they were made with the purpose of inducing plaintiff to buy campsites. Factual analysis of securities violations cases show this to be generally true. In fact, if the plaintiff can establish reasonable reliance on his part, he will have gone a long way to showing the intent to induce action. A representation that can be reasonably relied on is likely to be one seriously made with the intent to affect the hearer. *See* Logan v. Arnold, 82 Fla. 237, 239-40, 89 So. 551, 552 (1921).

189. *See* Logan v. Arnold, 82 Fla. 237, 239-40, 89 So. 551, 552 (1921).

190. *See, e.g.*, Cameron v. Outdoor Resorts of America Inc., 608 F.2d 187, 196 (5th Cir. 1979). The plaintiffs could not show scienter and were precluded from bringing federal action. *Id.* at 194. They were able to show intent to induce action from the same facts and so were able to bring successful action under negligent misrepresentation which does not require scienter. *Id.*

191. 82 Fla. 237, 89 So. 551 (1921).

192. *Id.* at 239, 89 So. at 553.

193. *Id.*

194. *Logan v. Arnold* imposed liability because there was a fiduciary relationship. Other cases have followed this rule by holding the inverse, that there is no liability absent such a relationship. It is important to remember, however, that the requirement to be in a fiduciary relationship applies to cases of nondisclosure only and not to ordinary misrepresentation. *See* Ramel v. Chasebrook Constr. Co., 135 So. 2d 876 (Fla. 2d D.C.A. 1961). In this case the court held that in the absence of a fiduciary relationship, mere nondisclosure is ordinarily not actionable unless an artifice or chicanery is used to prevent the plaintiff's inquiry. *Id.* at 882. *See also* Watson v. Jones, 41 Fla. 241, 254, 25 So. 678, 682 (1899) (liability was imposed after a fiduciary relationship was established).

195. *See* W. PROSSER, *supra* note 60, at 697. There are two other circumstances that will support liability in a case of nondisclosure. The first is where the speaker makes a representa-

This special relationship between the parties is also necessary in an action for negligent misrepresentation, but to a lesser degree than for nondisclosure. While nothing as stringent as a face to face transaction or a fiduciary relationship is required, the plaintiff still must show some form of privity to recover.[196] This is the major obstacle faced by a plaintiff in this action and is the most likely source of problems.[197] For example, while the courts have found enough of a relationship to support liability where the misrepresentations were made by corporate officers or directors to their shareholders or creditors,[198] if there is no privity, at least to this degree, relief remains in doubt.[199]

In an early Florida case, *Beach v. Williamson*,[200] a director was held liable to the shareholders and creditors for his misrepresentations in inducing a transfer of corporate assets to him.[201] Here the fiduciary duty of a director to the shareholders and his relationship to an outside creditor satisfied the requirement of privity, but it is significant that the defendant had an active part in the transaction. If he had not been a trader in the transaction, it appears doubtful that the court would have imposed liability.[202]

As applied to the context of a securities exchange, the rationale that some privity should be required would make it extremely difficult to support a finding of negligent misrepresentation against both nontrading tippers and other parties who trade through a broker.[203] In a situation where misrepresentation

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tion, but only tells part of the facts and does not disclose enough to keep his words from being misleading. *Id.* at 696. The second is where the defendant has special knowledge not available to the plaintiff and is aware that the plaintiff is under a misapprehension but does nothing to correct it. *Id.* at 697.

196. If the defendant had a face to face transaction with the plaintiff, the requirement of privity is obviously fulfilled. If there has not been a face to face transaction there must be at least some type of relationship between the parties. In Beach v. Williamson, 78 Fla. 611, 83 So. 860 (1920), for example, the relationship between the director of a corporation and its creditors was enough to fulfill the privity requirement, even though the director was not in a fiduciary relationship with the creditors, nor had been involved in a face to face transaction with them. *Id.* at 619, 83 So. at 862-63.

If there is no direct contact between the parties, the plaintiff is treated as a third party and privity becomes more difficult to establish. The general rule is to limit liability to those plaintiffs which the defendant had special reason to anticipate. *See* Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170, 174 N.E. 441 (1931). *See also* RESTATEMENT (SECOND) OF TORTS §§531-36 (1965). *See generally* W. PROSSER, *supra* note 55, at 702-08.

197. *See* Peek v. Gurney, L.R. 6E & I App. 377 (1873). Liability for a fraudulent prospectus was limited to action by the original investors and all were considered to lack the requisite privity.

198. *See, e.g.*, Beach v. Williamson, 78 Fla. 611, 83 So. 860 (1920).

199. *See, e.g.*, Ruden v. Medalie, 294 So. 2d 403 (Fla. 3d D.C.A. 1974). *Accord*, W. PROSSER, *supra* note 60, at 702-03.

200. 78 Fla. 611, 83 So. 860 (1920).

201. *Id.* at 619, 83 So. at 861-62.

202. *Id.* at 612-15, 83 So. at 860-62. Here the defendant received the assets directly from the plaintiffs. If he had caused them to be transferred to a third party instead of himself the case would have been closer. *Cf.* Ruden v. Medalie, 294 So. 2d 403 (Fla. 3d D.C.A. 1974) (where the defendant did not actually trade, but nonetheless took part in the transaction).

203. *See* Logan v. Arnold, 82 Fla. 237, 89 So. 551 (1921). Liability was imposed because they were not at arm's length in the transaction. *Id.* at 241-42, 89 So. at 553. It follows that, if

was made through a prospectus, the rationale of *Beach*[204] would extend the requisite privity and liability on the issuers of the prospectus, but only in favor of the original recipients.[205] Parties who received the prospectus third-hand would have difficulty establishing privity and would probably not be granted relief.[206] An action for negligent misrepresentation remains a potent source of relief for a defrauded plaintiff, but it is limited somewhat by the requirement of privity, especially in cases of nondisclosure. Shareholders and creditors at the time of the misrepresentation have a good cause of action against corporate officers and directors,[207] while others will be limited to actions against those with whom they had face to face transactions.

Once the plaintiff has established the elements of action for negligent misrepresentation, it may still not be actionable if it is seen as a representation of opinion rather than fact.[208] Although there are exceptions,[209] Florida law has long rejected any action for a false opinion or a false estimate of future value. The general rule is illustrated by the case of *Sparks v. State*,[210] in which the defendant represented that the stock offered for sale would triple in value after six months. When the plaintiff's expectations were not fulfilled, he brought suit under Florida's blue sky law for fraudulent sale of securities.[211] While this was not a common law action, it rested in part on common law principles which the court applied to deny relief.[212] The court held that the defendant's statements

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they had been at arm's length the action would have failed. These problems will be exacerbated if the deception is nondisclosure rather than misrepresentation. See note 196 *supra*.

204. 72 Fla. 611, 83 So. 860 (1919).

205. *Id.* at 619, 83 So. at 862-63. The rationale of *Beach* established a fiduciary relationship because the parties were not at arm's length. The converse would also be true, that if the transaction were at arm's length, the requisite relationship would be absent, preventing liability. As applied to a prospectus, the original recipients would be in direct relationship to the issuers and under the *Beach* analysis could bring action for misrepresentation. Parties beyond the initial recipients would not have this relationship and would fall under the *Ultramares* doctrine. *See* Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170, 174 N.E. 441 (1931). They would have a cause of action only if they were part of that class of recipients which the defendants could have reasonably anticipated would receive the prospectus.

206. See note 205 *supra*.

207. 72 Fla. at 619, 83 So. at 862-63.

208. *See* Vokes v. Arthur Murray Inc., 212 So. 2d 906, 908-09 (Fla. 2d D.C.A. 1968). The general rule in Florida is that a misrepresentation of opinion is not actionable. *Id. See also* W. PROSSER, *supra* note 60, at 728.

209. Vokes v. Arthur Murray, Inc., 212 So. 2d 906, 908-09 (Fla. 2d D.C.A. 1968). The rule does not apply where there is a fiduciary relationship between the parties or where an artifice or trick is employed by the representer to prevent the plaintiff from discovering the true facts. Other exceptions are where the parties are not at arm's length or where the representee does not have an equal opportunity to become appraised of the falsity of the opinion. *Id.*

210. 256 So. 2d 537 (Fla. 4th D.C.A. 1972).

211. *Id.* at 538.

212. *Id.* It was easier to find liability under the blue sky law than under common law. Therefore the fact that liability was denied under the blue sky law makes the principle that an expression of opinion is not a basis for liability even stronger in the common law which has a higher burden of proof. *See* FLA. STAT. §517.171 (1979). *See also* 11c H. SOWARDS & N. HIRSCH, BUSINESS ORGANIZATIONS, BLUE SKY REGULATIONS 6-5 (1979). *Cf.* McGregor v.

were not made in connection with a material fact, but were an expression of opinion regarding a future event and as such could not be the basis for liability.[213]

While the holding of *Sparks v. State* is the general rule in Florida, there are exceptions that allow the plaintiff relief even if the misrepresentation consists merely of opinion. If a fiduciary relationship exists between the parties, an opinion may be actionable misrepresentation, but a factual analysis of the cases indicates that the courts will only apply this exception when there has been truly egregious behavior on the part of the defendant.[214] For example, the fiduciary relationship of a corporate director to shareholders was not enough to invoke this exception when the opinion was given to parties able to conduct an independent investigation.[215] Apparently, even though there is a fiduciary relationship, only when the defendant has a great advantage over the plaintiff and the plaintiff has no effective means of protection will the courts find an opinion to be actionable.[216]

The second exception to the *Sparks v. State*[217] rule is that of misrepresentation of the fact that an opinion is believed by the party making it. The opinion itself may not be actionable, but there is a secondary implied representation which is made concurrently with the opinion, a representation that the opinion holder actually believes the opinion at the time of his representation.[218] No showing of a fiduciary relationship is necessary here. All the plaintiff is required

Provident Trust Co., 119 Fla. 718, 162 So. 323, 333 (1935) (placed a heavy burden of proof on the plaintiff in an action for common law fraud).

213. 256 So. 2d at 538. *See also* Bower v. Selecman, 52 So. 2d 680, 681 (Fla. 1951) (minority shareholders bought out the majority shareholder's stock after he made representations that he could obtain additional franchises, and the court held this to be a rash statement and as such not actionable); Evans v. Gray, 215 So. 2d 40, 41 (Fla. 3d D.C.A. 1968) (a director was absolved from liability in his representation of the value of corporate assets since it viewed this representation as mere opinion). *Accord*, Bissett v. Ply Gem Indus. Inc., 533 F.2d 142, 145 (5th Cir. 1976); Brod v. Jernigan, 188 So. 2d 575, 579 (Fla. 2d D.C.A. 1966).

214. *See* Vokes v. Arthur Murray Inc., 212 So. 2d 906 (Fla. 2d D.C.A. 1968). Misrepresentation of opinion was used by the defendant to sell a widow over $31,000 worth of dancing lessons. *Id.* at 907. The court found the requisite relationship to uphold liability. *Id.* at 909. *See also* Logan v. Arnold, 82 Fla. 237, 89 So. 551 (1921). A corporate vice president misrepresented by opinion the value of corporate stock which the widow of the former corporate president held. Liability was upheld by the court finding a semifiduciary relationship between the parties *Id.* at 243, 89 So. at 553.

215. *See* 256 So. 2d 537. Here even though the misrepresentation was by a director to corporate shareholders and concerned the value of the corporate stock, the action was dismissed. *Id.* at 538. A major factor in the court's decision was the ability of the plaintiffs to conduct an independent evaluation of the security. *Id. See also* Bower v. Selecman, 52 So. 2d 680 (Fla. 1951).

216. 256 So. 2d 537.

217. *Id.* The rule is that, in general, a misrepresentation of opinion is not actionable. *Id.* at 538.

218. *See* Watson v. Jones, 41 Fla. 241, 25 So. 678 (1899). This is not a misrepresentation of opinion, but of fact. The fact misrepresented is that the defendant actually held the opinion when he made it. If he does not, the misrepresentation is actionable. *Id.* at 254, 25 So. at 682. *See also* Bisset v. Ply Gem Indus., Inc., 533 F.2d 142 (5th Cir. 1976). The Fifth Circuit would hold defendants liable under Florida law if they had expressed an opinion when facts in their possession would make that opinion false. *Id.* at 146.

to show is that the defendant did not believe or hold the opinion when he made it. This can be inferred from circumstances and is a potent counter to the defense that the misrepresentation was mere opinion.[219]

The foregoing applies primarily to actions against a principal but will apply to actions against an aider and abettor with some significant additions. An action for aiding negligent misrepresentation becomes as difficult as an action for fraud because, in addition to all the elements of negligent misrepresentation, scienter must also be shown.[220] This makes an action against an aider even more difficult than an action under federal law. Although rule 10b-5 requires scienter, it does not require the privity necessary for negligent misrepresentation.[221] The common law action is further debilitated by the requirement, not present in rule 10b-5, that an aider must have performed some significant act to assist the misrepresentation. The Florida case of *Ruden v. Medalie*[222] illustrates that this act must be fairly significant in order to give rise to liability. In that case, a purchaser of debentures brought action against the attorney who signed the debentures as an aider and abettor.[223] The court held that the mere signing of the securities was not an act intended to induce the plaintiff to purchase and, therefore, would not support liability.[224] The court apparently sought a more active assistance even though there was scienter and privity on the part of the defendant.[225] In most circumstances, an action for negligent misrepresentation will not be as efficacious against an aider as it is against a principal due to the added elements of scienter and significant assistance.

After a plaintiff meets the elements of action and brings suit, whether against a principal or an aider, it is crucial to remember that it is a negligence action that is being brought. Florida's law of comparative negligence will apply to this action as with any other action based on a negligence claim independent of the blue sky laws.[226] If the plaintiff is seen as having not acted to safeguard

219. 533 F.2d at 146. If plaintiff can show that facts in the possession of the defendant would invalidate the opinion, the inference raised will support a finding of misrepresentation. *Id.* This is close to a negligence standard and the defendant will be held liable if it can be shown that he knew or should have known that his opinion was false or if it was made without knowledge of truth or falsity. *Id.* at 145. The general rule of no action for mere opinion is disfavored by the courts, hence the many exceptions.

220. The elements of the two actions are identical except for scienter which is only part of the action for fraud. *See* Bobby Jones Garden Apts., Inc. v. Suleski, 391 F.2d 172, 177 (5th Cir. 1968).

221. See notes 97 & 210 *supra*.

222. 294 So. 2d 403 (Fla. 3d D.C.A. 1974).

223. *Id.* at 406.

224. *Id.*

225. *Id.* The defendant knew the debentures were not what they purported to be and had face to face contact with the plaintiff in the transaction. The defendant did not have privity of trade however and rendered only minimal assistance to the representation. *Id.* Scienter is not enough for an aider to negligently mistrepresent; there must be significant assistance and the defendant must engage in some acts which induce the purchaser to purchase. *Id.*

226. FLA. STAT. §517.211 (1979). Contributory negligence is not a defense to the Florida blue sky laws. All that need be shown is a violation of the statute and defendant's only defense is to either deny the violation or to plead an exemption to the statute. Comparative negligence does apply to the common law actions, however, and can serve to reduce the plaintiff's recovery. *See* Ruden v. Medalie, 294 So. 2d 403, 406 (Fla. 3d D.C.A. 1974).

his own interests, the claim of being induced by the misrepresentation will be weighed against the duty to use reasonable care in one's own behalf.[227] As applied to securities misrepresentation, Florida's law of comparative negligence requires not only that there be justifiable reliance on the defendant's representation,[228] but also that the plaintiff exercised due care on his own behalf.[229] Even if all the elements of action are met, the plaintiff's own negligence may serve to reduce his recovery.

An action for negligent misrepresentation offers the plaintiff an excellent chance to circumvent the scienter requirement which may cripple a federal action. The plaintiff must be aware, however, of the other elements of action not present in the federal law, and recognize that as it is a negligence-based claim, comparative negligence principles apply. The plaintiff's major obstacle is showing privity, an obstacle more difficult in cases of nondisclosure. If this obstacle can be surmounted, the state action offers a significant alternative to those who can show privity but not scienter. Under those circumstances, the state action is more appropriate than the now restrictive federal law.

Fraud and breach of fiduciary duty are the other common law actions available to the plaintiff in a securities deception case. Neither is as favorable as negligent misrepresentation because the elements required are often too rigorous to afford a meaningful alternative to federal action. Both actions are useful mainly as additional grounds for relief that will provide punitive damages, but generally they will not be supportable as independent actions.[230]

An action for common law fraud requires that the plaintiff show both scienter and privity.[231] If scienter is not an obstacle in a particular case, rule

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227. *Id.*

228. *See* Kutner v. Kalish, 173 So. 2d 763 (Fla. 3d D.C.A. 1965). Justifiable reliance is an element of action totally separate from the doctrine of comparative negligence and is required even in intentional fraud. *Id.* at 765. The element of justifiable reliance does not effect whether the plaintiff exercised due care in his own behalf, but is concerned with the narrower question of whether it was justifiable to rely on the representation in the circumstances in which it was made. The plaintiff could have justifiably relied on the representation and still be contributorily negligent if he neglected to exercise due care outside of the immediate circumstances of the representation. *See also* Bobby Jones Garden Apts., Inc. v. Suleski, 391 F.2d 172, 177 (5th Cir. 1968).

229. *See* 294 So. 2d at 406. The plaintiff justifiably relied on the defendant's representation of the debentures; there was nothing in the immediate circumstances to belie the representation. *Id.* at 405. The defendant did have the defense of comparative negligence however, in that the plaintiff failed to exercise due care in her own behalf in the totality of the transaction by not investigating the credit and solvency of the corporation whose debentures she purchased. *Id.* at 406. This defense is available in an action for negligent misrepresentation but not in an action for fraud which is an intentional tort. *See generally* W. PROSSER, *supra* note 60, at 716.

230. See notes 245 & 253 *infra*.

231. *See* Joiner v. McCullers, 158 Fla. 562, 28 So. 2d 823 (1947). "A false representation of a material fact, made with knowledge of its falsity, to a person ignorant thereof, with intention that it shall be acted upon, followed by reliance upon and by action thereon amounting to substantial change of position, is a fraud of which the law will take cognizance." *Id.* at 564-65, 28 So. 2d at 824 (quoting Wheeler v. Baars, 33 Fla. 696, 15 So. 584 (1894)). The Florida supreme court included the elements of privity and scienter in this definition of fraud. First, the representation had to be made to the person ignorant of its falsity, which

10b-5 will often apply in the first instance,[232] making the state action superfluous. If rule 10b-5 still does not apply though scienter can be shown, the plaintiff must still go on to prove privity in order to establish a claim in fraud.[233] This will often be an insurmountable barrier if the transaction was consummated through an exchange or if redress is sought for market manipulation absent a purchase or sale.[234] Because of privity and scienter, an action for fraud is more difficult than action under rule 10b-5 and, therefore, usually is relegated to an ancillary status.[235]

An action for breach of fiduciary duty by a corporate officer or director to corporate shareholders, like an action for fraud, may be useful in only a minority of cases. If the plaintiff can show individual malfeasance by an officer or director, an action for breach of fiduciary duty may be available.[236] Unfortunately beyond that this action has probably been foreclosed by the Florida supreme court in *Schein v. Chasen*.[237] In that case the court rejected a derivative suit for a leak of corporate information to a securities broker and the broker's subsequent misuse of that information.[238] The court held that absent "harm to the corporation," derivative suits are inappropriate.[239]

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implies privity. Second, it had to be made with the knowledge of its falsity, which implies scienter. *See* Bobby Jones Garden Apts., Inc. v. Suleski, 391 F.2d 172, 177 (5th Cir. 1968); Poliakoff v. National Emblem Ins. Co., 249 So. 2d 477, 478 (Fla. 3d D.C.A. 1971); Kutner v. Kalish, 173 So. 2d 763, 765 (Fla. 3d D.C.A. 1965). *See generally* W. PROSSER, *supra* note 60, at 686.

232. Cameron v. Outdoor Resorts of America Inc., 608 F.2d 187 (5th Cir. 1979). The plaintiffs were forced to state law because they could not establish scienter. *Id.* at 194. If they could have established scienter, action under the Act would have gone forward making state law unnecessary. Once they were forced under state law the same scienter requirement that defeated action under the Act defeated an action for fraud, forcing them to use negligent misrepresentation. *Id.* at 195.

233. See note 231 *supra. See* McGregor v. Provident Trust Co., 119 Fla. 718, 744, 162 So. 323, 333 (1935).

234. *See* Washburn & Steig, *supra* note 20, at 776. The inability of action for fraud to deal with deception in the securities market was a motivating factor for passage of the Act. When a trade is made through an exchange the requisite privity is lacking and an action for fraud will not lie. Likewise, if there is no purchase or exchange, fraud becomes an extremely difficult ground for relief. *See, e.g.,* Ruden v. Medalie, 294 So. 2d 403 (Fla. 3d D.C.A. 1974).

235. Both actions require scienter, but only fraud requires privity. See text accompanying note 97 *supra. See generally* Note, *supra* note 4, at 1215.

236. *See* Beach v. Williamson, 78 Fla. 611, 83 So. 860 (1920). Usually breach of fiduciary duty can be supported where the officer or director has usurped a corporate opportunity or has been guilty of self dealing at the corporation's expense. In *Beach* the defendant, a director, defrauded the corporation into selling him corporate property. *Id.* at 614-16, 83 So. at 861-62. This type of activity, where the director gains to the corporation's detriment, will always support a derivative action by the shareholders. *Id.* at 622, 83 So. at 864. It is important to remember that no matter how well supported, derivative action is only available to shareholders and not to the general public. This means that, in the securities context, a shareholder at the time of the deception has standing, but one, who becomes a shareholder due to deception is in a more questionable position. One who refrains from becoming a shareholder has no standing at all.

237. 313 So. 2d 739 (Fla. 1975).

238. *Id.* at 739-46.

239. *Id.* at 746. *See also,* Palma v. Zerbey, 189 So. 2d 510, 511 (Fla. 3d D.C.A. 1966);

The court's action will preclude most derivative actions for securities abuse because the corporation is rarely harmed by these activities. Typically, the corporation has not traded and so has not suffered damages, leaving the plaintiff in the difficult position of having to allege intangible harm such as loss of goodwill. In the rare case in which the corporation has traded in securities, it usually has benefited from the inside information, and under the analysis of *Schein v. Chasen* a derivative action could not be maintained.[240] The plaintiff would only have a chance for success if he could show self-dealing by insiders at corporate expense resulting in either a loss of corporate opportunity or direct harm to the corporate entity. Otherwise, like an action for fraud, an action for breach of fiduciary duty has limited effectiveness in securing relief for securities fraud.

Even though actions for fraud or breach of fiduciary duty are not tremendously effective avenues for relief in securities fraud, an action for negligent misrepresentation is. Counsel, representing a plaintiff defrauded in a securities transaction, should not neglect common law alternatives, especially action for negligent misrepresentation. All forms of common law action suffer from the inconvenience of having to establish state jurisdiction and the difficulty of showing privity. These disadvantages are outweighed by the lack of other elements, such as scienter, which can restrict rule 10b-5. Although the common law has been eclipsed by rule 10b-5, the use of the rule has passed its apogee and is now in decline. Action by common law should once again assume a more primary role in providing relief for securities fraud.

CONCLUSION

Assuming that the present restrictive trend of the federal courts in applying the Act is a permanent phenomenon, state action, both statutory and common law, will have to provide an increasing share of relief for securities fraud. Fortunately, for the most part, Florida's statutory and common law are able to meet this demand and can provide relief. In fact, the Florida blue sky laws are, in many ways, a codification of the earlier liberal federal interpretations of the Act and will support relief in much the same manner.

The main difficulty in both the common and statutory law of Florida, other than jurisdictional problems which are present in any state action, is the problem of privity. The effectiveness of Florida's actions would be markedly increased if the elements of causality and materiality were adopted as a replacement for privity. This is essentially the federal solution, and if implemented in Florida, would protect Florida investors nearly as effectively as did the Act at its zenith.

Any changes made in this area should apply only to the blue sky law and not to the common law. The deletion of the privity requirement from negligent misrepresentation, for example, would have ramifications beyond securities

Maronek v. Atlantis Hotel, 148 So. 2d 721 (Fla. 3d D.C.A. 1962). *Cf.* Schein v. Chasen, 478 F.2d 817, 822-23 (2d Cir. 1973) (where the Second Circuit held that Florida would not require damage to the corporation in a derivative suit), *vacated*, 416 U.S. 386 (1974).

240. 313 So. 2d 739, 746 (Fla. 1975). The court applied this doctrine in a securities action to deny relief.

fraud and would expand this action beyond desirable limits of liability.[241] The blue sky laws are specifically tailored to securities violations, however, and an expansion would not affect other areas of the law. This change would result in a Florida securities law that would be able to carry out the intent of the legislature[242] in many cases where it is now ineffectual. Together, Florida's statutory and common law offer the plaintiff a good alternative to the Act, and with slight modification of the statutes, this alternative would become even more viable.

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241. *See, e.g.*, Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170, 174 N.E. 441 (1931). The problem of limiting liability in negligence actions was part of the policy behind this decision. Expansion of the limits of liability for negligence has far reaching consequences and should only be done cautiously.

242. *See* Data Lease Financial Corp. v. Barad, 291 So. 2d 608, 612 (Fla. 1974). The intent of the Florida blue sky law is to protect investors. Both judicial and legislative action should seek to implement that intent by correcting existing deficiencies in the law that prevent relief.