# Securities Regulation

John L. Latham

Jay E. Sloman

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by John L. Latham[*]
and
Jay E. Sloman[**]

This Article surveys significant cases decided by the United States Court of Appeals for the Eleventh Circuit ("Eleventh Circuit") during 1993 and 1994 in the field of securities regulation. This Article also examines selected United States Supreme Court decisions during this survey period that affect Eleventh Circuit precedent.

## I. THE APPLICATION OF SECTION 12(2)

Section 12(2) of the Securities Act of 1933[1] ("Securities Act") imposes civil liability for selling or offering to sell securities through the use of false communications.[2] In *First Union Discount Brokerage Services, Inc. v. Milos*,[3] the Eleventh Circuit faced the issue of whether Section 12(2)

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* Partner in the firm of Nelson Mullins Riley & Scarborough, L.L.P., Atlanta, Georgia. University of Toledo (B.A. cum laude with honors, 1976); Emory University (J.D., 1979). Member, State Bar of Georgia.

** Associate in the firm of Nelson Mullins Riley & Scarborough, L.L.P., Atlanta, Georgia. University of Georgia (B.S. summa cum laude, 1987); University of South Carolina (M.B.A., 1990); University of Georgia (J.D. cum laude, 1994). Member, State Bar of Georgia.

1. 15 U.S.C. 77l (1988).
2. Section 12 provides that any person who:

> (1) offers or sells a security in violation of Section 5, or
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> (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
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> shall be liable to the person purchasing such security from him . . . .

15 U.S.C. § 77l (1988).

3. 997 F.2d 835 (11th Cir. 1993).

applies to post-distribution, or aftermarket, securities transactions. The Eleventh Circuit had left the applicability of Section 12(2) to aftermarket transactions unresolved in its 1991 decision in *Ryder International Corp. v. First American National Bank*.[4]

In *First Union*, defendants Nick and Catherine Milos had invested heavily in put options through a nondiscretionary account with plaintiff First Union, a discount broker.[5] After failing to meet a margin call[6] necessitated by the stock market crash of October 1987, the defendants' securities positions were liquidated pursuant to agreements between the Miloses, First Union, and First Union's clearing broker.[7] Plaintiff First Union liquidated the account and paid its clearing broker the remaining deficiency.[8] First Union then brought suit to recover the deficiency from the Miloses, who counterclaimed and alleged First Union had made material false representations to them, in violation of Section 12(2) of the Securities Act.[9] First Union responded that the defendants' counterclaim under Section 12(2) was subject to dismissal on the grounds, *inter alia*, that the prohibitions of Section 12(2) against false and misleading communications did not apply to aftermarket or secondary market transactions, which were at issue here. The district court agreed with First Union and granted that aspect of its motion to dismiss.[10]

On appeal, the Eleventh Circuit affirmed the grant of First Union's motion to dismiss.[11] The court agreed that Section 12(2) applies only to initial offerings and held that it does not apply to aftermarket

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4. 943 F.2d 1521, 1530 n.16 (11th Cir. 1991).

5. 997 F.2d at 837. A put option is a contract that entitles the buyer of the put to sell a specified number of shares of a particular security to the writer of the put at a specified "strike" price at or within a specified time. *Id.* at 837-38.

6. A margin call is a demand by a broker that an investor deposit additional cash or securities in the investor's account to eliminate or reduce a margin deficiency. *Id.* at 838 n.4. *See* 12 C.F.R. § 220.2(n) (1995). A margin deficiency occurs when the equity in an investor's account is less than that required by law to support the account's liabilities. *Id.* *See* 12 C.F.R. § 220.2(o) (1995).

7. 997 F.2d at 839-40. The parties had entered into a Margin Agreement and an Options Agreement, both of which granted First Union or its clearing broker the right to liquidate the Miloses' accounts at any time without notice. *Id.* at 839 n.7.

8. *Id.* at 840.

9. *Id.* Defendants alleged six other violations of state law in its counterclaim. *Id.* at 840-41. The district court subsequently dismissed the Securities Act claim and granted summary judgment in favor of First Union's complaint and against the defendants' counterclaim. *Id.*

10. First Union Brokerage v. Milos, 717 F. Supp. 1519, 1523 (S.D. Fla. 1989).

11. 997 F.2d at 848.

transactions.[12] In reaching its decision, the court relied upon the United States Court of Appeals for the Third Circuit's ("Third Circuit") ruling in *Ballay v. Legg Mason Wood Walker, Inc.*[13] The decision in *Ballay* was the first by a federal court of appeals to consider this issue.[14] In *Ballay*, plaintiffs sued a full service broker for making certain false representations in connection with the recommendation and sale of stock. The Third Circuit held Section 12(2) did not apply to aftermarket transactions for three reasons.[15]

First, the Third Circuit found that the language of Section 12(2) is limited to initial securities distributions.[16] The court stated that the placement of the phrase "oral communication" near the term "prospectus" suggested that the former, more general, term should be limited to conform to the latter, more restrictive, term.[17] Therefore, the admonition of Section 12(2) against misleading oral communications should be limited to initial offerings because Congress defined and intended the term "prospectus" to relate to initial securities offerings.[18]

Second, the Third Circuit noted that Section 12(2) is positioned after Sections 11[19] and 12(1)[20] of the Securities Act, which govern the registration of securities and create civil liability for sales of unregistered securities.[21] Section 12(2) is also positioned before Section 13,[22] which establishes a limitations period for Sections 11 and 12. The court determined that, because the section is placed between sections that deal exclusively with initial securities distributions, Section 12(2) must also be limited to initial distributions.[23]

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12. *Id.* at 843-44.
13. 925 F.2d 682 (3d Cir.), *cert. denied*, 502 U.S. 820 (1991).
14. 997 F.2d at 843. Several district courts had, however, addressed this issue with inconsistent results. *See* Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading and Postdistribution Markets*, 32 WM. & MARY L. REV. 847 (1991).
15. 925 F.2d at 695.
16. *Id.* at 688.
17. *Id.*
18. *Id.* The term "prospectus" means "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security . . . ." 15 U.S.C. § 77b(10) (1988).
19. Section 11 of the Securities Act provides for civil liability on account of false registration statements. *See* 15 U.S.C. § 77k (1988).
20. Section 12(1) of the Securities Act provides for civil liability for violations of Section 5 of the Securities Act, which makes it a civil violation, inter alia, to sell securities interstate without a registration statement in effect. *See* 15 U.S.C. § 77l(1) (1988).
21. 925 F.2d at 691.
22. *See* 15 U.S.C. § 77m (1988).
23. 925 F.2d at 691.

Third, the Third Circuit distinguished the Supreme Court's decision in *United States v. Naftalin*,[24] in which the Court held Section 17(a) of the Securities Act applies to aftermarket transactions.[25] The Third Circuit rejected the argument that *Naftalin* requires the application of Section 12(2) to the aftermarket transactions because Sections 12(2) and 17(a) have materially distinct language.[26] Section 17(a) prohibits conduct employed "directly or indirectly . . . to obtain money or property by means of any untrue statement . . . ."[27] The court of appeals stated this language encompasses all types of conduct and not just conduct related to a "prospectus" or "oral communication."[28] The Third Circuit stated that the language of Section 17(a) is therefore expansive, while the language of Section 12(2) is restrictive.[29]

In *First Union*, The Eleventh Circuit adopted the reasoning in *Ballay*.[30] In adopting the Third Circuit's reasoning, the Eleventh Circuit recognized that other courts[31] and commentators[32] have argued Section 12(2) should be applied to aftermarket transactions.[33] The Eleventh Circuit, however, agreed with the Third Circuit in saying "'the language and legislative history of section 12(2), as well as its relationships to sections 17(a) and 10(b) within the scheme of the 1933

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24. 441 U.S. 768 (1979).

25. *Id.* at 778.

26. 925 F.2d at 691.

27. 15 U.S.C. § 77q(a) (1988).

28. 925 F.2d at 691.

29. *Id.* at 692. In addition, it has been noted by at least one commentator that even the Supreme Court recognized Section 17(a) as a major departure from the Securities Act's primary concern with regulation of new offerings and opined that the language adopted by the Supreme Court "arguably implies that the Court would limit Section 12(2)'s application to the distribution of securities." STEINBERG, SECURITIES REGULATION § 6.02[1], 6-4 to 6-5 (Law Journal Press 1988) (referring to language at 441 U.S. at 777-78).

30. 997 F.2d at 843-44.

31. *Id.* at 843 (citing Elysian Fed. Sav. Bank v. First Interregional Equity Corp., 713 F. Supp. 737 (D.N.J. 1989); Scotch v. Moseley, Hallgarten, Estabrook & Weeden, Inc., 709 F. Supp. 95 (M.D. Pa. 1988)). The Eleventh Circuit did not address the Seventh Circuit's decision in Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578 (7th Cir. 1993), which criticized the decision in *Ballay* and expressly held that Section 12(2) applies to secondary market transactions. *Id.* at 595.

32. 997 F.2d at 843 (citing Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading and Postdistribution Markets*, 32 WM. & MARY L. REV. 847 (1991); Adam D. Hirsh, Comment, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. CHI. L. REV. 955 (1990)). *See also* Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908 (1992) (criticizing the decision in *Ballay*).

33. 997 F.2d at 843.

and 1934 Acts, compel [the] conclusion that section 12(2) applies only to initial offerings and not to aftermarket trading.'"[34]

The Eleventh Circuit holding appears to be consistent with the intent of the Securities Act and follows the trend of narrowly construing the securities laws.[35] After the survey period ended, on February 28, 1995, the Eleventh Circuit reasoning was impliedly approved by the United States Supreme Court.[36] In *Gustafson v. Alloyd Co.*,[37] the Court held that Section 12(2) is limited to initial public offerings.[38] In so ruling, the Court stated the term "prospectus" was a term of art which refers to a document that describes a public offering of securities.[39]

## II. THE APPLICATION OF RULE 10B-5

### A. *Contribution*

Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act")[40] and Rule 10b-5 of the Securities and Exchange Commission[41]

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34. *Id.* (quoting *Ballay*, 925 F.2d at 693).

35. *See, e.g.*, Pinter v. Dahl, 486 U.S. 622 (1988); Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 114 S. Ct. 1439 (1994).

36. Gustafson v. Alloyd Co., 115 S. Ct. 1061 (1995).

37. 115 S. Ct. 1061 (1995). Justice Kennedy delivered the opinion of the Court in which Rehnquist, C.J., and Stevens, O'Connor, and Souter, J.J., joined. *Id.* Thomas, J., filed a dissenting opinion in which Scalia, Ginsburg, and Breyer, J.J., joined. *Id.* at 1074. Ginsburg, J., filed a dissenting opinion in which Breyer, J., joined. *Id.* at 1079.

38. *Id.* at 1073-74. The Court had expressly granted certiorari to resolve the split between the Third Circuit opinion in *Ballay*, 925 F.2d at 682, and the Seventh Circuit opinion in Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578 (1993). 115 S. Ct. at 1061.

39. 115 S. Ct. at 1073-74.

40. Section 10(b) provides:

> [I]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, of any facility of any national securities exchange . . . . (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device . . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1988).

41. Rule 10b-5, promulgated pursuant to 15 U.S.C. § 78j, provides:

> [It] shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

are silent on whether defendants in a suit based on an implied private right of action under Section 10(b) or Rule 10b-5 may seek contribution from joint tortfeasors. Prior to 1993, the federal courts of appeals were split on this issue.[42] In *Musick, Peeler & Garrett v. Employers Insurance of Wausau*,[43] the Supreme Court resolved this split and held an implied right to contribution does exist in actions under Section 10 and Rule 10b-5.[44] Respondents were insurers who funded the settlement of a lawsuit in which stock purchasers alleged violations of Sections 11 and 12 of the Securities Act.[45] The suit was brought against the issuer of the security, Cousins Home Furnishings, Inc. ("Cousins"), the parent company, various officers and directors of Cousins, and the two lead underwriters.[46] Respondents brought their lawsuit seeking contribution from petitioners, the attorneys and accountants involved in the public offering.[47] The question of whether the insurers had a right to contribution was not discussed in the lower court proceedings, in which the United States Court of Appeals for the Ninth Circuit ("Ninth Circuit") ruled in favor of the insurers.[48] After the Ninth Circuit's ruling, the United States Court of Appeals for the Eighth Circuit rendered a contrary decision in *Chutich v. Touche Ross & Co.*,[49] which prompted the attorneys and accountants in *Musick* to petition the Supreme Court to resolve the conflict among the courts of appeals.

17 C.F.R. § 240.10b-5 (1994).

42. The majority of courts of appeals to address this issue have ruled a right to contribution is implied in a 10b-5 action. *See In re* Jiffy Lube Sec. Litig., 927 F.2d 155 (4th Cir. 1991); Smith v. Mulvaney, 827 F.2d 558 (9th Cir. 1987); Sirota v. Solitron Devices, Inc., 673 F.2d 566 (2d Cir.), *cert. denied*, 459 U.S. 838 (1982); Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981), *aff'd in part, rev'd in part*, 459 U.S. 375 (1983); and Heizer Corp. v. Ross, 601 F.2d 330 (7th Cir. 1979). The Eighth Circuit has ruled there is no implied right to contribution. *See* Chutich v. Touche Ross & Co., 960 F.2d 721 (8th Cir. 1992).

43. 113 S. Ct. 2085 (1993). Kennedy, J., authored the majority opinion which was joined by Rehnquist, C.J., and White, Stevens, Scalia, and Souter, J.J. *Id.* Thomas, J., joined by Blackmun and O'Connor, J.J., dissented, arguing there is no implied right to contribution under Section 10(b) and Rule 10b-5. *Id.* at 2092.

44. *Id.* at 2086.

45. *Id.*

46. *Id.* The named defendants settled the case for $13.5 million of which respondents funded $13 million. *Id.*

47. *Id.*

48. *Id.* at 2087. The issues addressed below were the principles for determining whether the respondents' insurers had paid more than their fair share of liability in the class settlement. *Id.*

49. 960 F.2d 721 (8th Cir. 1992) (holding an implied right to contribution does not exist in a 10b-5 action).

The Supreme Court began its analysis by noting the private right of action under Rule 10b-5 was implied by the judiciary on the theory that courts should recognize private remedies to supplement federal statutory duties, and not on the theory Congress had given an unequivocal direction to the courts to do so.[50] The Court stated federal courts have accepted and exercised the principal responsibility for the continuing elaboration of the scope of 10b-5 rights and the definition of the duties they impose.[51] Furthermore, "'where a legal structure of private statutory rights has developed without clear indications of congressional intent,' a federal court has the . . . power to define 'the contours of that structure.'"[52]

The Supreme Court then proceeded to examine the contours of a 10b-5 action to determine whether a right of contribution did exist. The goal of the Court was to "attempt to infer how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act."[53] The Court noted the language of Section 10(b) does not reveal any inference of congressional intent regarding contribution among joint tortfeasors.[54]

The Supreme Court then analogized Sections 9[55] and 18[56] of the Exchange Act to Section 10b because Sections 9 and 18 are close in structure, purpose, and intent to a 10b-5 action.[57] Both Section 9 and 18 confer an explicit right of action in favor of private parties, and in doing so, disclose "a congressional intent regarding the definition and apportionment of liability among private parties."[58] The Court stated these express causes of action are significant in determining how Congress would have resolved the question of contribution had it provided for an express private cause of action under Section 10(b).[59] First, Sections 9 and 18 are significant in that both "'target the precise dangers that are the focus of Section 10(b) . . . .'"[60] Second, the intent

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50. 113 S. Ct. at 2088 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).

51. *Id.* at 2089.

52. *Id.* (quoting Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1104 (1991)).

53. *Id.* at 2089-90 (citing Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 359 (1991); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200-01 (1976)).

54. *Id.* at 2090.

55. Section 9 concerns the manipulation of security prices. *See* 15 U.S.C. § 78i (1988).

56. Section 18 addresses liability for misleading statements in applications and reports of documents filed with the Securities and Exchange Commission. *See* 15 U.S.C. § 78r (1988).

57. 113 S. Ct. at 2090 (citing *Lampf, Pleva*, 501 U.S. at 360-61).

58. *Id.*

59. *Id.*

60. *Id.* (quoting *Lampf, Pleva*, 501 U.S. at 360-61).

underlying all three Sections is the same, that is, one "'to deter fraud and manipulative practices in the securities market, and to insure full disclosure of information material to investment decisions.'"[61]

The Supreme Court noted additional similarities between Sections 9, 10(b), and 18:

> All three causes of action impose direct liability on defendants for their own acts as opposed to derivative liability for the acts of others;[62] all three involve defendants who have violated the securities law with scienter;[63] all three operate in many instances to impose liability on multiple defendants acting in concert;[64] and all three are based on securities provisions enacted into law by the 73rd Congress.[65]

Given these similarities, the Supreme Court held those charged with liability in a 10b-5 action have a right to contribution.[66]

The Court did not address several other important questions relating to the contribution issue. For example, the decision does not define the method which should be applied to calculate the share of liability attributable to joint tortfeasors when contribution claims are asserted in a 10b-5 action. Also, the Court did not decide whether claims for indemnification may arise in the context of a 10b-5 action. These issues remain subject to continued debate and future litigation.

### B. *Aiding and Abetting Actions—Private Plaintiffs*

The most significant decision during the survey period addressed whether a private plaintiff may maintain an action against a defendant for aiding and abetting under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.[67] This question was answered in the negative by the Supreme Court in *Central Bank of Denver v. First*

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61. *Id.* (quoting Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986)).
62. *Id.*
63. *Id.* (citing *Ernst & Ernst*, 425 U.S. at 209 n.28).
64. *Id.* at 2091 (citing 3 L. LOSS, SECURITIES REGULATION 1739-40 n.178 (2d ed. 1961)).
65. *Id.* at 2090-91. The Court distinguished six other express liability provisions of the Securities Act and the Exchange Act from the implied Section 10 remedy. *Id.* at 2091. Section 15 of the Securities Act and Section 20 of the Exchange Act impose derivative liability only. *Id.* Sections 11 and 12 of the Securities Act and Section 16 of the Exchange Act do not require scienter in all instances. *Id.* Section 12 of the Securities Act and Section 16 of the Exchange Act do not always create joint defendant liability. *Id.* Section 20A of the Exchange Act was not an original liability provision enacted into law by the 73rd Congress. *Id.*
66. *Id.* at 2092.
67. For the text of Section 10(b) *see supra* note 27.

*Interstate Bank of Denver*.[68] The ruling was contrary to the law in each circuit, including the Eleventh Circuit, which had recognized, at least tacitly, the existence of aiding and abetting liability under Section 10(b) and Rule 10b-5.[69]

The litigation in *Central Bank* arose out of 1986 and 1988 bond issues initiated by the Colorado Springs-Stetson Hills Public Building Authority ("Authority") for the financing of public improvements.[70] Plaintiff Central Bank served as the indenture trustee for the bond issues. The bonds were secured by landowner assessment liens which required the land subject to the liens to be worth at least 160% of the bonds' outstanding principal and interest.[71] The bond covenants required AmWest Development ("AmWest"), the Stetson-Hills developer, to provide Central Bank an annual report evidencing that the 160% requirement was met. The 1988 appraisal provided to Central Bank reflected land values that were almost unchanged from 1986. Central Bank then received a subsequent letter from the senior underwriter for the 1986 bonds which expressed concern that the 160% requirement was not being met because property values in Colorado Springs were declining and Central Bank was operating under a sixteen-month old appraisal. After Central Bank's in-house appraiser determined the property values to be optimistic, Central Bank sought to obtain an independent appraisal. A proposed independent appraisal was postponed by agreement between AmWest and Central Bank until the end of 1988, six months after the June closing of the bond issue. The Authority defaulted on the bond issue before the end of the year.[72]

Plaintiffs, First Interstate and Naber, were purchasers of the 1988 bonds. Plaintiffs sued the Authority, the 1988 underwriter, a junior underwriter, and an AmWest director for violations of Section 10(b).[73] Plaintiffs also sued Central Bank, alleging Central Bank was secondarily liable by aiding and abetting the other defendants in their violations of Section 10(b).[74] The district court granted summary judgment to

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68. 114 S. Ct. 1439 (1994). The majority opinion was written by Kennedy, J., in which Rehnquist, C.J., and O'Connor, Scalia, and Thomas, J.J., joined. Stevens, J., authored a dissenting opinion in which Blackmun, Souter, and Ginsburg, J.J., joined.

69. *See, e.g.*, Schneberger v. Wheeler, 859 F.2d 1477 (11th Cir. 1988). For a list of the circuits previously recognizing aiding and abetting liability *see Central Bank*, 114 S. Ct. at 1456 n.1 (Stevens, Blackmun, Souter & Ginsburg, J.J., dissenting).

70. 114 S. Ct. at 1443.

71. *Id.* The liens covered approximately 250 acres for the 1986 issue and approximately 272 acres for the 1988 issue. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

Central Bank, and the United States Court of Appeals for the Tenth Circuit ("Tenth Circuit") reversed.[75] Applying its standard for Section 10(b) aiding and abetting causes of action,[76] the Tenth Circuit found a material issue of genuine fact had been raised by plaintiffs as to whether the defendants had acted recklessly and held that a reasonable trier of fact could conclude Central Bank had rendered substantial assistance to the primary violators.[77] The Supreme Court granted certiorari to "resolve the continuing confusion over the existence and scope of the § 10(b) aiding and abetting action."[78]

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75. *Id.* at 1439.

76. *Id.* at 1443. The Tenth Circuit's elements for a Section 10(b) aiding and abetting cause of action are: (1) a primary violation of Section 10(b); (2) recklessness by the aider and abettor as to the existence of the primary violation; and (3) substantial assistance given to the primary violator by the aider and abettor. *See* First Interstate Bank of Denver, N.A. v. Pring, 969 F.2d 891, 898-903 (10th Cir. 1992), *rev'd*, Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 114 S. Ct. 1439 (1994).

77. 114 S. Ct. at 1444. The court of appeals found Central Bank was aware of concerns about the 1988 appraisal, knew the sale of the bonds was imminent, knew purchasers were relying on the appraisal, and possibly assisted in delaying the independent appraisal. *Id.*

78. *Id.* The Court's grant of certiorari on this issue is one of the more unusual aspects of the Court's action. As noted by the dissent, the Court addressed the existence of aiding and abetting liability under Section 10 *sua sponte*. *Id.* at 1457 (Stevens, J., dissenting). Neither party raised the issue on appeal as both believed a private action for aiding and abetting did exist. *Id.* Petitioner had sought review on the questions of whether an indenture trustee could be found liable as an aider and abettor absent a breach of an indenture agreement or based only on a showing of recklessness. *Id.*

The Court did note it had reserved this question in two prior decisions. *Id.* at 1443. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 379 n.5 (1983) and Ernst & Ernst v. Hochfelder, 425 U.S. 185, 191-92 n.7 (1976). The Court also referred to a limited number of courts and commentators who, in the past 20 years, have questioned whether aiding and abetting liability under Section 10(b) was still available. 114 S. Ct. at 1444. *See* Akin v. Q-L Investments, Inc., 959 F.2d 521, 525 (5th Cir. 1992); Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 495 (7th Cir. 1986); Benoay v. Decker, 517 F. Supp. 490, 495 (E.D. Mich. 1981), *aff'd*, 735 F.2d 1363 (6th Cir. 1984); SEC v. Seaboard Corp., 677 F.2d 1301, 1311 n.12 (9th Cir. 1982); Little v. Valley Nat'l Bank, 650 F.2d 218, 220 n.3 (9th Cir. 1981); and Fischel, *Secondary Liability under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 82 (1981).

As the dissent pointed out, however, all eleven courts of appeals that have considered this question have recognized a private cause of action against aiders and abettors under Section 10(b) and Rule 10b-5. *Id.* at 1456 n.1 (citing Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 986 (10th Cir. 1992); Schatz v. Rosenberg, 943 F.2d 485 (4th Cir. 1991), *cert. denied*, 112 S. Ct. 1475 (1992); K & S Partnership v. Continental Bank, N.A., 952 F.2d 971, 977 (8th Cir. 1991), *cert. denied*, 112 S. Ct. 2993 (1992); Levine v. Diamanthuset, Inc., 950 F.2d 1478, 1483 (9th Cir. 1991); Fine v. American Solar King Corp., 919 F.2d 290, 300 (5th Cir. 1990); Schlifke v. Seafirst Corp., 866 F.2d 935, 947 (7th Cir. 1989); Schneberger v. Wheeler, 859 F.2d 1477, 1480 (11th Cir. 1988), *cert. denied*, 490 U.S. 1091 (1989); Moore v. Fenex, Inc., 809 F.2d 297, 303 (6th Cir.), *cert. denied sub nom.* Moore v. Frost, 483 U.S. 1006, (1987); Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983); IIT v. Cornfeld, The Court stated it has confronted two main issues in its decisions addressing Section 10(b) and Rule 10b-5. First, the Court has had to determine the scope of conduct prohibited by Section 10(b).[79] Second, in cases where a defendant has committed a violation of Section 10(b), the Court has had to decide questions regarding the elements of the 10b-5 liability scheme.[80] In *Central Bank*, the Supreme Court ruled that its decision was to be resolved by reference to the scope of the prohibited conduct.[81] The Court then determined the express language of Section 10(b) does not apply to those who aid and abet.[82]

The Court continued, however, and stated that even if the language of the statute itself did not resolve the issue, the Court would reach the same conclusion through an alternative means of analysis. When the text of Section 10(b) does not resolve a particular issue, the Court's task is to infer "how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act."[83] To accomplish this task, the Court stated it must use the express causes of action already existing in the Securities Act and the Exchange Act as a model for the private Section 10(b) action.[84] The reason for this method of analysis is premised on the belief that had the 73rd Congress enacted a private Section 10(b) action, it would have done so in a manner similar to the other express causes of action in those Acts.[85] The Court noted none of the express causes of action in the

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619 F.2d 909, 922 (2d Cir. 1980); Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 799-800 (3d Cir.), *cert. denied sub nom.* First Pennsylvania Bank, N.A. v. Monsen, 439 U.S. 930 (1978)).

The only court of appeals not to have squarely recognized aiding and abetting in private § 10(b) actions has done so in an action brought by the SEC, see Dirks v. SEC, 681 F.2d 824, 844 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983), and has suggested that such a claim was available in private actions. *See* Zoelsch v. Arthur Andersen & Co., 824 F.2d 27, 35-36 (D.C. Cir. 1987).

79. 114 S. Ct. at 1445 (citing Dirks v. SEC, 463 U.S. 646 (1983); Aaron v. SEC, 446 U.S. 680 (1980); Chiarella v. United States, 445 U.S. 222 (1980); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)).

80. *Id.* (citing *Musick, Peeler*, 113 S. Ct. 2085 (1993); *Lampf, Pleva*, 501 U.S. 350; Basic Inc. v. Levinson, 485 U.S. 224 (1988); Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985)). The Court stated this issue has posed difficulty because Congress did not create a private Section 10(b) cause of action and has had no occasion to provide guidance regarding the elements of a private liability scheme. *Id.* at 1446.

81. *Id.* The Court noted adherence to the text in defining conduct covered by Section 10(b) was consistent with its prior decisions. *Id.* at 1446-47 (citing Pinter v. Dahl, 486 U.S. 622 (1988)).

82. *Id.* at 1447.

83. *Id.* at 1448 (quoting *Musick, Peeler*, 113 S. Ct. at 2090).

84. *Id.*

85. *Id.*

Exchange Act impose liability on an aider or abettor of the primary violator.[86] Therefore, the Court inferred Congress would not have created a private Section 10(b) action to impose liability on aiders and abettors.[87]

The Eleventh Circuit recently followed *Central Bank* in *Twiss v. Kury*.[88] In that case, plaintiff investors brought suit against Kury, a registered securities sales representative, and each of his former employers[89] for Kury's operation of a "pyramid" or "ponzi" scheme.[90] Defendant Hutton, Kury's first employer, was sued for aiding and abetting violations of Section 10(b) of the Exchange Act and Rule 10b-5.[91] The district court granted summary judgment in favor of Hutton and plaintiffs appealed.

The Eleventh Circuit noted that at the time of the district court's orders, the prevailing law in the circuit recognized private Section 10(b) actions for aiding and abetting.[92] The court of appeals, however, applied the recent ruling in *Central Bank* and upheld the district court's grant of summary judgment.[93]

86. *Id.* at 1449. The Court noted Section 11 of the Securities Act identifies the categories of defendants, none of which are aiders and abettors. *Id.* Section 12 of the Securities Act is limited to those who offer or sell a security. *Id.* Section 9 of the Exchange Act prohibits any person from engaging in specific acts, such as wash sales and matched orders. *Id.* Section 16 of the Exchange Act imposes liability on owners, directors and officers. *Id.* Section 20A prohibits any person from engaging in insider trading. *Id.*

87. *Id.*

88. 25 F.3d 1551 (11th Cir. 1994).

89. Kury had worked as a registered sales representative for E.F. Hutton & Company, Inc., Prudential-Bache Securities Corporation, Associated Planners Securities Corporation, Kury Financial Planning Group, Inc., and American Capital Equities Corporation. *Id.* at 1553.

90. A pyramid or ponzi scheme is one in which funds from new investors are used to satisfy interest and principal obligations due on earlier investors' notes. *Id.* at 1553 n.6.

91. *Id.* at 1554. Plaintiffs also sued Hutton in negligence for lack of due care and breach of duty to Kury's then and future customers, for misrepresenting the reasons for Kury's termination, and for failing to report properly to regulatory authorities. *Id.* The district court granted Hutton's motion for summary judgment on these claims, holding Hutton owed no duty to the plaintiffs under Florida law. *Id.* The court of appeals reversed this portion of the district court's decision. *Id.* at 1558.

92. *Id.* At that time, a party bringing and aiding and abetting action had to prove: (1) the commission of a securities law violation by some other party; (2) a general awareness on the part of the accused party that its role was part of an overall activity that was improper; and (3) the accused aider and abettor knowingly and substantially assisted the violation. *Id.* *See* Rudolph v. Arthur Andersen & Co., 800 F.2d 1040, 1045 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987); Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94-97 (5th Cir. 1975).

93. 25 F.3d at 1558.

### C. Aiding and Abetting Actions—S.E.C. Enforcement

Although the Supreme Court's ruling in *Central Bank* addressed only the existence of aiding and abetting liability in private Section 10(b) actions,[94] it is arguable the decision also applies to the Securities and Exchange Commission ("Commission" or "SEC") as well. Justice Stevens, in his dissenting opinion, stated the "majority leaves little doubt that the Exchange Act does not even permit the *Commission* to pursue aiders and abettors in civil enforcement actions under § 10(b) and Rule 10b-5."[95]

The Eleventh Circuit may have the opportunity to address the application of *Central Bank* in the upcoming year in the matter of *Zimmerman v. SEC.*[96] In that case, the SEC has brought aiding and abetting charges against an accountant for his alleged role in helping a Drexel Burnham Lambert broker defraud investors. The district court enjoined the accountant from violating securities laws and ordered him to disgorge monies allegedly received from the fraud.[97] While his appeal was pending, the Supreme Court issued the decision in *Central Bank*. Based on *Central Bank*, the accountant moved for a remand of his case to the district court with instructions for a dismissal based on the Supreme Court's ruling.[98] The SEC argued in rebuttal that *Central Bank* did not apply or, in the alternative, that a remand of the case was appropriate to allow the SEC to amend its complaint to charge the accountant as a primary violator.[99] The Eleventh Circuit has remanded the case for a determination by the district court of the SEC's right to amend and, if necessary, the issue in *Central Bank*.

A number of commentators have questioned whether the ruling in *Central Bank* should be applied to the SEC.[100] The potential argu-

94. "[W]e hold that a private plaintiff may not maintain an aiding and abetting suit under § 10(b)." 114 S. Ct. at 1455.

95. 114 S. Ct. at 1460 (Stevens, J., dissenting) (emphasis in original).

96. No. 93-9266 (11th Cir. filed Sept. 1993).

97. SEC v. Scherm, 854 F. Supp. 900 (N.D. Ga. 1993).

98. Lynn S. Hume, *SEC v. Zimmerman Decision Could Limit Further SEC Enforcement Efforts*, THE BOND BUYER, Oct. 3, 1994, at 23.

99. *Id.*

100. *See* Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429 (1994); Lisa K. Wager & John E. Failla, Central Bank of Denver, N.A. v. First Interstate Bank of Denver—*The Beginning of an End, Or Will Less Lead to More?*, 49 BUS. LAW. 1451 (1994); David S. Ruder, *The Future of Aiding and Abetting and Rule 10b-5 after Central Bank of Denver*, 49 BUS. LAW. 1479 (1994).

ments for both Zimmerman[101] and the SEC[102] have already been briefed and published in the form of hypothetical Supreme Court decisions.

### D. *Statute of Limitations*

In *Morgan Stanley & Co. v. Pacific Mutual Life Insurance Co.*,[103] the Supreme Court affirmed *per curiam* a United States Court of Appeals for the Fifth Circuit ruling declaring Section 27A(b) of the Exchange Act[104] to be a constitutional exercise of congressional authority.[105] As a practical matter, Section 27A(b) provides that the one year/three year limitation period adopted by the Supreme Court on June 20, 1991 in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*[106] did not apply to actions filed on or before June 19, 1991. The Court's affirmance lends support to the Eleventh Circuit's 1992 determination of the constitutionality of Section 27A in *Henderson v. Scientific-Atlanta, Inc.*[107]

### E. *"Bespeaks Caution" Doctrine*

Although occurring outside of the survey period, the Eleventh Circuit recently adopted the "bespeaks caution" doctrine for securities fraud

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101. *See* Edward C. Brewer, III & John L. Latham, SEC v. Central Bank: *A Draft Opinion for the Court's Conference*, 50 BUS. LAW. 19 (1994).

102. *See* Simon M. Lorne, Central Bank of Denver v. SEC, 49 BUS. LAW. 1467 (1994).

103. 114 S. Ct. 1827 (1994).

104. Section 27A was adopted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991 and amended the Exchange Act to provide as follows:

> (a) The limitation period for any private civil action implied under section 78j(b) of this title that was commenced on or before June 19, 1991, shall be the limitation period provided by the laws applicable in the jurisdiction, including principles of retroactivity, as such laws existed on June 19, 1991.
>
> (b) Any private civil action implied under section 78j(b) of this title that was commenced on or before June 19, 1991 —
>
> (1) which was dismissed as time barred subsequent to June 19, 1991, and (2) which would have been timely filed under the limitation period provided by the laws applicable in the jurisdiction, including principles of retroactivity , as such laws existed on June 19, 1991, shall be reinstated on motion by the plaintiff not later than 60 days after Dec. 19, 1991.

15 U.S.C.A. § 78aa-1 (West Supp. 1992).

105. The Fifth Circuit ruled that Section 27A(b) did not violate the due process rights of the defendants in that case, did not violate the separation of powers doctrine, and did not usurp judicial authority by upsetting final judgments. Pacific Mut. Life Ins. Co. v. First Republicbank Corp., 997 F.2d 39 (5th Cir. 1993).

106. 111 S. Ct. 2773 (1991).

107. 971 F.2d 1567 (11th Cir. 1992). For a discussion of *Henderson* see John L. Latham & James A. Shuchart, *Securities Regulation*, 44 MERCER L. REV. 1281, 1293-94 (1993).

suits.[108] In *Saltzberg v. TM Sterling/Austin Associates*,[109] the court of appeals ruled that, in considering allegations of securities fraud under Section 10(b) of the Exchange Act and Rule 10b-5, the context in which statements in an offering document are made is important.[110] The court stated that when projections in an offering document are accompanied by meaningful cautionary statements and specific warnings of risk, such warning language may be sufficient to render alleged omissions or misrepresentations immaterial as a matter of law.[111] In *Saltzberg*, the warning language was not boilerplate, but was explicit, repetitive and linked to the offering projections forming the basis of the plaintiffs' complaint. Accordingly, the court upheld the district court's grant of summary judgment.[112]

## III. SEC DISCIPLINARY ACTIONS

### A. *Markups*

The National Association of Securities Dealers ("NASD") has for many years enforced a five percent markup policy[113] on agency trades made by brokerage firms with their public customers. The policy is based on the NASD's interpretation of Article III, Sections 1 and 4 of the NASD Rules of Fair Practice.[114] In *Orkin v. SEC*,[115] the Eleventh Circuit

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108. The Eleventh Circuit expressly adopted the doctrine as explained by the Third Circuit in *In re* Donald J. Trump Casino Sec. Litig., 7 F.3d 357 (3d Cir. 1993). The Third Circuit defined the "bespeaks caution" doctrine as one allowing the dismissal of securities fraud claims because the cautionary language in the offering document negates the materiality of an alleged misrepresentation or omission. 7 F.3d at 371. The Third Circuit noted the doctrine had been applied by a number of Circuits. *See* Sinay v Lamson & Sessions Co., 948 F.2d 1037 (6th Cir. 1991); *In re* Convergent Technologies Sec. Litig., 948 F.2d 507 (9th Cir. 1991); I. Meyer Pincus & Assocs. v. Oppenheimer & Co., 936 F.2d 759 (2d Cir. 1991); Romani v. Shearson Lehman Hutton, 929 F.2d 875 (1st Cir. 1991); Polin v. Conductron Corp., 552 F.2d 797 (8th Cir.), *cert. denied*, 434 U.S. 857 (1977).

109. 45 F.3d 399 (11th Cir. 1995).

110. *Id.* at 400.

111. *Id.*

112. *Id.*

113. A markup is the increase in the price of a security added by a broker for effecting the securities transaction. The NASD's five percent policy generally limits brokers to a markup of five percent of the price of the underlying security. *See generally*, *In re* Alstead, Dempsey & Co., 30 S.E.C. 208 (1994).

114. Article III, Section 1 of the NASD Rules of Fair Practice states a "member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." NASD Manual ¶ 2151 (CCH 1994). Section 4 states:

> In "over-the-counter" transactions, whether in "listed" or "unlisted" securities, if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair, taking into

reviewed for the first time the SEC's application and endorsement of the NASD's five percent policy.

In January 1989, the NASD filed a complaint against petitioner Orkin charging that he and others effected over-the-counter sales of corporate securities to public customers at prices which were not fair. Orkin had been the president of Ortech Industries, Inc. ("Ortech"), from November 1986 through August 1987.[116] In May 1987, Orkin entered an employment agreement with Tri-Bradley Investments, Inc. ("Tri-Bradley"), and served as a Tri-Bradley retail salesman and branch manager.[117] Prior to the initial public offering of Ortech stock in October 1987, Orkin left Ortech and negotiated with Brownstone-Smith Securities Corp. ("Brownstone"), the sole underwriter of the offering, to acquire Ortech warrants for Tri-Bradley.[118]

It was the subsequent sale of Ortech stock that resulted in the NASD's allegations against Orkin. The NASD District Business Conduct Committee ("DBCC") determined the retail sales effected by Orkin did exceed the five percent markup permitted under the NASD's rules.[119] This finding was upheld by the NASD National Business Conduct Committee ("NBCC")[120] and subsequently upheld by the SEC.[121] Orkin then petitioned for review alleging that the SEC's finding of excessive markups was not supported by the evidence, he was not liable as he did not have authority to set final retail prices, and the five percent policy was unconstitutionally vague, illegal, or unfair.[122]

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> consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit; and if he acts as agent for his customer in any such transaction, he shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances including market conditions with respect to such security at the time of the transaction, the expense of executing the order, and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor.

NASD Manual ¶ 2154 (CCH 1994).

115. 31 F.3d 1056 (11th Cir. 1994).

116. *Id.* at 1058.

117. *Id.* at 1059.

118. *Id.*

119. *Id.* at 1060. The DBCC imposed the following sanctions: censure, $50,000 fine, costs, and suspension from all NASD activity for thirty days. *Id.*

120. *Id.* The NBCC determined, however, that Orkin's role was more limited than determined by the DBCC. *Id.* The NBCC upheld the sanctions of censure and costs, but reduced the fine to $15,000 and increased the suspension to 90 days. *Id.*

121. *Id.* at 1063. The SEC upheld the NBCC sanctions. *Id.*

122. *Id.* at 1058. Orkin also alleged the SEC erroneously upheld the NBCC when the SEC based its findings on a different prevailing market price than the NBCC and the

The Eleventh Circuit found the SEC had established a standard procedure in evaluating excessive markups. The first step in markup cases is to determine the prevailing market price for the security issue.[123] The general rule is that, in the absence of countervailing evidence, the best evidence of the prevailing market price is a dealer's contemporaneous cost in acquiring the security.[124] If the dealer is a market maker,[125] however, the prevailing market price is the price paid by the dealer for the security.[126] Once the prevailing market price is determined, markups can be computed using the price charged by market makers in actual sales to other dealers.

Relying on this procedure, the SEC determined Orkin charged excessive markups for the trades he effected. The SEC had determined the prevailing market price for the Ortech retail sales was \$.03 per share.[127] The subsequent retail sales by Tri-Bradley, which were solicited by Orkin, were effected at a cost of \$.035 to \$.06 per share resulting in markups of 16.67% to 100%, all well above the NASD's five percent rule.[128] The SEC determined Orkin played a significant role in pricing and was grossly negligent in aiding Tri-Bradley in effecting retail sales of Ortech stock at excessive prices.[129] The SEC noted Orkin was an NASD-registered general securities principal, a Tri-Bradley branch manager, familiar with the five percent markup policy, and had an understanding of securities pricing.[130] Because he was involved in Ortech's initial public offering, Orkin also was in a position to know that Ortech stock was not actively traded and that Brownstone dominated and controlled the market.[131] The Eleventh Circuit ruled

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sanctions imposed were too severe. The Eleventh Circuit rejected these arguments. *Id.* at 1064-67.

123. *Id.* at 1060. A markup must be reasonably related to the prevailing market price, i.e., the price at which dealers trade with one another. *See In re* Alstead, Dempsey & Co., 30 S.E.C. 208 (1984).

124. 31 F.3d at 1060.

125. A market maker is a dealer who, with respect to a security, buys from and sells to other dealers. *Id.* at 1059 n.3.

126. *Id.* at 1061 (citing *In re* Meyer Blinder, 52 S.E.C. 1435 (1992)).

127. *Id.* The DBCC had determined that Tri-Bradley's contemporaneous cost of \$.0175 per share was the prevailing market price. Therefore, the 208 sales at \$.035 to \$.06 resulted in markups of 100% to 243%. *Id.* at 1060. The SEC, however, determined Brownstone's inter-dealer price of \$.03 per share was the maximum prevailing market price in a thinly traded market controlled by Brownstone and Tri-Bradley. *Id.* at 1061.

128. *Id.* at 1061.

129. *Id.*

130. *Id.*

131. *Id.*

the SEC had appropriately and fairly applied its markup analysis procedure to the facts of this case.[132]

The Eleventh Circuit rejected Orkin's claim that he was not liable for the markup violations because he relied on his superiors to comply with the NASD pricing rules. The court noted the Fifth Circuit had previously rejected the argument that stockbrokers or salesman are exempt from responsibility for fair pricing under Article III, Sections 1 and 4 of the NASD Rules of Fair Practice in *Amato v. SEC.*[133] In *Amato*, the SEC had found a salesman liable for charging excessive markups because he was intimately involved in the pricing of securities within the parameters set by his firm's trading department. The salesman purchased stock from customers which he then resold to other customers; therefore, he was in a position to know the firm's cost, unlike many stockbrokers. The Fifth Circuit based its finding of the salesman's liability on this particular knowledge.[134] The Eleventh Circuit expressly adopted the Fifth Circuit's reasoning in *Amato* and likened the knowledge possessed by Orkin to that possessed by the salesman in *Amato.*[135] In addition the Eleventh Circuit stated a salesman cannot absolve himself of responsibility for compliance with the NASD Rules simply by relying on the directives of his superiors.[136]

The Eleventh Circuit also rejected Orkin's claim that the NASD markup policy is illegal, unfair, and unconstitutional. The court noted the SEC had already considered these arguments in *In re Meyer Blinder*[137] and relied on the SEC's reasoning in ruling the NASD's markup policy was not illegal, unfair, or unconstitutional.[138]

### B. *Right to Counsel*

In *Elliott v. SEC,*[139] the Eleventh Circuit addressed for the first time a party's right to counsel during a disciplinary proceeding before the SEC. Petitioner Elliott had been barred by the SEC from associating with any securities broker or dealer.[140] Elliott had operated and

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132. *Id.* at 1064.
133. 18 F.3d 1281 (5th Cir.), *cert. denied*, 115 S. Ct. 316 (1994).
134. 18 F.3d at 1283.
135. 31 F.3d at 1065.
136. *Id.* (citing *In re* Dan King Brainard, 47 S.E.C. 991 (1983)).
137. 52 S.E.C. 1145 (1992).
138. 31 F.3d at 1066.
139. 36 F.3d 86 (11th Cir. 1994).
140. *Id.* at 87. The SEC may bar a person from associating with securities, brokers or dealers if, among other things, the person has been enjoined from activities involving the purchase or sale of securities or has been convicted within the past ten years of certain enumerated crimes including mail or securities fraud, if the SEC finds that such a bar

controlled several closely related financial services businesses in the 1980s. In 1987 the SEC sought injunctive relief against Elliott for alleged violations of the Securities Act and the Exchange Act.[141] Elliott consented to the entry of an injunction barring further securities law violations and providing the appointment of a receiver over his businesses. Three years later Elliott was convicted of thirty-seven counts of mail and securities fraud based on the same conduct which gave rise to the SEC's earlier action for injunctive relief. The SEC then barred Elliott from associating with any securities broker or dealer.[142]

On appeal Elliott argued, among other things, that he was prejudiced by his lack of representation by counsel during his administrative proceeding.[143] The Eleventh Circuit rejected this argument and ruled there is no statutory or constitutional right to counsel in an SEC administrative hearing.[144]

## IV. CLASS ACTION SETTLEMENTS

In *Leverso v. SouthTrust Bank*,[145] the Eleventh Circuit vacated a district court-approved settlement agreement of a class action suit brought by bondholders against the indenture trustee of the bond proceeds. In *Leverso*, defendant SouthTrust Bank of Alabama had been chosen to serve as indenture trustee for bonds issued by the Palms of Terra Ceia Bay Community Development District to fund a condominium project in Palmetto, Florida.[146] The bonds were issued pursuant to a resolution of the development district and a trust indenture between the district and SouthTrust Bank.[147] The development project failed and defaulted on its interest payments to bondholders. Plaintiffs then brought a class-action suit on behalf of all bondholders against

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would be in the public interest. 15 U.S.C. § 78o(b)(6)(A)(ii) & (iii) (1983).

141. 36 F.3d at 87.

142. *Id.*

143. *Id.* Elliott also argued the validity of his criminal conviction, which was not addressed by the court as a direct criminal appeal was pending. *Id.* In addition, Elliott argued his bar was against the public interest, and that the SEC had acted improperly as both enforcer and arbitrar and had erred in denying his motion to produce certain documents, none of which were shown by Elliott to be exculpatory. The court of appeals rejected all of these claims. *Id.* at 87-88.

144. *Id.* at 88 (citing Feeney v. SEC, 564 F.2d 260 (8th Cir. 1977), *cert. denied*, 435 U.S. 969 (1978); and United States v. Rogers, 534 F.2d 1134 (5th Cir.), *cert. denied*, 429 U.S. 940 (1976)).

145. 18 F.3d 1527 (11th Cir. 1994).

146. *Id.* at 1529.

147. *Id.* The development district issued $11,500,000 in bonds on March 1, 1983. The bonds were secured by a pledge of revenues from taxes and assessments to be levied on the property purchased with the bond proceeds. *Id.*

SouthTrust Bank.[148] A settlement agreement was reached which included a distribution plan that allocated the net settlement funds among the bondholders according their cost basis or amount each bondholder paid for the bonds.[149] The bondholders who had purchased bonds in the secondary market, at prices lower than the initial offering price, objected to the distribution plan and appealed the district court's approval of the plan.

In vacating the district court's ruling, the Eleventh Circuit noted the lower court did not apply the bonds' governing trust indenture or the principles of contract law.[150] Because bondholders' rights are a matter of contract law,[151] the court of appeals ruled the district court abused its discretion in failing to apply the terms of the trust indenture and principles of contract law in determining whether the distribution plan was fair.[152] Therefore, while noting it could still affirm the district court, the court of appeals examined the distribution plan to see if it was invalid as a matter of law.[153]

The Eleventh Circuit held that the governing trust indenture, when construed under principles of contract law, did not permit the settlement proceeds to be distributed according to the bondholders' cost basis.[154] The court noted the plain language of the trust unambiguously provided for each bond to be treated as every other bond,[155] and that no provision in the trust indenture provided for distinguishing among bonds.[156] Therefore, the court ruled a distribution plan based on each bondholder's cost basis could not be reconciled with the clear language of the trust indenture.[157]

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148. *Id.* The district court created two subclasses. One included all persons who owned bonds at the time the class was certified. The second included bondholders who had purchased their bonds prior to January 1, 1985, and who still owned bonds at the time the class was certified. *Id.* at 1529 n.3.

149. *Id.* at 1529 n.3. The settlement agreement defined "cost basis" as "that amount, net of premiums, accrued interest, discounts, or other adjustments, actually paid by each Bondholder for the Bond or Bonds which he or she owns." *Id.* at 1529-30.

150. *Id.* at 1531.

151. *Id.* (citing Broad v. Rockwell Int'l Corp., 642 F.2d 929, 940-41 n.10 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981)).

152. *Id.*

153. *Id.*

154. *Id.* at 1534.

155. *Id.*

156. *Id.* at 1535. The court noted the trust indenture was established to provide equal benefits for all bondholders "without privilege, priority or distinction . . . . " *Id.* at 1534 (quoting Indenture of Trust). In addition, the court looked to other sections of the trust indenture which consistently stated no bond was to be privileged over another. *Id.*

157. *Id.* at 1536.

This decision will have an impact on future class action settlement involving bonds or other debt securities subject to an indenture. Among other things, it will cause counsel to consider whether separate classes should be certified for initial and secondary market holders and how future settlements should be structured to satisfy the bondholder plaintiffs and the courts.

## V. ARBITRATION

### A. Power to Enjoin Arbitration

In *Kelly v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[158] the Eleventh Circuit addressed the issue of whether a district court had properly enjoined arbitration proceedings on the basis of *res judicata*. Plaintiffs held investment accounts with defendant Merrill Lynch. Plaintiffs had brought a prior suit against Merrill Lynch based on violations of SEC Rules 10b-5 and 10b-16[159] in which the district court granted summary judgment to defendant Merrill Lynch.[160]

After the district court granted summary judgment in the prior suit, plaintiffs initiated arbitration of four state common law claims alleging essentially the same conduct they alleged in the earlier action. Merrill Lynch moved for a preliminary injunction against the arbitration. The district court granted the injunction, concluding the Anti-Injunction Act[161] grants federal courts the power to protect their judgments by issuing injunctions and that *res judicata* barred the arbitration claims.[162]

The Eleventh Circuit first addressed whether a district court has the power to enjoin arbitration proceedings. Plaintiffs argued the Anti-Injunction Act allows federal courts to enjoin only state court proceedings and, therefore, the Act did not apply because arbitration is not a state court proceeding.[163] The court of appeals, however, looked to the

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158. 985 F.2d 1067 (11th Cir.), *cert. denied*, 114 S. Ct. 600 (1993).

159. SEC Rule 10b-16 governs the disclosure of credit terms in margin agreements between a broker firm and its customers. 17 C.F.R. § 240.10b-16 (1994).

160. 985 F.2d at 1068. The district court's grant of summary judgment was affirmed by the Eleventh Circuit in Kelly v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 948 F.2d 1297 (11th Cir. 1991).

161. The Anti-Injunction Act states: "A court of the United States may not grant an injunction to stay proceedings in a State court except as expressly authorized by an Act of Congress, or where necessary in aid of its jurisdiction, or to protect or effectuate its judgments." 28 U.S.C. § 2283 (1988).

162. 985 F.2d at 1068.

163. *Id.* at 1069.

All-Writs Act[164] which grants federal courts broad injunctive powers to protect their own judgments, including the power to enjoin arbitration to prevent re-litigation.[165] The court of appeals reasoned the Anti-Injunction Act merely carves out an exception to the courts' injunctive powers under the All-Writs Act and, therefore, the district court had the power to enter an injunction.[166]

The Eleventh Circuit then directed its attention to whether the district court properly resolved the *res judicata* defense, rather than leaving the issue for the arbitrators to resolve. The court of appeals noted the general rule for deciding which questions belonged to the courts or to the arbitrators is that, "while federal courts can decide if an issue is arbitrable or not, they cannot reach the merits of arbitrable issues."[167] Plaintiffs argued *res judicata* must be left to arbitration because it is an affirmative defense that goes to the merits of their claims.[168] The court of appeals rejected this argument and held the better rule is that courts can decide whether *res judicata* applies.[169] The court of appeals stated the underlying issue is one of protecting a district court's prior judgments and the district court should not have to stand by while parties re-litigate claims that have already been resolved.[170]

The Eleventh Circuit also determined the district court had decided the *res judicata* issue properly. The court of appeals stated plaintiffs could have asserted the state claims in the prior district court action.[171] The arbitration agreements entered between plaintiffs and defendant Merrill Lynch gave both parties the right to compel arbitra-

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164. The All-Writs Act provides:

> (a) The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law.
>
> (b) An alternative writ or rule nisi may be issued by a justice or judge or a court which has jurisdiction.

28 U.S.C. § 1651 (1988).

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id. See, e.g.*, Enterprises Ass'n Local 638 v. Empire Mechanical, Inc., No. 91 CIV. 5014, 1992 WL 84689 (S.D.N.Y Apr. 9, 1992).

169. 985 F.2d at 1069 (citing Miller Brewing Co. v. Forth Worth Distrib. Co., 781 F.2d 494 (5th Cir. 1986); New York State Ass'n for Retarded Children v. Carey, 456 F. Supp. 85 (E.D.N.Y. 1978); City of Rochester v. AFSCME Local 1635, 388 N.Y.S.2d 489 (N.Y. App. Div. 1976)).

170. *Id.*

171. *Id.* at 1070. The district court would have had pendent or diversity jurisdiction over the state claims. *Id.*

tion of state law claims, but not of federal securities claims.[172] The agreements did not constitute an express or implied waiver of *res judicata*; instead, they simply allowed plaintiffs to institute two suits based on the same events.[173] The court ruled Merrill Lynch was entitled to assert the *res judicata* defense because nothing in the agreements indicated that "the parties understood—or that the defendant led plaintiff to believe—that the end of the first action would not preclude the start of the second."[174]

### *B. Types of Claims for Which Arbitration May be Compelled*

During the survey period, the Eleventh Circuit issued two decisions analyzing the arbitrability of certain types of securities claims. In *Wheat, First Securities, Inc. v. Green*,[175] plaintiff Wheat, an NASD-member securities broker, sought a declaratory judgment that it was not obligated to arbitrate fraud claims brought by investors based on transactions with Wheat's predecessor in interest, Marshall & Co. Securities, Inc. ("Marshall"). The investors had filed an arbitration proceeding against Wheat, Marshall, Kentwood Brett Thackston (a former agent of Marshall and later an agent of Wheat), and others.[176] The investors alleged Thackston and Marshall made certain material misrepresentations to them in connection with their purchases of certain stock.[177] Wheat was made a defendant in the arbitration by virtue of an Asset Purchase Agreement it entered with Marshall under which Wheat purchased certain of Marshall's assets and assumed certain of Marshall's contracts. The Agreement expressly provided that Wheat did not "assume any liability, known or unknown, fixed or contingent, of [Marshall] except for [Marshall's] liabilities and obligations" under the

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172. *Id.* at 1069. Each agreement stated: "Except to the extent that controversies involving claims arising under the federal securities laws may be litigated, any controversy between us arising out of such option transactions or this agreement shall be settled by arbitration." *Id.* at 1068 n.1.

173. *Id.* at 1070.

174. *Id.* The nature of the agreements allowed the court to distinguish this case from others relied on by plaintiffs. *Id.* at 1070 n.2. Defendant exhibited no misleading conduct as did defendants in Calderon Rosado v. General Elec. Circuit Breakers, Inc., 805 F.2d 1085 (1st Cir. 1986) (defendant agreed to plaintiff's dismissal of state claims and then asserted res judicata in the subsequent federal action). *Id.* Neither did Merrill Lynch acquiesce in the bringing of simultaneous suits. *Cf.* Kendall v. Avon Prods., Inc., 711 F. Supp. 1178 (S.D.N.Y. 1989); Imperial Constr. Management Corp. v. Laborers Int'l Local 96, 729 F. Supp. 1199 (N.D. Ill. 1990).

175. 993 F.2d 814 (11th Cir. 1993).

176. *Id.* at 815.

177. *Id.* Wheat was not involved in any of the investors' stock purchases. *Id.*

customer agreements listed in an exhibit to the Agreement.[178] The investors' customer agreements with Marshall were not included in the exhibit to the Agreement.

In response to the investors' arbitration claims, Wheat sought a declaratory judgment that it had no obligation to arbitrate the investors' claims. The district court ruled Wheat was not obligated to arbitrate any claims based on trading conducted by the investors through their Marshall accounts.[179]

The Eleventh Circuit first determined if the district court had properly decided whether the arbitrability of the investors' claims should first be litigated before the district court. The court of appeals applied the two-component test originally adopted in *Chastain v. Robinson-Humphrey Co.*,[180] which requires the party seeking to avoid arbitration to deny that an agreement to arbitrate was reached and to offer evidence to substantiate the denial.[181] Wheat denied it was bound to arbitrate the investors' claims and stated it had never entered any agreement to arbitrate the investors' Marshall claims. The Eleventh Circuit agreed that no agreement to arbitrate was ever executed by the parties because Wheat and the investors had no relationship at the time of the events on which the investors based their claims.[182] The court of appeals held the district court committed no error in deciding the arbitrability question because the facts of the case called into question whether an arbitration agreement actually existed.[183]

The Eleventh Circuit then analyzed whether the district court properly ruled Wheat was not obligated to arbitrate any claims arising out of the investors' trading conducted with Marshall. The court of appeals noted the investors raised an issue of first impression in the Eleventh Circuit by arguing that Wheat's membership in the NASD imposes on Wheat the duty to submit to arbitration all of the investors' claims.[184] The Eleventh Circuit, however, decided the dispute on narrower grounds and reserved the membership issue for another day.[185]

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178. *Id.* at 816.

179. *Id.*

180. 957 F.2d 851 (11th Cir. 1992) (adopting test set forth in T & R Enters. v. Continental Grain Co., 613 F.2d 1272 (5th Cir. 1980)).

181. 993 F.2d at 817.

182. *Id.* at 818-19.

183. *Id.* at 819.

184. *Id.*

185. *Id.* at 820. The court noted that at least one other court of appeals has held the rules and regulations of self-regulatory organizations similar to the NASD are sufficient in and of themselves to compel arbitration of covered disputes under the Federal Arbitration Act. *See* Paine, Webber, Jackson & Curtis, Inc. v. Chase Manhattan Bank,

The investors argued Sections 1 and 12(a) of the NASD Code of Arbitration Procedure[186] require Wheat to arbitrate their claims. The Eleventh Circuit noted these sections contain two prerequisites before an NASD member can be compelled to arbitrate. First, a complaining party must be a "customer" of an NASD member.[187] Second, the dispute, claim, or controversy must have arisen "in connection with the business of such member."[188] The court of appeals held that customer status for the purposes of the "customer" requirement of Sections 1 and 12(a) must be determined at the time of the events providing the basis arbitration claims.[189] The court rejected the investors' argument because they did not become customers of Wheat until after the allegedly fraudulent transactions with Marshall took place.[190] The court stated no NASD member would have contemplated that its membership alone would require it to arbitrate claims which arose while a claimant was a

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N.A., 728 F.2d 577 (2d Cir. 1984). The court also referenced a district court decision in its own jurisdiction which had made a similar ruling. *See* Scobee Combs Funeral Home, Inc. v. E.F. Hutton & Co., 711 F. Supp. 605, 608 (S.D. Fla. 1989) (stating where no written agreement to arbitrate exists between an NASD member and its customer, Section 12(a) is binding on defendant NASD member).

186. Section 1 provides, in part:

> This Code of Arbitration is prescribed and adopted . . . for the arbitration of any dispute, claim, or controversy arising out of or in connection with the business of any member of the Association, or arising out of the employment or termination of employment of associated person(s) with any member, with the exception of disputes involving the insurance business of any member which is also an insurance company:
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> (1) between or among members;
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> (2) between or among members and associated persons;
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> (3) between or among members or associated persons and public customers, or others; and
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> (4) between or among members, registered clearing agencies with which the Association has entered into an agreement to utilize the Association's arbitration facilities and procedures, and participants, pledges, or other persons using the facilities of a registered clearing agency, as these terms are defined under the rules of such a registered clearing agency.

NASD Manual ¶ 3701 (CCH 1994).

Section 12(a) provides, in part:

> Any dispute, claim or controversy eligible for submission under Part I of the Code between a customer and a member and/or associated person arising in connection with the business of such member or in connection with the activities of such associated person shall be arbitrated under this Code, as provided by any duly executed and enforceable written agreement or upon the demand of the customer.

NASD Manual ¶ 3712 (CCH 1994).

187. 993 F.2d at 820.

188. *Id.*

189. *Id.*

190. *Id.*

customer of another member simply because the claimant subsequently becomes its customer.[191] Such a ruling would do "significant injustice" to the reasonable expectations of NASD members and create the potential for abuse by investors.[192]

In *Kidd v. Equitable Life Assurance Society*,[193] the Eleventh Circuit was faced with the question of whether the NASD Code of Arbitration, prior to its amendment in 1993, required compulsory arbitration of employment related disputes. Plaintiffs, Ronald Kidd and Thomas Hampton, were securities sales agents with defendant Equitable. In connection with their employment, each completed an application with the NASD known as a "U-4" application. Both applications contained a provision requiring the applicant to submit to arbitration "any dispute, claim or controversy between me and my firm . . . that is required to be arbitrated under the rules, constitutions or by-laws of the [NASD]."[194] At the time Plaintiffs signed the U-4 applications, Section 8 of the NASD Code of Arbitration did not expressly provide for the compulsory arbitration of employment-related disputes.[195]

Plaintiffs brought suit against Equitable in January of 1993, alleging race discrimination in violation of Title VII of the Civil Rights Act of 1964,[196] and Section 1981 of the Civil Rights Act of 1866.[197] Equitable's motion to compel arbitration, based on the argument that the pre-amendment version of the NASD Code required Plaintiffs to arbitrate the claims, was denied.[198] While Equitable's appeal was pending, the NASD amended its rules in October of 1993 to expressly provide for compulsory arbitration of employment related disputes.[199] On appeal,

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191. *Id.*

192. *Id.*

193. 32 F.3d 516 (11th Cir. 1994).

194. *Id.* at 517.

195. *Id.* The pre-Amendment version of Section 8 provided in part:

> Any dispute, claim or controversy eligible for submission under Part I of this Code between or among members and/or associated persons, and/or certain others arising in connection with the business of such member(s) or in connection with the activities of such associated person(s), shall be arbitrated under this Code, at the instance of:
>
> (1) a member against another member;
>
> (2) a member against a person associated with a member or a person associated with a member against a member . . . .

NASD Manual ¶ 3708 (CCH 1968).

196. 42 U.S.C. §§ 2000e-2000e-17 (1993).

197. 42 U.S.C. § 1981 (1983).

198. 32 F.3d at 518.

199. *Id.* Section 8, as amended, provides, in part: "the arbitration of any dispute, claim, or controversy arising out of or in connection with the business of any member of the

the Eleventh Circuit addressed the question of whether Plaintiffs are bound by this amendment to arbitrate their pre-amendment claims.[200] Plaintiffs argued the amended Code constituted a substantive change in the NASD Code and should not be applied retroactively. The Eleventh Circuit rejected this argument and found the pre-amendment Code compelled arbitration of employee-related disputes.

The court of appeals first ruled that Section 1 of the pre-amendment Code required the arbitration of any dispute connected to a member's business.[201] The court rejected Plaintiffs' argument for the adoption of the United States Court of Appeals for the Seventh Circuit ("Seventh Circuit") ruling in *Farrand v. Lutheran Brotherhood*.[202] In *Farrand*, the Seventh Circuit held Section 1 of the pre-amendment NASD Code did not mandate arbitration of employment related disputes.[203] The court of appeals reasoned the placement of the colon in Section 1 limited the type of disputes required to be arbitrated to disputes between or among members or between or among members and public customers or others.[204] According to the Seventh Circuit, an employee-stockbroker could not be an "other" because including employees within the definition of "others" would render superfluous Section 1's limitations on the persons subject to compulsory arbitration.[205]

The Eleventh Circuit declined to follow the decision in *Farrand*.[206] Instead, the court of appeals held the colon in Section 1 modifies the insurance clause immediately preceding the colon.[207] Therefore, Section 1 requires arbitration for any dispute connected to an NASD member's business, except for disputes involving the insurance business

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Association, *or arising out of the employment or termination of employment of associated person(s) with any member*." NASD Manual ¶ 3708 (CCH 1994) (emphasis added).

200. 32 F.3d at 518. The court considered the issue because it was a question of law, even though the amendment was passed while Equitable's appeal was pending and not argued in the district court proceeding. *Id.* at 518 n.3.

201. *Id.* at 519. Section 1, prior to the 1993 amendments, required arbitration for:

> any dispute, claim, or controversy arising out of or in connection with the business of any member of the Association, with the exception of disputes involving the insurance business of any member which is also an insurance company:
> (1) between or among members;
> (2) between or among members and public customers, or others . . . .

NASD Manual ¶ 3701 (CCH 1968).

202. 993 F.2d 1253 (7th Cir. 1993).

203. *Id.* at 1255.

204. *Id.* at 1254-55.

205. *Id.* at 1255.

206. 32 F.3d at 519.

207. *Id.* (citing WILLIAM STRUNK, JR. & E.B. WHITE, THE ELEMENTS OF STYLE 7-8 (3d ed. 1979); TEXAS LAW REVIEW, MANUAL ON STYLE 36 (4th ed. 1979)).

of an NASD member that are (1) between NASD members or (2) between NASD members and public customers or others.[208]

In addition, the Eleventh Circuit stated ample evidence existed showing the pre-amendment version of the NASD Code of Arbitration required arbitration of employment disputes.[209] The court cited with approval the opinion of current Justice Ruth Bader Ginsburg in *Association of Investment Brokers v. SEC*,[210] in which then Judge Ginsburg stated "NASD rules mandate arbitration of employer-employee disputes, and did so, to the same extent as they do now, before the development of [U-4 forms]."[211] Furthermore, the NASD had expressly stated in 1987 that employment disputes between NASD members and their "registered representatives," were subject to mandatory arbitration.[212]

### C. *Arbitration Agreements*

In *Luckie v. Smith Barney, Harris Upham & Co.*,[213] the Eleventh Circuit addressed the issue of whether customers can limit by agreement their ability to elect arbitration before the American Arbitration Association ("AAA")[214] as provided under the provisions of the American Stock Exchange ("AMEX") Constitution.[215] Plaintiff customers had filed demands with the AAA for the arbitration of disputes with Defendant Smith Barney over the alleged mismanagement of their accounts. Plaintiffs contended the provisions of their customer agreements with Smith Barney provided them the option of electing AAA arbitration under Article VIII, Section 2 of the AMEX Constitution, referred to by the parties as the "AMEX Window."[216] Smith Barney

208. *Id.*

209. *Id.* at 520.

210. 676 F.2d 857 (D.C. Cir. 1982).

211. 32 F.3d at 520 (quoting *Association of Inv. Brokers*, 676 F.2d at 861)).

212. *Id.* (citing 52 Fed. Reg. 9232 (1987) and 58 Fed. Reg. 45,932 (1987) (stating NASD amended language to clarify employment disputes are, and have been, arbitrable)).

213. 999 F.2d 509 (11th Cir. 1993).

214. Most predispute arbitration agreements provide for arbitration before one of the self-regulatory organizations, namely the National Association of Securities Dealers ("NASD"), New York Stock Exchange ("NYSE"), or the American Stock Exchange ("AMEX"). The American Arbitration Association ("AAA") is a private, nonregulatory entity that provides a forum for private arbitration proceedings.

215. The AMEX Constitution requires members of the stock exchange to: "arbitrate all controversies arising in connection with their business . . . between them and their customers as required by any customer's agreement or, in the absence of a written, if the customer chooses to arbitrate." AMEX CONST., Art. VIII, § 1.

216. The AMEX Window states that:

argued the customer agreements did not provide for arbitration in front of the AAA.[217]

Plaintiffs filed a complaint in Florida state court seeking a declaratory judgment that it had the right to compel Smith Barney to submit to arbitration before the AAA.[218] Smith Barney moved to dismiss the action and then removed the case to district court.[219] In district court, plaintiffs filed a motion to compel arbitration pursuant to the Federal Arbitration Act.[220] The district court denied Plaintiffs motion to compel arbitration and granted Smith Barney's motion to dismiss, ruling the language of the customer agreements and the AMEX Window did not permit the Plaintiffs to compel Smith Barney to submit to arbitration before the AAA.[221]

The Eleventh Circuit ruled the parties had closed the AMEX Window by virtue of entering the customer agreements.[222] The court relied on two prior rulings of the United States Court of Appeals for the Second Circuit ("Second Circuit") in reaching its decision. In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Georgiadis*,[223] and *PaineWebber, Inc. v. Rutherford*,[224] the Second Circuit, under similar facts, held "the

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> Arbitration shall be conducted under the arbitration procedures of this Exchange, except as follows: . . . (c) if any of the parties to a controversy is a customer, the customer may elect to arbitrate before the American Arbitration Association in the City of New York, unless the customer has expressly agreed, in writing, to submit only to the arbitration procedure of the Exchange.

AMEX CONST., Art. VIII, § 2.

217. Each individual customer agreement varied slightly. Plaintiff Luckie's agreement provided for arbitration "before the National Association of Securities Dealers, Inc., the New York Stock Exchange, the American Stock Exchange, or any recognized arbitration facility provided by any exchange and in accordance with the rules of such body then obtaining . . . ."

Plaintiff Moshie's agreement provided for arbitration "in accordance with the rules, then obtaining, of the New York Stock Exchange, American Stock Exchange or National Association of Securities Dealers as [Moshie] may elect . . . ."

Plaintiff Kahn's agreement provided for arbitration "in accordance with the rules, then obtaining, of either the Boards of Arbitration of the New York Stock Exchange, American Stock Exchange or National Association of Securities Dealers as [Kahn] may elect . . . ." 999 F.2d at 511.

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.* The district court waited two years to make its ruling, pending the outcome of a similar action Smith Barney had filed in New York state court. The district court proceeded with its action, after lifting a stay brought by plaintiffs, when the New York court continued in delaying its decision. *Id.*

222. *Id.* at 514.

223. 903 F.2d 109 (2d Cir. 1990).

224. 903 F.2d 106 (2d Cir. 1990).

arbitration provision of the AMEX Constitution may be superseded by a more specific customer agreement between the parties[.]"[225] The Eleventh Circuit agreed with the Second Circuit's ruling.[226] The Eleventh Circuit noted the customer agreements in question limited arbitration to take place in accordance with the rules of the New York Stock Exchange, American Stock Exchange or the National Association of Securities Dealers. The Plaintiffs had therefore "closed the AMEX Window by agreement" and could not compel Smith Barney to submit to AAA arbitration.[227]

### D. *Arbitration Awards*

The Eleventh Circuit reaffirmed its procedural framework to be used by courts for reviewing arbitration awards in *Brown v. Rauscher Pierce Refsnes, Inc.*[228] Plaintiffs David and Rita Brown were issued a lump-sum award for $16,000 in damages and $4,000 in forum fees after bringing an arbitration proceeding against Defendant Rauscher for losses incurred in the trading of the Browns' account.[229] The Browns filed a motion to vacate the award in district court and sought entry of a final judgment in their favor for over $700,000. The district court first remanded the award to the arbitration panel for clarification.[230] The district court then denied the Browns' motion.[231] Although it affirmed the denial of the motion, the Eleventh Circuit criticized the procedural manner in which the district court reached its conclusion.

The court of appeals noted that its review of commercial arbitration awards is controlled by the Federal Arbitration Act ("FAA").[232] Review under the FAA is limited and provides only four reasons for vacating an arbitration award.[233] In addition, the Eleventh Circuit has recognized

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225. 999 F.2d at 513 (quoting *Georgiadis*, 903 F.2d at 114).

226. *Id.*

227. *Id.* at 514.

228. 994 F.2d 775 (11th Cir. 1993).

229. *Id.* at 778. The award was issued by a panel of the New York Stock Exchange. *Id.*

230. *Id.* The panel's award was in response to administrative and procedural oversights committed by the defendants, namely, failure for the defendant broker to become licensed in Florida. *Id.*

231. *Id.*

232. 9 U.S.C. §§ 1-16 (1988).

233. The FAA provides that a district court may vacate an award:

(1) Where the award was procured by corruption, fraud, or undue means.

(2) Where there was evident partiality or corruption in the arbitrators, or either of them.

(3) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing ,upon sufficient cause shown, or in refusing to hear evidence pertinent and

two non-statutory reasons for vacating an arbitration award. An arbitration award may be vacated if it is arbitrary and capricious[234] or if enforcement of the award would be contrary to public policy.[235] In order to vacate an award on a non-statutory basis, the district court must first review the award.[236] "When no rationale is given for a lump sum award, the reviewing court first reviews the arbitration award to determine if there is a rational basis for the award."[237] The court of appeals determined that the district court had erroneously reviewed the award for a rational basis because the arbitration panel had clearly expressed it's rationale for its award.[238] Even though the district court failed to follow the correct procedural framework for review, the Eleventh Circuit upheld the decision because the award was not arbitrary and capricious nor did the award violate public policy.[239]

There were no Supreme Court decisions during the survey period reviewing the scope or appropriateness of arbitration awards for securities disputes. This area, however, will receive much scrutiny in

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> material to the controversy; or of any other misbehavior by which the rights of any party may have been prejudiced.
>
> (4) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

9 U.S.C. § 10(a) (1988). The court of appeals stated none of these reasons applied in this case. 994 F.2d at 778-79.

234. 994 F.2d at 779 (citing Ainsworth v. Skurnick, 960 F.2d 939 (11th Cir. 1992), *cert. denied*, 113 S. Ct. 1269 (1993); Raiford v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 903 F.2d 1410 (11th Cir. 1990); United States Postal Serv. v. National Ass'n of Letter Carriers, 847 F.2d 775 (11th Cir. 1988)).

235. *Id.* (citing Delta Air Lines, Inc. v. Air Line Pilots Ass'n, Int'l, 861 F.2d 665 (11th Cir. 1988), *cert. denied*, 493 U.S. 871 (1989); *United States Postal Serv.*, 847 F.2d at 777)).

236. *Id.*

237. *Id.* (citing Robbins v. Day, 954 F.2d 679 (11th Cir.), *cert. denied*, 113 S. Ct. 201 (1992)).

238. *Id.* at 780. The court of appeals also criticized the district court for remanding the award for clarification. An award can be remanded for clarification only when the award itself can be interpreted in a number of ways. *Id.* at 780 n.4 (citing *Ainsworth*, 909 F.2d at 457). The court of appeals further criticized the district court's application of Robbins, which requires the party seeking to vacate the award to refute every possible rational basis upon which the arbitrators could have relied. *Id.* The district court apparently interpreted Robbins to allow for the court's own examination for evidence of misconduct or impartiality. *Id.* Such an interpretation is erroneous as these matters are expressly covered in FAA's statutory grounds for vacatur. *Id.*

239. *Id.* at 781-82. The court of appeals reviewed the decision *de novo*. While recognizing its normal procedure is to remand such decisions to the district court, the court of appeals chose not to remand the case for two reasons: first, the issues raised by the Browns were matters of law and, second, a remand would defeat a goal of arbitration—to decide disputes expeditiously. *Id.* at 781.

the coming year. In October 1994, the Supreme Court agreed to review a Seventh Circuit decision to address the issue of whether a federal court can properly vacate an award of punitive damages by an arbitration panel when the governing law selected by the parties did not allow arbitrators to award punitive damages.[240] In December 1994, the Supreme Court agreed to review a Third Circuit decision to address the issue of whether a district court reviewing an arbitration award should review the decision on the merits and as if no decision had already been rendered by the arbitrators.[241] In that same case, the Court said it would also review the issue of whether a federal court of appeals should review a district court ruling on an arbitration judgment in the same way, i.e., as if the case were being heard for the first time.[242]

## VI. SECURITIES LITIGATION REFORM EFFORTS

A federal bill[243] to reform private securities litigation was recently reviewed and amended by the House Commerce Committee.[244] If passed by Congress, the bill would curtail "strike suits," class actions brought by shareholders against a company after the company's stock price drops.[245] The bill imposes a two-tiered system of liability, providing joint and several liability for knowingly making fraudulent statements, while allowing proportionate liability for reckless conduct.[246] The bill would amend the definition of "recklessness" under the Exchange Act to include a requirement that the defendant was "consciously aware" of the danger of misleading buyers or sellers in making the alleged fraudulent statements.[247] The bill also includes provisions that would: (1) introduce fee-shifting; (2) impose heightened pleading requirements; (3) codify standards to established reckless conduct and fraud-on-the-market; (4) define a safe harbor for forward looking statements by companies; (5) introduce plaintiff steering committees; (6) prohibit payments of bonuses to named plaintiffs; and (7) require plaintiffs to post security for their costs.[248] The bill is expected to be considered by Congress before the current session ends. If enacted,

240. *See* Mastrobuono v. Shearson Lehman Hutton, Inc., 115 S. Ct. 305 (1994), *cert. granted*, Mastrobuono v. Shearson Lehman Hutton, Inc., 20 F.3d 713 (7th Cir. 1994).

241. *See* First Options of Chicago, Inc. v. Kaplan, 115 S. Ct. 634 (1994), *cert. granted*, Kaplan v. First Options of Chicago, Inc., 29 F.3d 111 (3d Cir. 1994).

242. *See id.*

243. H.R. 10, 104th Cong., 1st Sess. (1995).

244. 27 Sec. Reg. & L. Rep. (BNA) No. 8 at 295-96 (Feb. 24 1995).

245. *Id.* at 296.

246. *Id.*

247. *Id.*

248. *Id.*

counsel can once again expect to see an increased number of cases from the courts as they struggle to interpret and apply the new law.

## VII. CONCLUSION

The most significant decision during the survey period was the decision by the Supreme Court in *Central Bank*. It appears almost certain that the holding will be applicable to SEC enforcement actions under Rule 10b-5 as well. The decision in *Central Bank* continues the recent trend of restricting the scope of securities laws, and, in particular, their application to secondary participants. This trend was also apparent in the Eleventh Circuit decision in *First Union*.

Not surprisingly, an increasing number of decisions arose in the arbitration context, due to the arbitrability of customer disputes under the Securities Act and the Exchange Act. This trend will likely continue until the law in this area is further defined. The heightened enforcement activity by the SEC and self-regulatory organizations such as the NASD will likely spawn a number of appellate decisions in this area as well over the coming years.