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Implied Rights of Action

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IMPLIED RIGHTS OF ACTION

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IN *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*,[1] the United States Supreme Court declined to imply a private right of action for damages under the Investment Advisers Act of 1940.[2] *Transamerica* is the most recent of a series of Supreme Court decisions limiting the availability and scope of implied private actions under the federal securities laws.[3] It stands in sharp contrast to *J.I. Case Co. v. Borak*,[4] a 1964 decision in which the Court seemed to extend an open invitation to "private attorneys general" to supplement SEC enforcement with private damage actions.

The Court's withdrawal from the *Borak* experiment reflects a deep and perhaps justified disenchantment with private enforcement of the securities acts. Indeed, the wisdom of permitting private damage actions by implication from the securities acts is questionable.[5] The Court's chosen doctrine of implied rights of action, however, is unduly narrow. Whereas *Borak* expresses the view that the federal courts have inherent power to imply private rights of action for statutory violations,[6] *Transamerica* treats implication as essentially a matter of statutory construction.[7] The *Transamerica* doctrine whittles away a legitimate common-law power of the

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[1] 444 U.S. 11 (1979).

[2] 15 U.S.C. §§ 80b-1 to 80b-15 (1976). The Court, however, did allow private actions for rescission of investment advisory contracts that violate the statute and for restitution of amounts paid under those contracts. 444 U.S. at 18-19.

[3] *See, e.g.*, Touche Ross & Co. v. Redington, 442 U.S. 560 (1979) (allowing no private right of action for damages under § 17(a) of the Securities Exchange Act of 1934); Piper v. Chris-Craft Indus., 430 U.S. 1 (1977) (holding that a defeated tender offeror has no private right of action under Williams Act); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (holding that the plaintiff in a private damage action under rule 10b-5 must allege scienter); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (limiting private actions under rule 10b-5 to plaintiffs who have purchased or sold securities).

[4] 377 U.S. 426 (1964).

[5] *See* notes 90-147 *infra* and accompanying text.

[6] *See* 377 U.S. at 432-33; notes 29-31 *infra* and accompanying text.

[7] *See* 444 U.S. at 24; notes 37-53 *infra* and accompanying text.

federal courts and precludes the courts from fashioning implied rights of action where they could play a useful and important role.

I. THE *Borak* DECISION

In *J.I. Case Co. v. Borak*,[8] a shareholder challenged a consummated merger on the ground that approval for the merger had been obtained by the use of misleading proxy statements, in violation of section 14(a) of the Securities Exchange Act of 1934[9] and rule 14a-9 promulgated thereunder.[10] The plaintiff sought a judgment that the merger was void, as well as damages for himself and other shareholders.[11]

Section 14(a) and rule 14a-9 merely declare certain conduct unlawful;[12] they do not expressly grant private rights of action for violations. The Court, however, invoked section 27 of the 1934 Act, which grants to the federal district courts "exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder."[13] The Court deemed it "clear that private parties have a right under § 27 to bring suit for violation of § 14(a)."[14]

The Court, however, emphasized the "broad remedial purposes" of section 14(a),[15] noting that "among [its] chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result."[16] The Court reasoned, furthermore, that "[p]rivate enforcement of the proxy rules provides a necessary supplement to [SEC] action"[17] and concluded that "under the circumstances here it is the duty of the

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[8] 377 U.S. 426 (1964).

[9] 15 U.S.C. § 78n(a) (1958) (amended 1964) (prohibiting solicitation of proxies except in conformity with SEC rules and regulations).

[10] 17 C.F.R. § 240.14a-9 (1964) (prohibiting the solicitation of proxies by means of false or misleading statements or omissions).

[11] 377 U.S. at 430.

[12] *See* notes 9-10 *supra*.

[13] 15 U.S.C. § 78aa (1958).

[14] 377 U.S. at 430.

[15] *Id.* at 431. *Cf.* Touche Ross & Co. v. Redington, 442 U.S. 560, 577 (1979) (Section 27 "creates no cause of action of its own force and effect"; *Borak* "found a private cause of action implicit in § 14(a).").

[16] 377 U.S. at 432.

[17] *Id.*

courts to be alert to provide such remedies as are necessary to make effective the Congressional purpose."[18] In sum, the *Borak* Court recognized an implied private right of action under section 14(a) on the premise that the creation of remedies to vindicate federal statutory rights is a proper function of the federal courts.[19]

Borak is significant in two chief respects: first, in its emphasis on the deterrent effect of private enforcement and, second, in its conception of judicial power to create private rights of action.

A. Deterrence, Compensation, and Implied Private Rights of Action

Historically, courts have justified the implication of private causes of action on the grounds that a prohibitory statute may create a right in the plaintiff, and that if the defendant breaches that right and injures the plaintiff, a right to compensation follows automatically. In *Texas & Pacific Railway v. Rigsby*,[20] the 1916 case generally credited with originating the federal doctrine of implication,[21] the Supreme Court wrote:

> A disregard of the command of the statute is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied, according to a doctrine of the common law expressed . . . in these words: "So, in every case, where a statute enacts, or prohibits a thing for the benefit of a person, he shall have a remedy upon the same statute for the thing enacted for his advantage, or for the recompense of a wrong done to him contrary to the said law." This is but an application of the maxim, *Ubi jus ibi remedium* [Where there is a right, there is a remedy.][22]

The traditional focus, then, is on the plaintiff's right to obtain

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[18] *Id.* at 433.

[19] *See id.* at 433-34.

[20] 241 U.S. 33 (1916) (finding a private right of action for damages under the Federal Safety Appliance Act).

[21] *But see* Cannon v. University of Chicago, 441 U.S. 677, 732 (1979) (Powell, J., dissenting) (arguing that *Rigsby* did not imply a cause of action but merely applied a statutory standard in a negligence case, exercising general federal common-law powers then recognized under Swift v. Tyson, 41 U.S. (16 Pet.) 1 (1842)).

[22] 241 U.S. at 39-40 (citations omitted).

compensation for "a wrong done to him."[23]

By contrast, in the decisions implying private rights of action under the securities acts, the deterrence of unlawful conduct became a key factor.[24] Although the *Borak* opinion does not ignore compensation,[25] its principal rationale is deterrence:

> Private enforcement of the proxy rules provides a necessary supplement to [SEC] action. As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements. The Commission advises that it examines over 2,000 proxy statements annually and each of them must necessarily be expedited. Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representations contained therein at their face value, unless contrary to other material on file with it. Indeed, on the allegations of respondent's complaint, . . . [the] unlawful manipulation [alleged] would not have been apparent to the Commission until after the merger.
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> We, therefore, believe that under the circumstances here it is the duty of the courts to be alert to provide such remedies as are nec-

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[23] *Id.* at 39.

[24] *Cf.* Cannon v. University of Chicago, 441 U.S. 677, 690 n.13 (1979) (characterizing *Borak* as a deviation from the Court's usual "reluctan[ce] to imply causes of actions under statutes that create duties . . . for the benefit of the public at large").

Of course, courts have long recognized that implied private rights of action can serve the public interest in deterring undesirable behavior. The *Rigsby* Court, for instance, commented that "the consequences that shall follow a breach of the law are vital and integral to its effect as a regulation of conduct, [and] liability to private suit is or may be as potent a deterrent as liability to public prosecution." 241 U.S. at 41-42. Traditionally, however, decisions implying private rights of action have emphasized redressing the plaintiff's injury rather than modifying the defendant's behavior.

Justice Harlan spoke in this tradition in Bivens v. Six Unknown Named Agents of Fed. Bureau of Narcotics, 403 U.S. 388 (1971):

> [T]he appropriateness of according [the plaintiff] compensatory relief does not turn simply on the deterrent effect liability will have on federal official conduct. Damages as a traditional form of compensation for invasion of a legally protected interest may be entirely appropriate even if no substantial deterrent effects on future official lawlessness might be thought to result. [The plaintiff], after all, has invoked judicial processes claiming entitlement to compensation for injuries resulting from allegedly lawless official behavior, if those injuries are properly compensable in money damages. I do not think a court of law—vested with the power to accord a remedy—should deny him his relief simply because he cannot show that future lawless conduct will thereby be deterred.

Id. at 407-08 (concurring in the judgment) (footnote omitted).

[25] *See* note 16 *supra* and accompanying text.

essary to make effective the congressional purpose.[26]

In effect, *Borak* treats plaintiffs not as victims so much as "private attorneys general" to whom damages are paid as a reward for bringing lawsuits that serve the public purpose of deterring securities violations. Thus, *Borak* departs significantly from the traditional compensatory rationale for implied rights of action. Arguably, the strategy of enlisting private plaintiffs to enforce the securities laws is seriously flawed. Although the *Borak* Court envisioned private litigation in the service of public goals, it left unchanged the forms and assumptions governing private actions. As will be argued below,[27] this melding of private enforcement and public goals may be ill-suited to the regulatory scheme of the securities acts.

B. Private Rights of Action and Judicial Power

The second important aspect of *Borak* is its implicit concept of judicial power to create implied rights of action. Two views of this judicial power have been expressed in case law. Some cases treat the implication of private actions as an exercise in construing the intent of the legislature. By this view, "[a] statute 'creates' no liability unless it discloses an intention express or implied that from disregard of a statutory command a liability for resultant damages shall arise."[28] An alternative theory is that in recognizing an implied private right of action, a court exercises an inherent judicial power to create common-law remedies for statutory violations.[29]

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[26] 377 U.S. at 432-33. *See also* Cannon v. University of Chicago, 441 U.S. 677, 736 (1979) (Powell, J., dissenting) ("[*Borak's*] rationale . . . lies ultimately in the judgement that '[p]rivate enforcement of the proxy rules provides a necessary supplement to [SEC] action'. . . . ").

[27] *See* notes 93-145 *infra* and accompanying text.

[28] Schmidt v. Merchants Despatch Transp. Co., 270 N.Y. 287, 305, 200 N.E. 824, 829 (1936). For the Supreme Court's recent elaboration of this view, see notes 37 - 53 *infra* and accompanying text.

[29] *See, e.g.*, Bivens v. Six Unknown Named Agents of Fed. Bureau of Narcotics, 403 U.S. 388, 402 n.4 (1971) (Harlan, J., concurring in the judgment) (quoted in text accompanying note 31 *infra*); Montana-Dakota Utils. Co. v. Northwestern Pub. Serv. Co., 341 U.S. 246, 261 (1951) (Frankfurter, J., dissenting). *See generally* People's Hous. Dev. Corp. v. City of Poughkeepsie, 425 F. Supp. 482, 488-90 (S.D.N.Y. 1976); Harried, *Implied Causes of Action: A Product of Statutory Construction or the Federal Common Law Power?*, 51 U. COLO. L. REV. 355 (1980); Note, *Implying Civil Remedies From Federal Regulatory Statutes*, 77 HARV. L. REV. 285, 291-92 (1963). For an argument favoring the view that the role of federal

Borak seems to adopt the latter view.[30] As Justice Harlan later noted:

> The *Borak* case is an especially clear example of the exercise of federal judicial power to accord damages as an appropriate remedy in the absence of any express statutory authorization of a federal cause of action. There we "implied"—from what can only be characterized as an "exclusively procedural provision" affording access to a federal forum [§ 27 of the 1934 Act], . . .—a private cause of action for damages for violation of § 14(a). . . . We did so in an area where federal regulation has been singularly comprehensive and elaborate administrative enforcement machinery had been provided. The exercise of judicial power involved in *Borak* simply cannot be justified in terms of statutory construction, . . . nor did the *Borak* Court purport to do so. . . . The notion of "implying" a remedy, therefore, as applied to cases like *Borak,* can only refer to a process whereby the federal judiciary exercises a choice among traditionally available judicial remedies according to reasons related to the substantive social policy embodied in an act of positive law.[31]

Under this theory, federal courts need not wait for congressional authorization to create private rights of action. Rather, they may create such rights on their own, subject only to the normal constraints that govern the process of federal common law making. Thus, when the legislature manifests an intention that a particular substantive prohibition should *not* be enforced by private actions, the courts are barred from recognizing such actions. Indeed, the *Borak* Court recognized that in shaping common-law doctrines courts should heed statutory policies. The Court observed:

> When a federal statute condemns an act as unlawful, the extent

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courts in implying causes of action should extend beyond conventional statutory construction, see notes 65-89 *infra* and accompanying text.

[30] *See* notes 15-19 *supra* and accompanying text.

[31] Bivens v. Six Unknown Named Agents of Fed. Bureau of Narcotics, 403 U.S. 388, 402 n.4 (1971) (Harlan, J., concurring in the judgment) (emphasis in original) (citations omitted). *See also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) ("When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it, see *J.I. Case Co. v. Borak,* . . . but it would be disingenuous to suggest that either Congress . . . or the Securities and Exchange Commission . . . foreordained the present state of the law with respect to Rule 10b-5.").

> and nature of the legal consequences of the condemnation, though left by the statute to judicial determination, are nevertheless federal questions, *the answers to which are to be derived from the statute and the federal policy which it has adopted.*[32]

II. From *Borak* to *Touche Ross* and *Transamerica*: Narrowing the Doctrine of Implied Rights of Action

A. *The Retreat From* Borak

In the decade following *Borak*, private securities litigation flourished. *Borak* itself authorized private actions under section 14(a), and soon after *Borak* the Supreme Court acknowledged and approved[33] the lower courts' creation of private damage actions under section 10(b) of the 1934 Act[34] and rule 10b-5 promulgated thereunder.[35] In addition, the courts recognized implied private rights of action under a variety of other federal statutory provisions, both within and outside the securities field.[36]

In 1975, however, in *Cort v. Ash*,[37] the Supreme Court qualified the doctrine of implied private rights of action.[38] Attempting to assemble sixty years of case law relating to the implication of private remedies into a harmonious whole, the Court announced the following four-part test:

> In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant. First, is the plaintiff "one of the class for whose *especial* benefit the statute

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[32] 377 U.S. at 433 (emphasis added) (quoting Sola Elec. Co. v. Jefferson Elec. Co., 317 U.S. 173, 176 (1942)).

[33] *See* Superintendent of Ins. v. Banker's Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

[34] 15 U.S.C. § 78j(b) (1976).

[35] 17 C.F.R. § 240.10b-5 (1979). The first court decision to recognize a private right of action under § 10(b) and rule 10b-5 was Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

[36] *See, e.g.*, Allen v. State Bd. of Educ., 393 U.S. 544, 554-55 (1969) (finding a private right of action for declaratory and injunctive relief under § 5 of the Voting Rights Act of 1965); Bossier Parish School Bd. v. Lemon, 370 F.2d 847, 852 (5th Cir.) (recognizing a private right of action for injunctive relief under § 601 of the Civil Rights Act of 1964), *cert. denied*, 388 U.S. 911 (1967); Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 181 (2d Cir.) (holding that an implied private remedy exists under § 6(b) of the Securities Exchange Act of 1934, but that the plaintiff failed to state a claim), *cert. denied*, 385 U.S. 817 (1966).

[37] 422 U.S. 66 (1975).

[38] The Court held that no private derivative action for damages was available under a federal criminal statute, Act of June 25, 1948, ch. 645, 62 Stat. 723 (repealed 1976), forbidding corporations from making certain political contributions. *See* 422 U.S. at 85.

> was enacted"—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of a legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?[39]

In three subsequent cases, the Court applied this test to deny private rights of action under particular federal statutes.[40] These decisions emphasized one or another of the *Cort* factors but in general followed the flexible approach of that opinion. In a fourth case, *Cannon v. University of Chicago*,[41] however, the Court moved toward a more restrictive test whereby legislative intent came to subsume the other *Cort* factors.

The Court in *Cannon* held that a private right of action exists under title IX of the Education Amendments of 1972.[42] Invoking the *Cort* test, the *Cannon* Court considered each of the *Cort* factors in detail. In an important change in emphasis, however, the Court framed the implication issue as a "question of statutory construction"[43] and stated that "before concluding that Congress *intended* to make a remedy available to a special class of litigants, a court must carefully analyze the four factors that *Cort* identifies as indicative of such an *intent*."[44] Justice Rehnquist's concurring

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[39] 422 U.S. at 78 (emphasis by the Court) (citations omitted).

[40] *See* Chrysler Corp. v. Brown, 441 U.S. 281 (1979) (Trade Secrets Act); Santa Clara Pueblo v. Martinez, 436 U.S. 49 (1978) (Indian Civil Rights Act); Piper v. Chris-Craft Indus., 430 U.S. 1 (1977) (Williams Act).

[41] 441 U.S. 677 (1979).

[42] 20 U.S.C. §§ 1681-1683 (1976) (prohibiting sex discrimination in federally funded educational programs and institutions).

[43] 441 U.S. at 688. The Court found that Congress modeled title IX of the Education Amendments on title VI of the Civil Rights Act of 1964. *See* 441 U.S. at 694. As of 1972, when title IX was enacted, the federal courts had recognized implied private remedies under title VI. *Id.* at 696 & n.20 (citing cases). The *Cannon* Court reasoned that in basing title IX on title VI, Congress had intended to incorporate the contemporary case law applicable to title VI. *Id.* at 696-703.

[44] 441 U.S. at 688 (emphasis added) (footnote omitted). By contrast, the *Cort* opinion itself acknowledged that "in situations in which it is clear that federal law has granted a class of persons certain rights, it is not necessary to show an intention to *create* a private cause of action, although an explicit purpose to *deny* such cause of action would be controlling." 422 U.S. at 82 (emphasis in original).

opinion in *Cannon* underscores the implicit shift in doctrine:

> [T]he approach of the Court, reflected in its analysis of the problem in this case [and other recent decisions] is quite different from the analysis in earlier cases such as *J.I. Case Co. v. Borak*. The question of the existence of a private right of action is basically one of statutory construction. And while state courts of general jurisdiction still enforcing common law as well as statutory law may be less constrained than are federal courts enforcing laws enacted by Congress, the latter must surely look to those laws to determine whether there was an intent to create a private right of action under them.[45]

Justice Powell, dissenting in *Cannon,* carried this view even farther in emphasizing difficulties of constitutional magnitude. Criticizing the *Cort* test as one that "allows the Judicial Branch to assume policymaking authority vested by the Constitution in the Legislative Branch,"[46] Justice Powell remarked:

> [The four *Cort*] factors were meant only as guideposts for answering a *single question,* namely, whether Congress intended to provide a private cause of action. But, as the opinion of the Court today demonstrates, the *Cort* analysis too easily may be used to deflect inquiry away from the intent of Congress, and to permit a court instead to substitute its own views as to the desirability of private enforcement.[47]

Under Justice Powell's theory, the federal courts *lack power* to create private remedies in the absence of affirmative legislative authorization.

The majority adopted something akin to Justice Powell's view in two subsequent securities cases. In *Touche Ross & Co. v. Redington,*[48] the Court denied a private right of action under section 17(a) of the 1934 Act.[49] Confining itself "solely to determining whether Congress intended to create the private right of action asserted by [the plaintiffs],"[50] the Court commented:

> It is true that in *Cort v. Ash,* the Court set forth four factors that it

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[45] 441 U.S. at 717-18 (Rehnquist, J., concurring) (citations omitted).
[46] *Id.* at 743 (Powell, J., dissenting). *See also id.* at 731-32.
[47] *Id.* at 740 (emphasis added).
[48] 442 U.S. 560 (1979).
[49] 15 U.S.C. § 78q(a) (1976).
[50] 442 U.S. at 568.

> considered "relevant" in determining whether a private remedy is implicit in a statute not expressly providing one. But the Court did not decide that each of these factors is entitled to equal weight. The central inquiry remains whether Congress intended to create, either expressly or by implication, a private cause of action. Indeed, the first three factors discussed in *Cort*—the language and focus of the statute, its legislative history, and its purpose—are ones traditionally relied upon in determining legislative intent.[51]

Similarly, in *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*,[52] the Court stated: "The dispositive question remains whether Congress intended to create any [private] remedy. Having answered that question in the negative, our inquiry is at an end."[53]

Thus, the Supreme Court has fashioned an extraordinarily restrictive doctrine of implication. The Court has retreated from the notion, central to *Borak*, that the federal judiciary has inherent power to create private remedies for statutory violations absent a contrary congressional intent. Instead, the Court now treats the implication of private rights of action as a matter of statutory construction and thereby confines analysis to the question whether Congress, in enacting a particular statute, intended to authorize the private remedies sought.[54] *Touche Ross* and *Transamerica* demonstrate the current Court's reluctance to imply private damage remedies under the securities laws.[55] Although the Court continues to recognize private causes of action under section 10(b) and rule 10b-5, apparently it does so only in acquiescence to the long-standing acceptance of such actions in the lower federal courts.[56] Similarly, without eliminating *Borak*'s implied remedies under section 14(a), the Court has explicitly abandoned the *Borak* doctrine of implication in favor of a "stricter standard."[57]

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[51] *Id.* at 575-76 (citation omitted).

[52] 444 U.S. 11 (1979) (discussed in notes 1-2 *supra* and accompanying text).

[53] *Id.* at 24. *See also id.* at 15-16.

[54] For a general discussion of methods by which lower courts can recognize limited implied causes of action while adhering to the Supreme Court's current restrictive doctrine of implication, see Comment, *Implied Rights of Action in Federal Legislation: Harmonization Within the Statutory Scheme*, 1980 DUKE L.J. 928.

[55] *See* note 59 *infra*.

[56] *See* Touche Ross & Co. v. Redington, 442 U.S. at 577 n.19; Cannon v. University of Chicago, 441 U.S. at 690 n.13.

[57] Touche Ross & Co. v. Redington, 442 U.S. at 578. This development signals a retreat from judicial encouragement of private enforcement of regulatory statutes, a trend that ex-

Touche Ross and *Transamerica* must be evaluated on their own terms—that is, as general statements of a doctrine of federal implied rights of action. Upon analysis, the doctrinal basis of *Touche Ross* and *Transamerica* seems inadequate.[58] In addition, these decisions may be read as expressing the Court's dissatisfaction with private damage actions in the specific context of securities regulation.[59] This dissatisfaction seems well founded; private securities litigation for damages does pose serious problems. These difficulties, however, can be resolved without adopting the current Court's overly restrictive view of judicial power to imply private causes of action for statutory violations.[60]

B. Doctrinal Underpinnings of Touche Ross *and* Transamerica

The Court has articulated no clear rationale for its restrictive doctrine of implied rights of action. *Touche Ross* and *Transamerica* seem to rest, however, on the notion that federal courts lack

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tends beyond implied rights of action cases. The trend appears in decisions refusing to assess attorney's fees against losing parties in the absence of statutory "fee shifting" provisions, *see* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240 (1975), and limiting the effectiveness of the class action under rule 23, *see* Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974), and the derivative suit under rule 23.1 of the Federal Rules of Civil Procedure, *see* Burks v. Lasker, 441 U.S. 471 (1979). Like *Touche Ross* and *Transamerica*, these decisions will diminish the zeal of "private attorneys general" to enforce statutory policies by means of private lawsuits.

[58] *See* notes 62-89 *infra* and accompanying text.

[59] *See generally* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975) ("There has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."). The Court may be less hesitant to imply private remedies to protect personal liberties than to supplement statutes that, like the securities acts, are primarily concerned with economic regulation. *See generally* Bivens v. Six Unknown Named Agents of Fed. Bureau of Narcotics, 403 U.S. 388, 396-97 (1971); D'Oench, Duhme & Co. v. Federal Deposit Ins. Corp., 315 U.S. 447, 471 n.9 (1942) (Jackson, J., concurring); Katz, *The Jurisprudence of Remedies: Constitutional Legality and the Law of Torts in* Bell v. Hood, 117 U. PA. L. REV. 1, 31 (1968). In *Touche Ross*, the Court commented that "when Congress wished to provide a private damages remedy [under the 1934 Act], it knew how to do so and did so expressly." 442 U.S. at 572. This language stands in marked contrast to the Court's statement in *Cannon* that "[t]he fact that other provisions of a complex statutory scheme create express remedies has not been accepted as a sufficient reason for refusing to imply an otherwise appropriate remedy under a separate section." 441 U.S. at 711 (citing *Borak*). *Cannon*, of course, dealt with civil rights legislation. *See* notes 42-43 *supra* and accompanying text.

Under the securities laws, moreover, the Court may imply equitable remedies more readily than damage remedies. *See* Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis, 444 U.S. at 18-19.

[60] *See* notes 148-60 *infra* and accompanying text.

power to grant relief for statutory violations unless Congress manifestly and specifically confers that power.[61] The Court's apparent reluctance to overrule inconsistent precedents in the securities area underscores the problematic nature of that assumption. The fundamental difficulty is that the narrow concept of judicial competence in *Transamerica* and *Touche Ross* runs counter to established federal common-law powers in areas similar to the implication of rights of action.

Touche Ross and *Transamerica* are irreconcilable with the continued recognition of certain implied rights of action under the 1934 Act. Neither section 14(a) nor section 10(b) may plausibly be read as evincing a congressional intention to authorize private lawsuits.[62] Taken on their own terms, the recent decisions indicate that *Borak* should be overruled.[63] By the same token, if it is unconstitutional to imply private rights of action except as intended by Congress, the Supreme Court may not continue to acquiesce in the private enforcement of section 10(b) permitted by the lower courts.[64]

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[61] The Court has simply declared that implication is a matter of statutory construction, thereby avoiding the troublesome task of explaining contrary precedents. *See* Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis, 444 U.S. at 15-16; Touche Ross & Co. v. Redington, 442 U.S. at 568. One can only infer that the arguments advanced in separate opinions by Justice Rehnquist and Justice Powell, *see* notes 45-47 *supra* and accompanying text, have persuaded the majority.

[62] *See* note 31 *supra* and accompanying text. Justice Powell has taken implicit constitutional concerns of the recent decisions to their logical conclusion: "[The Court] should not condone the implication of any private action from a federal statute absent the most compelling evidence that Congress in fact intended such an action to exist." Cannon v. University of Chicago, 441 U.S. at 749 (dissenting opinion).

[63] *But see* Touche Ross & Co. v. Redington, 442 U.S. at 577 ("We do not now question the actual holding of [*Borak*]. . . . ").

[64] *But see id.* at 577 n.19. It should also be noted that *Touche Ross* and *Transamerica* will not necessarily accomplish their apparent purpose of relieving federal courts' dockets of private damage claims for securities violations. If the Court's restrictive doctrine of implication rests on the limited jurisdiction of the federal courts, *see* Cannon v. University of Chicago, 441 U.S. at 746 (Powell, J., dissenting); *id.* at 717 (Rehnquist, J., concurring), the doctrine poses no obstacle to the creation of private rights of action under state law. Subject only to the supremacy clause, state courts of general jurisdiction remain free to recognize private actions for the violation of duties derived from the federal securities acts and incorporated in state common law. The exclusive jurisdictional provision of the 1934 Act, 15 U.S.C. § 78aa (1976), would not appear to bar state courts from entertaining such actions. *See* Pan Am. Petrol. Corp. v. Superior Court, 366 U.S. 656, 663-64 (1961). Thus, state courts could grant private remedies for securities violations as to which Congress itself did not intend private relief. In that event, the Supreme Court might well find it necessary to review state court decisions to ensure the correct and uniform interpretation of the underlying

It is doubtful, however, that the Constitution mandates such a restrictive doctrine of implied private actions. Federal courts possess recognized power to create substantive common law in areas of important federal interest.[65] That power exists not only to protect federal rights "[i]n [the] absence of an applicable Act of Congress,"[66] but also "to generate substantive rules governing primary behavior in furtherance of broadly formulated policies articulated by statute or [the] Constitution."[67] In implementing statutory policy, the Court has foreclosed defenses not expressly prohibited by statute[68] and given effect to an immunity that Congress deleted before enacting a bill into law.[69] Similarly, the Court has asserted the power to make rules applicable to express statutory remedies[70] and to grant remedies other than those provided by Congress.[71]

The federal judiciary, then, has both the power and the responsibility to make substantive common law ancillary to federal statutes. It would appear, therefore, that no *constitutional* principle bars federal courts from recognizing by implication claims of private plaintiffs who are clearly members of the class the statute was

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federal statutes. *See* Crane v. Cedar Rapids & I.C. Ry., 395 U.S. 164, 166 (1969); Moore v. Chesapeake & O. Ry., 291 U.S. 205, 214 (1934). Moreover, the lower federal courts would also be called upon to exercise diversity and pendant jurisdiction over state-law claims.

[65] *See, e.g.*, Textile Workers Union v. Lincoln Mills, 353 U.S. 448 (1957); Clearfield Trust Co. v. United States, 318 U.S. 363 (1943). *See generally* Monaghan, *The Supreme Court, 1974 Term—Foreword: Constitutional Common Law,* 89 HARV. L. REV. 1 (1975).

[66] Clearfield Trust Co. v. United States, 318 U. S. 363, 367 (1943).

[67] Bivens v. Six Unknown Named Agents of Fed. Bureau of Narcotics, 403 U.S. 388, 403 (1971) (Harlan, J., concurring).

[68] *See* Sola Elec. Co. v. Jefferson Elec. Co., 317 U.S. 173 (1942); D'Oench, Duhme & Co. v. Federal Deposit Ins. Corp., 315 U.S. 447 (1942); Deitrick v. Greaney, 309 U.S. 190 (1940).

[69] *See* Farmers Educ. & Coop Union v. WDAY, Inc., 360 U.S. 525, 531-35 (1959) (construing § 315(a) of the Federal Communications Act of 1934, 47 U.S.C. § 315(a) (1958) (amended 1972) and holding that the statute, by prohibiting licensed stations from censoring broadcasts by candidates for public office, implicitly immunizes the stations from liability for such candidates' defamatory statements). *See also* O'Brien v. Western Union Tel. Co., 113 F.2d 539, 541 (1st Cir. 1940) (holding that federal common law governs liability for libels published by means of interstate telegrams).

[70] *See* Board of County Comm'rs v. United States, 308 U.S. 343 (1939) (holding as a matter of federal common law that a local governmental entity is not liable for prejudgment interest on taxes collected in violation of federal immunities).

[71] *See* Illinois v. City of Milwaukee, 406 U.S. 91, 103 (1972) ("The remedy sought . . . is not within the precise scope of remedies prescribed by Congress. Yet the remedies which Congress provides are not necessarily the only federal remedies available."); United States v. Republic Steel Corp., 362 U.S. 482, 492 (1960).

designed to protect.[72] Implication presents what is essentially an issue of remedial law.[73] To borrow Justice Harlan's phrase, "it would be at least anomalous"[74] to recognize the federal judiciary's power to make substantive law while denying its authority to make remedial law.[75]

If the Constitution does not reduce the implication of private remedies to an exercise in conventional statutory construction, then the narrow implication doctrine of *Touche Ross* and *Transamerica* is not only unnecessary but also unwise. The disadvantages of the doctrine are two-fold: First, it precludes the judiciary from supplementing express remedial schemes if they prove inadequate to accomplish clear congressional purposes.[76] Second, it in-

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[72] *See generally* notes 20-23 *supra* and accompanying text.

[73] *See* H. HART & A. SAKS, THE LEGAL PROCESS 154, 488 (tent. ed. 1958).

[74] Bivens v. Six Unknown Named Agents of Fed. Bureau of Narcotics, 403 U.S. 388, 403 (1971) (Harlan, J. concurring).

[75] Justice Powell has attempted to distinguish the two sorts of law:

> It is true that the federal judiciary necessarily exercises substantial powers to construe legislation, including, when appropriate, the power to prescribe substantive standards of conduct that supplement federal legislation. But this power normally is exercised with respect to disputes over which a court already has jurisdiction, and in which the existence of the asserted cause of action is established. Implication of a private cause of action, in contrast, involves a significant additional step. By creating a private action, a court of limited jurisdiction necessarily extends its authority to embrace a dispute Congress has not assigned it to resolve.

Cannon v. University of Chicago, 441 U.S. at 745-46. Justice Powell's argument is misplaced because implication and jurisdiction are separate questions. When a plaintiff claims an implied right of action under a federal statute, his case arises under the laws of the United States and therefore lies within the jurisdiction of the federal courts under 28 U.S.C. § 1331(a) (1976). This is so whether implication is treated as a matter of statutory construction, *see* Montana-Dakota Utils. Co. v. Northwestern Pub. Serv. Co., 341 U.S. 246, 249 (1950); *id.* at 257 (Frankfurter, J., dissenting), or federal common law, *see* Illinois v. City of Milwaukee, 406 U.S. 91, 99-100 (1972). If the court determines that no private right exists under the statute, the proper course is to dismiss for failure to state a claim on which relief may be granted rather than for lack of subject matter jurisdiction. *See* Montana-Dakota Utils. Co. v. Northwestern Pub. Serv. Co., 341 U.S. at 249-50 (majority opinion); Bell v. Hood, 327 U.S. 678, 682 (1946). *See generally* Note, *supra* note 29, at 287-89; Note, *Federal Jurisdiction in Suits for Damages Under Statutes Not Affording Such Remedy*, 48 COLUM. L. REV. 1090 (1948).

[76] *See* Comment, *Private Rights of Action Under* Amtrack *and* Ash: *Some Implications for Implication*, 123 U. PA. L. REV. 1392, 1426-37 (1975); Note, *supra* note 29 at 291 ("The weakness of the court as lawmaker—the lack of debates and hearings, the retroactive effect of its solution, the uncertainty of its public mandate—are less serious when conduct has already been proscribed by the legislature and only an additional remedy is sought. Making its decision in relation to an existing and functioning statute, the court may be in an even better position to assess the need for supplemental civil relief than was the legislature at the

fringes on the traditional judicial function of compensating the victims of statutory violations and thereby permits "the result, extraordinary in our jurisprudence, of a wrongdoer shifting responsibility for the consequences of his [violation] onto his victim."[77] These effects of a narrow theory of implication are sufficiently important that they should not be imposed by presumption, but only on an explicit congressional determination.[78]

By the better view, then, where "it is clear that federal law has granted a class of persons certain rights, it is not necessary to show [a congressional] intention to *create* a private cause of action, although an explicit [congressional] purpose to *deny* such cause of action would be controlling."[79] Of course, in making common law, federal courts are not free to disregard the policies of federal statutes.[80] "Federal common law implements the federal constitution and statutes, *and is conditioned by them.*"[81] As recognized in *Borak*,[82] courts should be careful to imply private rights of action only when private enforcement would accord with the goals of the

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time of enactment."). *See generally* Illinois v. City of Milwaukee, 406 U.S. 91, 103 (1972); United States v. Republic Steel Corp., 362 U.S. 482, 492 (1960). *See also* Friendly, *In Praise of* Erie—*and of the New Federal Common Law,* 39 N.Y.U. L. REV. 383, 419 (1964).

[77] Wyandotte Transp. Co. v. United States, 389 U.S. 191, 204 (1967). *See generally* Katz, *supra* note 59, at 17-31; notes 20-23 *supra* and accompanying text.

[78] By permitting the judiciary to decide implication issues by reference to statutory policies except when Congress expressly bars private actions, the proposed approach avoids an inherent dilemma created by the Court's current doctrine. The Court now treats legislative intent as dispositive even as to questions that Congress has not addressed. Under that theory, analysis almost inevitably degenerates to the application of simplistic maxims, most notably, *expressio unius est exclusio alterius* (expression of one thing is the exclusion of another). *See, e.g.,* Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis, 444 U.S. at 19-20; National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers, 414 U.S. 453, 458 (1974). For critiques of such reasoning, see Comment, *supra* note 76, at 1415-22; Note, *supra* note 29, at 290-91 ("[T]he maxim should be 'subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose.' ") (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 350-51 (1943)).

[79] Cort v. Ash, 422 U.S. at 82 (emphasis in original).

[80] *See* Moragne v. States Marine Lines Inc., 398 U.S. 375, 390-91 (1970) ("[The] legislative establishment of policy carries significance beyond the particular scope of each of the statutes involved. The policy thus established has become itself a part of our law, to be given its appropriate weight not only in matters of statutory construction but also in those of decisional law."). *See generally* Landis, *Statutes and the Sources of Law,* in HARVARD LEGAL ESSAYS 213 (1934).

[81] D'Oench, Duhme & Co. v. Federal Deposit Ins. Corp., 315 U.S. 447, 472 (1942) (Jackson, J., concurring) (emphasis added) (footnote omitted). *See also* Textile Workers Union v. Lincoln Mills, 353 U.S. 448, 457 (1957).

[82] *See* note 32 *supra* and accompanying text.

underlying statute. Statutory policy sometimes militates *against* private remedies. Illustrative cases are *Securities Investor Protection Corp. v. Barbour*[83] and *National Railroad Passenger Corp. v. National Association of Railroad Passengers*[84] (hereinafter *Amtrak*).

In *Barbour,* the Court denied a private litigant the right to compel the Securities Investors Protection Corporation (SIPC) to initiate against a broker-dealer the liquidation proceeding authorized by the Securities Investor Protection Act of 1970[85] (SIPA). The Court commented that "a private right of action under the SIPA would be consistent neither with the legislative intent, nor with the effectuation of the purposes it is intended to serve."[86] In view of the statute's purposes, the Court restricted the liquidation procedure to administrative enforcement:

> Congress' primary purpose in enacting the SIPA and creating the SIPC was, of course, the protection of investors. It does not follow, however, that an implied right of action by investors who deem themselves to be in need of the Act's protection, is either necessary to or indeed capable of furthering that purpose.
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> The SIPC properly treats an application for the appointment of a receiver and liquidation of a brokerage firm as a last resort. It maintains an early-warning system and monitors the affairs of any firm that it is given reason to believe may be in danger of failure. Its experience to date demonstrates that more often than not an endangered firm will avoid collapse by infusion of new capital or merger with a stronger firm. Even failing those alternatives, a firm may be able to liquidate under the supervision of one of the self-regulatory organizations, or the district court, without danger of loss to customers. The SIPC's policy, therefore, is to defer intervention "until there appear[s] to be no reasonable doubt that customers would need the protection of the Act." By this policy, the SIPC avoids unnecessarily engendering the costs of precipitate liquidations—the costs not only of administering the liquidation, but also of customer illiquidity and additional loss of confidence in the capital markets—without sacrifice of any customer protection that may ultimately prove necessary. A customer, by contrast, cannot be expected to consider, or have adequate information to consider,

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[83] 421 U.S. 412 (1975).
[84] 414 U.S. 453 (1974).
[85] 15 U.S.C. §§ 78aaa-78111 (1971).
[86] 421 U.S. at 424.

> these public interests in timing his decision to apply to the courts.[87]

Similar considerations governed in *Amtrak*. The plaintiff sought to enjoin the termination of passenger service along a particular route on the ground that the discontinuance would violate the Rail Passenger Service Act of 1970.[88] The Court held that no such private action is available under the Amtrak Act. Focusing on the Act's purposes, the Court stated:

> If the respondent's view of the Act were to prevail, a private plaintiff could secure injunctive process to prevent the discontinuance of an "uneconomic" passenger train *pendente lite,* which would force Amtrak to continue the train's operation and to incur the resulting deficits and dislocations within its entire system while the court considered the propriety of the proposed discontinuance. Since suits could be brought in any district through which Amtrak trains pass and since there would be a myriad of possible plaintiffs, the potential would exist for a barrage of lawsuits that . . . could frustrate or severely delay any proposed passenger train discontinuance. . . . This would completely undercut the efficient apparatus that Congress sought to provide for Amtrak to use in the "paring of uneconomic routes." . . . In the place of the state or federal regulatory bodies, the Congress would have substituted any and all federal district courts through whose jurisdictions an Amtrak train might run.[89]

Barbour and *Amtrak* confirm what is implicit in *Borak:* recognizing a federal common-law power to imply private rights of action does not give federal courts license to substitute their judgments for congressional decisions, nor does it relieve the judiciary of the duty to implement statutory policies. *Borak*'s sound doctrine of implication would require the courts to consider the recognition of private rights of action in light of the purposes of the securities acts. It is not the *Borak* doctrine of judicial power that

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[87] *Id.* at 421-22 (footnote and citation omitted).

[88] 45 U.S.C. §§ 501-645 (1970 & Supp. V 1975) (amended 1979).

[89] 414 U.S. at 463-64 (footnote omitted). In both *Barbour* and *Amtrak,* the Court also offered less convincing rationales for its holdings. The most unfortunate of these is the Court's reliance in *Amtrak* on "[a] frequently stated principle of statutory construction" that "when legislation expressly provides a particular remedy or remedies, courts should not expand the coverage of the statute to subsume other remedies." *Id.* at 458. *See generally* note 78 *supra.*

poses problems in the securities area but rather its implementation. Consequently, instead of focusing on doctrine, as the Supreme Court did in *Touche Ross* and *Transamerica,* the Court should address more directly the central concern of those decisions — the apparent deficiencies of private litigation in its present form as a tool of securities regulation.

III. A Policy Critique of Implied Private Rights of Action for Securities Violations

The restrictive doctrine of *Touche Ross & Co. v. Redington*[90] and *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*[91] may be attributed in part to the Supreme Court's dissatisfaction with private enforcement as a means of advancing the public policies of the securities acts.[92] Indeed, the *Borak* conception of traditional tort actions as devices for deterring securities violations seems seriously flawed.

Private enforcement of the securities acts represents a peculiar combination of private motives and public goals. Although the *Borak* Court justified private rights of action for securities violations as necessary deterrents,[93] private litigation takes the form of compensatory proceedings, *i.e.,* traditional tort suits. The impact of such proceedings on the functioning of the securities markets is, of course, an empirical question, and existing studies[94] support no firm conclusions.[95] Nonetheless, analysis and reflection suggest that such private compensatory actions (especially in the form of class actions) are ill-suited to the deterrence system of the securities laws and may hamper the central purposes of those statutes.

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[90] 442 U.S. 560 (1979).

[91] 444 U.S. 11 (1979).

[92] *See* note 59 *supra.*

[93] *See* notes 24-26 *supra* and accompanying text.

[94] *See, e.g.,* Dooley, *Enforcement of Insider Trading Restrictions,* 66 Va. L. Rev. 1 (1980); Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978,* 60 B.U. L. Rev. 306 (1980); Kennedy, *Securities Class and Derivative Actions in the United States District Court For the Northern District of Texas: An Empirical Study,* 14 Hous. L. Rev. 769 (1977).

[95] For example, the study of shareholder suits in Jones, *supra* note 94, only measured the incidence of private suits brought against reporting corporations; underwriters, a significant class of potential defendants, were thus omitted from the study. *See id.* at 308. Moreover, no study has yet attempted to measure systematically the costs of private enforcement. For a discussion of those costs, see notes 106-07 *infra* and accompanying text.

The Court's doctrinal approach to the problems raised by private enforcement, however, is neither necessary nor desirable. In turning to a narrow theory of implied rights of action, the Court has ignored the possibility of shaping private enforcement more closely to statutory policies and has precluded private remedies that serve a legitimate compensatory purpose.

A. Aspects of Private Enforcement: Remedies and Settlement

In important respects, the procedures of private litigation (especially in class actions for damages) are inconsistent with the public enforcement goals of the securities laws, which seek optimal deterrence.[96] In general, private plaintiffs engage in litigation to further their own economic interests; they rarely concern themselves with the social costs and social benefits of their lawsuits.[97] The different objectives of public and private enforcement reflect themselves in different preferences as to remedies and settlement.

Deterrence is the major focus of governmental enforcement. In view of the deterrence objective, public enforcement agencies usually seek declaratory or injunctive relief. Some private enforcers, such as consumer and environmental activists, who engage in litigation for public-oriented goals, likewise often prefer equitable remedies. These "ideological plaintiffs,"[98] however, play no significant role in the private enforcement of the securities laws. The incentive for private securities litigation is largely economic, and the remedy usually sought is damages.

Both governmental agencies and "ideological" private plaintiffs may seek relief that would deter too little or too much.[99] Courts, however, have considerable discretion in granting the equitable remedies that such parties usually seek,[100] which enables the judi-

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[96] Optimal deterrence is that level of enforcement that minimizes both the cost of violations and the cost of reducing the incidence of violations. *See* Schwartz, *An Overview of the Economics of Antitrust Enforcement*, 68 GEO. L.J. 1075, 1075 (1980).

[97] *See* Reich, *The Antitrust Industry*, 68 GEO. L.J. 1053, 1070 (1980). This generalization excludes those private plaintiffs who litigate to promote political, ideological, or public-oriented objectives.

[98] *See* note 97 *supra*.

[99] *See* Reich, *supra* note 97, at 1063-64 (discussing the incentives that affect attorneys in the antitrust agencies).

[100] Writing three years before *Borak*, Professor Louis Loss predicted that "private actions under the proxy rules will normally be in equity, which has ample discretion in the granting or withholding of relief." 2 L. LOSS, SECURITIES REGULATIONS 944 (2d ed. 1961). He added:

ciary to protect the public interest in optimal deterrence. By contrast, courts traditionally have not exercised substantial discretion over damage awards.[101] As a result, these private lawsuits may result in awards that, even if sensible in compensatory terms, are so large as to deter desirable conduct or so small as to leave significant violations undeterred. By relying principally on damages, then, private securities litigation severely limits the judiciary's ability to achieve optimal deterrence.

A similar analysis applies to settlement.[102] Because private lawsuits under the securities acts implicate public purposes, the public has an important interest in the timing and terms of settlement. Consistent with traditional compensatory procedures, however, private securities litigation places settlement within the control of the parties, and they exercise that control in their own interests. Even in class actions and derivative suits, which entail significant judicial review of settlement,[103] the compensatory goal predominates: the focus of such review is the protection of absent class members.[104] In its current form, then, private enforcement leaves the public interest in settlement unvindicated. It is not calculated to promote the central deterrent purpose of the securities acts. Indeed, as will be contended below,[105] private enforcement may significantly disrupt the statutory deterrence scheme.

B. The Potential for Overenforcement

An economically rational regulatory system deters only to the point at which the cost of preventing an additional violation just

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"[I]n the context of the proxy rules the discretion of the chancellor is certainly an adequate substitute for that of the prosecutor." *Id.*

[101] The compensatory rationale central to the common law of damages demands that "the compensation shall be equal to the injury," Wicker v. Hoppock, 73 U.S. (6 Wall) 94, 99 (1867), and therefore that damages not be limited by "arbitrary fiat," Chicago, M. & St. P. Ry. v. McCaull-Dinsmore Co., 253 U.S. 94, 100 (1920) (Holmes, J.). Although the compensation principle limits a defendant's liability to the value of the harm he caused, the principle does not otherwise take account of the deterrent effects of damage awards. The question whether the potential magnitude of liability in private securities actions calls for special judicial limitations on damages has arisen in several recent cases. *See* note 123 *infra.*

[102] *See generally* note 113 *infra.*

[103] *See* FED. R. CIV. P. 23(e), 23.1.

[104] *See, e.g.,* Desimone v. Industrial Bio-Test Labs., Inc., 83 F.R.D. 615, 619 (S.D.N.Y. 1979). On standards for evaluating class and derivative action settlements, see Haudek, *The Settlement and Dismissal of Stockholders' Actions* (pt. 2), 23 Sw. L.J. 765, 792-801 (1969).

[105] *See* notes 106-28 *infra* and accompanying text.

equals the cost of such violation. Optimal deterrence is likely to be considerably less than total deterrence.[106] In reality, any enforcement system mistakenly treats some nonviolators as violators and subjects them to sanctions. The possibility of mistaken sanctions creates an error cost—the deterrence of useful conduct by the risk of liability. In addition, defendants and potential defendants expend resources to avoid liability. Both error costs and liability-avoidance costs increase with the magnitude of the threatened sanction.[107] Therefore, excessive sanctions produce overenforcement—a level of enforcement at which the costs of deterrence marginally exceed its benefits.

The implication of private rights of action may well have led to overenforcement of the securities laws. Two aspects of private securities litigation are significant in this respect. First, section 10(b) and rule 10b-5 are textually broad and vague, and the case law has

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[106] Optimal deterrence has been the object of extensive study in the past ten years. *See, e.g.*, Diver, *A Theory of Regulatory Enforcement*, 28 PUB. POL'Y 257 (1980); Landes & Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1 (1975); Page, *Antitrust Damages and Economic Efficiency: An Approach to Antitrust Injury*, 47 U. CHI. L. REV. 467 (1980). These works focus on the net social cost or benefit of regulatory systems. The various theoretical models are difficult to apply because of their complexity, the scarcity of data, and the problems associated with quantifying costs and benefits. Nonetheless, the models are the best available tools for evaluating the effectiveness of enforcement systems.

Warren Schwartz has aptly summarized the need to assess enforcement systems from a comprehensive point of view; although his particular reference is to antitrust enforcement, his comments are equally pertinent to securities regulation:

> A court, legislature, or prosecutor confronted with the choices that determine the content of an enforcement system faces enormous uncertainty in ascertaining the efficiency of utilizing various means to reduce the incidence of harmful conduct. These choices turn on the costs and the benefits of a wide range of alternatives. Because calculating these costs and benefits will implicate difficult normative, methodological, and empirical issues going well beyond the facts of any particular case, the judge, legislator, or prosecutor will be challenged with a formidable task in attempting to make a decision that contributes to the efficiency of the enforcement system.
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> . . . [Nonetheless], someone in the public sector, whether judge, legislator, prosecutor, or some other official, must decide hard questions by taking a systemic view.

Schwartz, *supra* note 96, at 1079.

[107] The magnitude of a sanction is determined by the value of the sanction multiplied by the probability that it will be imposed. *See* Schwartz & Tullock, *The Costs of a Legal System*, 4 J. LEGAL STUD. 75, 78 (1975). In some cases the magnitude of the sanction may increase in a greater than linear fashion: if potential defendants are risk averse, large damages with a low probability of detection will produce greater deterrence than a sanction of equal magnitude produced by a higher probability of detection with lower damages. *See* K. ELZINGA & W. BREIT, THE ANTITRUST PENALTIES: A STUDY IN LAW AND ECONOMICS 112-38 (1976).

not yet coalesced into a clear, coherent model of liability.[108] Therefore, potential defendants (persons transacting in securities) cannot readily predict whether particular conduct will result in liability. Second, private actions expose potential defendants to the risk of damage awards that may be sizeable but cannot be measured in advance. Neither the statute nor the rule correlates the amount of damages that may be assessed against the defendant to the gravity of his violation or the extent of his profits.[109] Such a fortuitous relationship between conduct and liability magnifies the deterrent effect of the law. As one commentator has observed: "Predictabil-

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[108] *Cf.* 3 L. Loss, *supra* note 100, at 1789-90 ("[Certain developments in American securities law are] more than a little reminiscent of what a German scholar has called 'the flight into the general clauses': the tendency . . . to resolve more and more questions in terms of the handful of clauses in the Civil Code which are based on 'good faith' and similar formulas.").

[109] *See* 15 U.S.C. § 78j(b) (1976); 17 C.F.R. § 240.10b-5 (1979). This indeterminacy is especially great in insider trading cases, in which both the scope of liability and the proper measure of damages have been controversial. The Second Circuit has held that insiders selling in the market without adequate disclosure are liable not only to their direct purchasers but to all market purchasers trading concurrently in the same stock. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974). *Contra* Fridrich v. Bradford, 542 F.2d 307, 318-19 (6th Cir. 1976) (refusing to extend an insider trader's liability to "plaintiffs who traded on the impersonal market and who were otherwise unaffected by the wrongful acts of the insider."), *cert. denied,* 429 U.S. 1053 (1977). Although the *Fridrich* court rested its ruling primarily on the absence of a causal connection between the defendant's violation and the plaintiffs' losses, its underlying concern was "the problem of unlimited damages." *Id.* at 322.

Under the *Shapiro* rule, liability is potentially enormous and the measure of damages therefore becomes a matter of the greatest importance. The *Texas Gulf Sulphur* litigation will serve as an example. Insiders traded in Texas Gulf Sulphur stock for approximately five months while in possession of undisclosed material information concerning an ore strike in Canada; Texas Gulf Sulphur issued a misleading press release and corrected it four days later. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 843-47 (2d Cir. 1968) (en banc), *cert. denied,* 394 U.S. 976 (1969). One commentator estimates that if rescission had been used as the measure of damages (that is, if each potential plaintiff had been awarded the difference between the price of his stock when he sold it and the price he could have commanded had the inside information been available to the market), and if liability had been measured over the entire five month period, damages would have amounted to $390,000,000. *See* Ruder, Texas Gulf Sulphur—*The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 Nw. U.L. Rev. 423, 428-29 (1968).

In recognition of the potentially "Draconian" effect of the rescissionary measure, the Second Circuit has recently ruled that damages for tippee trading violative of rule 10b-5 are to be calculated by the "disgorgement measure," which limits the wrongdoer's liability to the extent of his profits. Elkind v. Liggett & Myers, Inc., Sec. Reg. & L. Rep. (BNA), No. 584, at L-1, 7-10 (2d Cir. Dec. 4, 1980). For discussion of the appropriateness of judicial limitations on recoveries in implied causes of action for securities violations, see notes 123 & 150-58 *infra* and accompanying text.

ity is obviously the most important factor in assessing the risks of legal liability, and the highest costs will be assigned to risks which are perceived to be not only substantial but indeterminate."[110]

Uncertainty as to the existence and magnitude of liability creates a powerful incentive for the defendant in a private securities action to settle claims against him without a trial on the merits. As the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*[111] observed:

> [I]n the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.[112]

The defendant often chooses to pay the plaintiff a fraction of the alleged damages rather than run the risk of an adverse judgment.[113] In short, private rights of action for damages under rule 10b-5 open the door to strike suits and to the rewarding of frivolous claims.[114]

The problem of an indeterminate risk of large penalties, which may produce overenforcement, is not unique to implied rights of action. For example, the expressly authorized treble-damage remedy for antitrust violations[115] has also been criticized as excessively

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[110] Dooley, *The Effects of Civil Liability on Investment Banking and the New Issue Market*, 58 VA. L. REV. 776, 801 (1972).

[111] 421 U.S. 723 (1975).

[112] *Id.* at 740.

[113] In one study of 348 shareholder suits, 260 cases (74.7%) were settled. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U. L. REV. 542, 545 (1980). Only two cases (0.6% of the total sample, 2.3% of the cases resolved by litigation) resulted in a judgment favorable to the plaintiffs. *Id. See also* 3 L. LOSS, *supra* note 100, at 1792-93 ("Few of the cases under Rule 10b-5 have gone to final judgment for the plaintiff on the merits. Frequently the last reported decision is on denial of the defendant's motion for summary judgment.").

[114] The incentive structure of private actions encourages contrived and groundless claims:

> One of the costs commonly associated with private as opposed to public enforcement has been termed the "misinformation effect." Because private plaintiffs stand to gain from collecting or settling a claim for damages, they have incentives to claim falsely that illegal behavior has taken place. The plaintiff may not knowingly file false claims but may merely construe every ambiguous situation (of which there appear to be many) to involve illegality.

Dooley, *supra* note 94, at 27 n.129.

[115] 15 U.S.C. § 15 (1976).

deterrent.[116] In comparison to implied rights of action, however, express rights of action pose less risk of overenforcement because they are usually circumscribed by statutory limitations of liability. The securities acts' express private remedies typically impose direct or indirect limitations on liability. Section 11(e) of the 1933 Act limits an underwriter's liability in a given transaction to the dollar amount of the securities he underwrote;[117] section 16(b) of the 1934 Act limits the plaintiff's recovery to the amount of the defendant's unlawful profit.[118] The security-for-costs requirement applicable to all private rights of action under the 1933 Act[119] may deter strike suits.[120] Like the statutes now in force, the American Law Institute's proposed Federal Securities Code[121] restricts private actions by a variety of means, including caps on damages.[122]

Comparable limitations do not apply to judicially created rights of action. Courts are reluctant to impose "arbitrary" ceilings on

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[116] *See, e.g.*, Crumplar, *An Alternative to Public and Victim Enforcement of the Federal Securities and Antitrust Laws: Citizen Enforcement*, 13 HARV. J. LEGIS. 76, 85 (1975). *See also* Breit & Elzinga, *Antitrust Enforcement and Economic Efficiency: The Uneasy Case for Treble Damages*, 17 J.L. & ECON. 329, 335-48 (1974).

[117] 15 U.S.C. § 77k(e) (1976).

[118] 14 U.S.C. § 78p(b) (1976).

[119] 15 U.S.C. § 77k(e) (1976).

[120] Introducing the amendment that added the security-for-costs requirement to § 11(e) of the 1934 Act, Senator Fletcher noted that one of the purposes of the amendment was to provide "a defense against blackmail suits." 78 CONG. REC. 8669 (1934).

[121] ALI FED. SEC. CODE (Proposed Official Draft 1978) [hereinafter cited as ALI CODE].

[122] The Code provides the remedy of damages for unlawful purchases and sales in market transactions, *id.* § 1702(b), and damages or rescission for unlawful purchases and sales in nonmarket transactions (those "not effected in a manner that would make the matching of buyers and sellers substantially fortuitous"), *id.* § 1702(a). Unlawful market transactions create liability to all persons who trade "a security of the same class on a day when the defendant [sells or buys]." *Id.* § 1702(b). These provisions codify existing law. The Code, however, departs from existing law in providing certain limitations on damages: liability for unlawful purchases and sales in the market may not exceed the amount of securities the defendant bought or sold. *Id.* § 1702(e)(2). For violations consisting of false filings or misleading publicity (absent scienter), or market manipulation, damages may not exceed the greatest of $100,000, or 1% (to a maximum of $1,000,000) of a company-defendant's gross revenues in the fiscal year preceding the lawsuit, or the defendant's unlawful trading profits. *Id.* § 1708(c)(2) (false registration and offering statements); *id.* § 1708(d) (misleading publicity); *id.* § 1710(d) (market manipulation). Certain violations expose the defendant to unlimited liability. *See id.* § 1708(c)(2) (knowing misrepresentation in filings or publicity); *id.* § 1709 (breach of fiduciary duty); *id.* § 1715 (unlawful trading practices).

For a discussion of limitations applicable to implied rights of action under the Code, see note 160 *infra*.

damages.[123] In the securities area, moreover, the courts have not limited liability by strictly construing substantive standards. On the contrary, the courts have expanded the scope of the antifraud provisions of the securities acts far beyond that of common-law fraud.[124] Although the Supreme Court has recently imposed more rigorous standards for rule 10b-5 claims,[125] the scope of liability remains far broader under implied rights of action than under common-law fraud or the private causes of action expressly provided by the securities acts.

The costs of liability created by private enforcement may fall not only on defendants but also on investors, consumers, and society at large. When a corporation pays a judgment or a settlement, the value of the corporation's stock may fall and its cost of capital rise. In that event, not only do shareholders sustain a loss,[126] but

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[123] *See* note 101 *supra*. The Second and Sixth Circuits are divided on the question whether judicial limitations on damages are appropriate in implied private causes of action under the securities acts. In eliminating the privity requirement with respect to the liability of insider traders, *see* note 109 *supra*, the Second Circuit commented: "[W]e do not foreclose the possibility that an analysis . . . of the nature and character of the . . . violations committed may require limiting the extent of liability imposed on [the] defendants." Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 242 (2d Cir. 1974). In a recent case, the court acted on that suggestion by limiting liability for tippee trading to the extent of the wrongdoer's profits. Elkind v. Liggett & Myers, Inc., SEC. REG. & L. REP. (BNA), No. 584, at L-1, 7-10 (2d Cir. Dec. 4, 1980).

By contrast, the Sixth Circuit has refused to dispense with the privity element as a prerequisite for insider trading liability. Fridrich v. Bradford, 542 F.2d 307, 318-19 (6th Cir. 1976). *See* note 109 *supra*. The *Fridrich* court based its decision partly on the ground that a contrary ruling would create excessive liability, *see* 542 F.2d at 321, and it rejected the expedient of a judicial limitation on damages: "As compared to Congress or administrative agencies such as the SEC, we think the courts are ill-fitted to the task of rulemaking which would be required." *Id.* *See* Dooley, *supra* note 94, at 22-23.

For the view that judicial limitations on damages in implied causes of action may be appropriate in light of statutory policies, see notes 150-58 *infra* and accompanying text.

[124] *See* Dooley, *supra* note 110, at 814-21.

[125] *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (holding that an allegation of fraud or breach of fiduciary duty does not state a claim under rule 10b-5 unless the defendant's conduct was deceptive or manipulative within the meaning of the 1934 Act); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (holding that the plaintiff in a private damage action under rule 10b-5 must allege scienter); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (limiting private actions under rule 10b-5 to plaintiffs who have purchased or sold securities); Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891, 892-900 (1977).

[126] Judge Moore has noted "the sardonic anomaly that the very members of society which Congress has charged the SEC with protecting, i.e., the stockholders, will be the real victims of its misdirected zeal." SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 889 (2d Cir. 1968) (dissenting opinion), *cert. denied*, 394 U.S. 976 (1969). *See generally* Note, *Rule 10b-5: The*

the productivity of the firm may decline—at some cost to society. Furthermore, by deterring the issuance of public securities, private enforcement may hinder investment. It has been suggested that the broad scope of liability under rule 10b-5 may induce investment bankers to shift their efforts from underwriting public issues to arranging private placements.[127] Because the suppliers of capital in the private placement market are institutions with conservative investment preferences, a significant shift in that direction would "deprive many new and smaller companies of any access to the capital markets."[128]

In sum, private actions under the securities acts create indeterminate, expansive liability and therefore probably deter much useful activity. The forgoing of such activity constitutes a cost of private enforcement and may outweigh the resulting benefits. Further inquiry suggests that the social benefits of private enforcement are decidedly limited.

C. Assessing the Benefits of Private Enforcement

Two policy arguments may support implied private rights of action under the securities laws: first, that private enforcement increases the detection of violations to some desirable extent and, second, that private remedies are necessary to compensate. The first rationale is of doubtful validity; the second is correct only when the plaintiff has suffered a substantial injury.

The *Borak* Court suggested that the SEC lacks sufficient staff to police the securities markets adequately and that the courts should therefore reward private plaintiffs for uncovering violations.[129] More detection, however, is not necessarily an unqualified good, since detection is not cost free. Higher detection rates may be accompanied by error costs: more detections produce more deterrence—including, perhaps, the deterrence of useful conduct.[130] If

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Rejection of the Birnbaum *Doctrine by* Eason v. General Motors Acceptance Corp. *and the Need for a New Limitation on Damages*, 1974 DUKE L.J. 610, 624 n.74.

[127] Dooley, *supra* note 110, at 841.

[128] *Id.* at 842.

[129] *See* 377 U.S. 426, 432 (1964). *See also* sources cited in Crumplar, *supra* note 116, at 83 n.43.

[130] This generalization assumes that the increase in detection rates is not offset by any decrease in the value of the applicable sanction. *See* note 107 *supra* and accompanying text. Implied private rights of action *increase* the potential sanctions threatening potential defen-

private actions greatly increase detection rates, they may thereby exacerbate the problem of overenforcement.[131]

It is questionable, however, whether private enforcement of the securities laws actually does augment detections significantly. Although private enforcement plainly adds to deterrence, the incremental deterrence may result from excessive sanctions rather than from an optimal combination of sanctions and detection rates.[132] To a considerable extent, private plaintiffs do not discover violations but instead hang on the coattails of the SEC and the bankruptcy courts.[133] This tendency is particularly marked in insider trading cases: a recent study reveals that private plaintiffs have seldom initiated such lawsuits without prior SEC action.[134] The investigative abilities of private plaintiffs may vary among the different kinds of infractions,[135] but they should not be overestimated.

The economic incentives that motivate plaintiff class attorneys encourage undesirable actions. Attorneys are paid not for discovering violations but for producing large judgments. The private class attorney therefore seeks the largest judgment with the least investment of time and money. If potential damages are high enough, an obvious violation that is already the subject of SEC action usually presents him with the greatest incentive to bring suit.[136]

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dants and thereby add to deterrence. *See* Fridrich v. Bradford, 542 F.2d 307, 321-22 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977). If private actions also increase the probability of detecting violations, then they create, in a sense, two upward pressures on the level of deterrence.

[131] *See generally* notes 106-28 *supra* and accompanying text.

[132] *See* note 107 *supra* and accompanying text.

[133] *See, e.g.*, Kennedy, *supra* note 94, at 784-88, 824 (estimating that 20% of private securities litigation is related to previous SEC proceedings and 30% to prior bankruptcy proceedings). *See also* Mowrey, *Attorney Fees in Securities Class Action and Derivative Suits*, 3 J. CORP. L. 267, 328-29 (1978).

[134] Dooley, *supra* note 94, at 16 n.82.

[135] For a discussion of the relative effectiveness of public and private enforcement with respect to the various securities violations, see *id.* at 15-17.

[136] The rules governing attorney fees create a complex and, in some respects, incoherent incentive structure. The general American rule is that absent a statutory "fee shifting" provision, *see, e.g.*, 15 U.S.C. §§ 77k(e), 78i(e), 78r(a) (1976), a successful litigant cannot recover attorney fees from the losing party. Alyeska Pipeline Co. v. Wilderness Soc'y, 421 U.S. 240, 247 (1975). In class actions, however, the court may award plaintiffs' attorneys a fee out of the "fund" resulting from a judgment or settlement; in theory, this exception prevents unjust enrichment of the members of the plaintiff class. *See* Dawson, *Lawyers and Involuntary Clients: Attorney Fees From Funds*, 87 HARV. L. REV. 1597, 1601-04 (1974). Courts consider various factors in awarding such fees. In general, the size of the recovery is the most important factor. *See* Mowrey, *supra* note 133, at 335-38. In recent years, some courts

Where the SEC has largely left the field to private enforcers, such as in enforcement of the proxy rules,[137] private class attorneys have no alternative but to seek out violations. If potential damages exceed potential investigation and litigation costs, private plaintiffs have an incentive to bring suit. In insider trading cases, however, detection costs tend to be so high that there is rarely an incentive for private investigation.[138] Private plaintiffs, moreover, are likely to detect only easily discoverable violations. Leaving enforcement to private plaintiffs may result in overdeterrence of the inept and the negligent and underdeterrence of the intentional "expert" insider trader.

The second rationale for implied private rights of action—that they are necessary for compensation—must be qualified. A potential plaintiff will not bring suit unless he expects a recovery greater than his litigation costs.[139] Thus, an *individual* suit usually requires a relatively substantial injury. The class action provision of rule 23 of the Federal Rules of Civil Procedure,[140] however, alters this calculus by making it feasible to maintain an action even when no individual has suffered a substantial loss. When individual injuries are insubstantial but the class action procedure is available, private lawsuits may result in damage awards that are not compensatory in any meaningful sense. As Justice Rehnquist has observed:

> [I]n the absence of any jurisdictional limit, there is considerable doubt . . . whether this type of action is indeed ultimately of pri-

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have considered other factors, such as the time invested by the attorney. *See, e.g.*, Detroit v. Grinnell Corp., 495 F.2d 448, 468-74 (2d Cir. 1974).

Linking fees to the size of the recovery gives the attorney an incentive to settle early if the recovery will be reasonably large. On the other hand, linking fees to the amount of work provides a disincentive to the enterpreneurial enforcer because it does not take into account his risk of loss in the event of failure. The work measure also provides an incentive for an attorney to spend more than enough time on a case that he expects to win. Courts sometimes balance these conflicting incentives by awarding an hourly rate and adding a premium when the probability of success was slight or the attorney's skill great. *See* Lindy Bros. Builders, Inc. v. American Radiator & Standard Sanitary Corp., 487 F.2d 161, 168 (3d Cir. 1973). Only rarely, however, do courts focus in this manner on the incentive structure created by the fee rules.

[137] *See* J.I. Case Co. v. Borak, 377 U.S. at 432.

[138] *See* Dooley, *supra* note 94, at 19-20.

[139] This statement excludes "ideological plaintiffs," such as environmental and consumer activists, who engage in litigation to further public-oriented goals. *See* notes 97-98 *supra* and accompanying text.

[140] FED. R. CIV. P. 23.

> mary benefit to [the plaintiffs], who may recover virtually no monetary damages, as opposed to the attorneys for the class, who stand to obtain handsome rewards for their services.[141]

Eisen v. Carlisle & Jacquelin[142] exemplifies such noncompensatory private actions. *Eisen* was a class action alleging violations of the antitrust and securities laws based on differential fees charged on "odd-lot" trades of securities.[143] The potential class was estimated at six million individuals and entities.[144] The representative plaintiff, who had made forty-seven trades over a period of several years, calculated his total damages at $70.[145] For many class members, damages would doubtless have been even less.

Many class actions, of course, have genuine compensatory goals.[146] In a complex securities fraud, litigation costs may be prohibitive for an individual plaintiff even if he has suffered a considerable loss. Compensation provides a legitimate rationale for permitting class actions in such cases.[147]

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[141] Reiter v. Sonotone Corp., 442 U.S. 330, 346 (1979) (concurring opinion).

[142] 417 U.S. 156 (1974).

[143] The differential was 12½ cents per share on stock selling below $40 per share and 25 cents per share on stock selling at or above $40 per share. *Id.* at 160.

[144] *Id.* at 166.

[145] *Id.* at 161. Whether this amount represented actual or trebled damages is not clear.

[146] The deficiencies of private actions are not attributable solely to the provisions of rule 23. Rather, they arise from the interaction of rule 23 and the underlying substantive law. *See* Miller, *Of Frankenstein Monsters and Shining Knights: Myth, Reality, and the "Class Action Problem,"* 92 HARV. L. REV. 664, 670 (1979) ("In almost every substantive area presently identified with class actions, there occurred major substantive changes unrelated to the rule's revision that affected practice under it."). *See also id.* at 673-74 (discussing implied private rights of action under the securities laws and rule 23); Note, *The Impact of Class Actions on Rule 10b-5,* 38 U. CHI. L. REV. 337 (1971). As Professor Hazard has observed:

> The legislature often pitches legislation at a higher level of expectation than it really intends to require. It anticipates a kind of discount for non-enforceability, and thereby enjoys a pleasant moral luxury in proclaiming high expectations. But one can't indulge that luxury, or its judicial equivalent in the form of expansive dicta, when one has to face up to enforcing the proposed rule. And that, of course, is what is involved in the class suit. That is why the strict liability rules of the securities legislation, the consumer protection laws, and the nuisance and warranty doctrines present so much difficulty in the class suit: substantive legal aspiration becomes reality through the procedural transformation of Rule 23.

Hazard, The Effect of the Class Action Device upon the Substantive Law (paper delivered in a symposium before the Judicial Conference of the Fifth Judicial Circuit), *reprinted in* 58 F.R.D. 307, 312 (1973).

[147] Courts, however, should address the deterrent effects of such lawsuits and find means of containing those effects. *See* notes 156-57 & 160 *infra* and accompanying text.

D. Responding to the Deficiencies of Private Enforcement

Private actions seem likely to disrupt the deterrence scheme of the securities acts and, indeed, may impair the functioning of the public capital markets.[148] Except in genuinely compensatory actions, moreover, the benefits flowing from private securities litigation appear meagre.[149] It is quite possible that, on balance, the implication of private rights of action has impeded rather than advanced the fundamental purposes of the securities acts.

That possibility underscores a basic inconsistency in the jurisprudence of implied private rights of action under the securities acts in the *Borak* era. On the one hand, in recognizing private remedies for securities violations, courts asserted the power to create federal common law to promote statutory policies.[150] On the other hand, the courts for the most part declined to assume the "legislative" task of limiting the liability in implied causes of action,[151] and until recently they gave little consideration to the possibility that the magnitude of that liability clashes with statutory purposes.[152]

Apparently in response to the problem of overdeterrence,[153] the Supreme Court in recent decisions has restricted private enforcement by narrowing the doctrine of implied rights of action. Declaring that implied rights of action must be founded on a manifest congressional intent, the Court has implicitly denied the common-law power of federal courts to implement statutory policies.[154] The better course would be to recognize judicial *power* to imply federal private rights of action together with judicial *responsibility* to do so only when private enforcement would serve—or at least would not disserve—the purposes of the underlying substantive

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[148] *See* notes 106-28 *supra* and accompanying text.

[149] *See* notes 129-47 *supra* and accompanying text.

[150] *See* notes 29-31 *supra* and accompanying text.

[151] *See* note 101 *supra* and accompanying text.

[152] *But see* Fridrich v. Bradford, 542 F.2d 307, 320-21 (6th Cir. 1976) ("By . . . extending the liability of defendants here beyond that which has already been imposed through the SEC enforcement action, we believe we would be doing violence to the intent of the statute and rule, creating a windfall for those fortuitous enough to be aware of their nebulous legal rights, and imposing what essentially must be considered punitive damages almost unlimited in their potential scope.") (footnote omitted), *cert. denied,* 429 U.S. 1053 (1977).

[153] *See generally* Blue Chips Stamps v. Manor Drug Stores, 421 U.S. at 739.

[154] *See* notes 37-54 *supra* and accompanying text.

statute.[155]

Under this proposed approach, the courts could respond in a more focused manner to the problem of overdeterrence arising from private actions under the securities laws. To safeguard the public interest in optimal deterrence, the judiciary should be prepared to modify the procedures and relief available under implied rights of action.[156] Desirable modifications may include limiting damages, changing the measure of damages, and providing special judicial oversight of the initiation and settlement of private securities litigation.[157] Such innovations would accord with a theory that bases implied rights of action on federal judicial power to make common law ancillary to and in support of federal statutes.[158]

Alternatively, while asserting the power to create common law, courts may nonetheless abandon deterrence-oriented private actions under the securities laws. There is much to be said for this alternative. The securities acts provide a comprehensive regulatory system. The acts are complex; they regulate not only transactions among individuals but also marketplace functions and the securities industry, and they strike a finely tuned balance of diverse interests. To enforce the acts, Congress created an agency that has developed a remarkable tradition of expertise and of sensitivity to economic conditions and society's needs. The courts may have acted precipitously in permitting "supplementary" private enforcement. It seems clear that such supplementary enforcement is unnecessary in many areas of the securities acts.

In any event, if further empirical work reveals a useful regulatory role for private enforcers, the legislature, rather than the

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[155] *See* notes 65-89 *supra* and accompanying text.

[156] *See generally* Note, *supra* note 29, at 296-98.

[157] *See* notes 96-104 *supra* and accompanying text.

[158] Before it adopted the rigid statutory-construction theory of implication, the Supreme Court acknowledged a special role for judicial limitations of liability in implied causes of action. In *Blue Chip Stamps*, the Court remarked:

> [I]f Congress had legislated the elements of a private cause of action for damages, the duty of the Judicial Branch would be to administer the law which Congress enacted. . . . But . . . we are not dealing here with any private right created by the express language of § 10(b) or Rule 10b-5. No language in either of those provisions speaks at all to the contours of a private cause of action for their violation. . . . We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question.

421 U.S. at 748-49.

courts, should determine that role. Congress has superior capacity to develop the necessary information and to strike the necessary compromises among competing interests. Until the legislature has spoken, however, the courts should not foreclose private rights of action for damages altogether. Rather, the courts should use their discretion to recognize private claims only when damages fulfill a significant compensatory purpose,[159] and they should develop the requisite standards for identifying compensable claims.[160]

IV. Conclusion

The past twenty-five years' experiment with private enforcement may have disturbed the balance inherent in the securities acts. The increased number of cases has resulted in increased enforcement costs, but there is little evidence of a commensurate creation of a rational and efficient deterrence system. Private enforcement has resulted in uncertainty as to the scope of liability and thereby has contributed to the risk under which corporate management and members of the securities industry conduct their business. Consequently, the Court's recent decisions seem salutary.

On the other hand, the Supreme Court has overreacted to the problem of overenforcement by grounding those decisions in an excessively restrictive doctrine of federal judicial power to imply private rights of action. Instead of undermining this power, courts should use it judiciously. The courts should follow the historical

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[159] *See generally* notes 20-23 & 77 *supra* and accompanying text.

[160] *See generally* ALI Code, *supra* note 121, The American Law Institute's proposed Federal Securities Code recognizes judicial power to imply private rights of action while prescribing standards for the exercise of that power. The Code directs courts to consider "the nature of the defendant's conduct, the degree of his culpability, the injury suffered by the plaintiff, and the deterrent effect of recognizing a private action." ALI Code, *supra* note 121, § 1722(a). Three specific provisions further limit judicial discretion. First, a court may recognize a private right of action "only if . . . the action is not inconsistent with the conditions or restrictions in any of the actions expressly created or with the scheme of this Code." *Id.* § 1722(a)(1). This provision bars the judiciary from supplanting the remedies designated by the legislature; for example, it would preclude the court from creating civil liability under rule 10b-5 for conduct covered by § 11 or § 12 of the 1933 Act. Second, a court must determine "that under the circumstances the type of remedy sought is not disproportionate to the alleged violation." *Id.* § 1722(a)(3). Hence, a court should not grant remedies that would produce an overdeterrent effect. Third, in cases "comparable" to those for which the Code expressly limits damages, a court must impose "a comparable maximum." *Id.* § 1722(a)(4). This provision attempts to restore a measure of predictability to the private enforcement scheme.

rationale for implication by recognizing private rights of action to compensate those who suffer substantial individual injuries as a result of securities violations. The courts should use their discretion, however, to deny private claims that have little compensatory value to individuals. The experiment with deterrence-oriented private actions as a supplement to public enforcement of the securities acts has not been successful.