

The New Deal and the Burger Court: The Significance of *United States v. Chiarella*

Jan G. Deutsch*

The current energy crisis, product of a single world market, signifies the destruction of economic and political frontiers behind which American society developed in distinctive ways. What has distinguished American society is the wide scope it affords to individual variations from social norms. The rapidity of economic growth in post-Civil War America was fueled by the immense personal fortunes made possible by this tolerance of individualism. The disparities in income resulting from such fortunes, however, were accepted by the society because the future brought not only more wealth, but also a wider economic gap between the United States and the other nations with which it compared itself. It is the end of that state of affairs that is signified by the global economic interdependence manifested in OPEC's power over the American economy.

The continent-wide free market that provided the context for American economic growth was created and maintained by the Supreme Court's interpretation of the commerce clause. In his book, *The Commerce Clause Under Marshall, Taney, and Waite*,¹ Felix Frankfurter demonstrated that the commerce clause decisions defining the nature of the American market simultaneously defined the nature of the law that authorized the Court to enforce its reading of the constitutional text.² Frankfurter's scholarly work was based on a perception of the judicial function that also shaped his work as a Justice of the Supreme Court. It was this perception of how an individual Justice should exercise the powers inherent in his office that underlay his disagreements with Hugo Black concerning the proper functioning of a Court that had accepted the institutional changes in American government attributable to the New Deal.

*H.P. Hood & Sons, Inc. v. Du Mond*³ is the commerce clause deci-

* Professor of Law, Yale Law School. B.A. 1955, Yale University; M.A. 1963, Clare College, Cambridge University; LL.B. 1962, Ph.D. 1962, Yale University.

1. F. FRANKFURTER, *THE COMMERCE CLAUSE UNDER MARSHALL, TANEY, AND WAITE* (1937).

2. *Id.* at 18-34.

3. 336 U.S. 525 (1949).

sion in which these aspects of recent Supreme Court history are most clearly presented. The case involved New York's denial of a license to a Massachusetts corporation that had requested authorization for an additional plant from which milk purchased from New York farmers would be shipped to Boston. At the license hearing New York milk dealers argued that some of their producers would be attracted to the new plant and introduced evidence concerning temporary milk shortages within New York. The New York courts, over commerce clause objections, upheld the State Commissioner's denial of the license, which was based on the New York Agriculture and Markets Law.

The Supreme Court reversed in an opinion that argued:

The material success that has come to inhabitants of the states which make up this federal free trade unit has been the most impressive in the history of commerce, but the established interdependence of the states only emphasizes the necessity of protecting interstate movement of goods against local burdens and repressions.

. . . .

Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality.⁴

Justices Frankfurter and Black filed separate dissents. Justice Frankfurter, joined by Justice Rutledge, argued:

Broadly stated, the question is whether a State can withhold from interstate commerce a product derived from local raw materials upon a determination by an administrative agency that there is a local need for it More narrowly, the question is whether the State can prefer the consumers of one community to consumers in other parts of its own territory. It is arguable, moreover, that the Commissioner was actuated not by preference for New York consumers, but by the aim of stabilizing the supply of all the local markets, including Boston . . . served by the New York milkshed. It may also be that he had in mind the potentially harmful competitive effect of efforts by dealers supplying the [New York] market[s] to repair, by attracting new producers, the aggravation of [New York] shortage[s] which would result

4. *Id.* at 538-39.

The New Deal and the Burger Court

from the diversion to Boston of part of [New York's] supply. These too are matters as to which more light would be needed if it were now necessary to decide the question.

In the view I take of the issue of destructive competition, however, this question need not now be decided. It is impossible to say from a reading of the opinions below that the Commissioner's finding that extension of Hood's license would tend to destructive competition would not by itself have been a sufficient basis for his order; and it is a basis which evidence adduced upon remand might put upon solid constitutional ground. A decision at this stage of the question of preferment of local needs, assuming that the record presents it, would prove to be purely advisory, therefore, if when the case came back to the State court, it found the order adequately supported by the justification of preventing destructive competition. It may be answered, to be sure, that the State would have no reason to decide whether or not the latter justification was adequate in the absence of an indication by this Court that the former—the retention of locally needed milk—is constitutionally invalid. And such an indication would amount to decision of the very constitutional issue professedly left open. To which my reply would be that it is a very different thing to recognize the difficulty of a constitutional issue and to point out circumstances in which it would not arise than it is to decide the issue.

My conclusion, accordingly, is that the case should be remanded to the Supreme Court of Albany County for action consistent with the views I have stated.⁵

Frankfurter's questions on remand seek to determine the effects of state actions claimed to violate the commerce clause. Such questions are relevant to a judicial determination of constitutional validity because of the ease with which legislative or administrative language can be made to disguise intent. In *Hood & Sons*, for example, the preface to the New York Agriculture and Markets Law or the opinion of the State Commissioner might well stress that the new plant "will have a tendency to deprive [New York] markets of a supply needed during the short season."⁶ Political contributions to legislators, however, or testimony that is in fact dispositive in the administrative hearings, might well reflect the position of New York producers that "Hood, by reason of conditions under which it sold in Boston, had competitive advantages under applicable federal milk orders, Boston health regulations, and OPA ceiling prices."⁷

The very nature of a competitive market, unfortunately, ensures

5. *Id.* at 575-76 (Frankfurter, J., dissenting).

6. *Id.* at 529.

7. *Id.* at 528.

that Frankfurter's questions, though relevant, can be answered with no more certainty than questions dealing with the weight to be given to legislative or administrative language. Thus, whether a given commercial innovation will disrupt or stabilize a market, or destroy as opposed to intensify competition, are inquiries that ultimately cannot be answered except in retrospect. Frankfurter's desire for remand, therefore, must have been based on his perception of the proper role of the judiciary in the constitutional process, which embodied a faith that "circumstances in which [a difficult constitutional issue] would not arise"⁸ will occur relatively frequently. Indeed, one of Frankfurter's law clerks, Alexander M. Bickel, in his book *The Least Dangerous Branch*,⁹ argued that judicial acts like a *Hood & Sons* remand could be characterized as "passive virtues" and that such acts play a crucial role in the successful functioning of the Court as an institution.¹⁰

At least in connection with commerce clause cases, faith in the virtue of avoiding decision of difficult constitutional issues was justified as long as national economic growth continued to transform what initially appeared as potentially destructive competition into reluctantly accepted business practices. Erosion of the certainty that such growth was inevitable was one of the costs exacted by the Depression of the 1930s, which eventuated in the governmental economic measures collectively known as the New Deal. In terms of its impact on the fact situation presented for decision in *Hood & Sons*, one of the consequences of this loss is most clearly apparent in *Tuscan Dairy Farms, Inc. v. Barber*,¹¹ which upheld the New York Commissioner of Agriculture and Markets' denial of an application for extension of a milk dealer's license.

The dissent, relying on *Hood & Sons*, argued that

the majority seeks to distinguish this case upon the theory that the constitutional infirmity in *Hood* stemmed from the fact that the commissioner premised his license denial upon a finding that operation of an additional milk receiving plant at the requested location would occasion the reception of a lower volume of milk by existing area plants, resulting in a decrease in operational efficiency—an economic, rather than health-related, interest. In marked contrast, maintains the majority, stands the present case, in which the commissioner premised his license denial not upon

8. *Id.* at 576 (Frankfurter, J., dissenting).

9. A. BICKEL, *THE LEAST DANGEROUS BRANCH* (1962).

10. *Id.* at 111-98.

11. 45 N.Y.2d 215, 380 N.E.2d 179, 408 N.Y.S.2d 348, *appeal dismissed for want of a substantial federal question*, 439 U.S. 1040 (1978).

The New Deal and the Burger Court

fear of the possibly debilitating effect competition might work upon the milk industry, but upon concern for the consumer.

. . . .
At the root of the commissioner's rationale lies the basic fear that appellant's entrance into the Richmond County milk market might, through competition, jeopardize the continued existence of milk distributors who service small volume wholesale customers, as well as making retail home deliveries necessary for consumer distribution. In my opinion, this reasoning constitutes nothing more than a subtle variant of the bootstrap argument that regulation of competition—an impermissible local interest—will in itself contribute to health—a permissible local interest.¹²

The Supreme Court refused review, not by denying certiorari, but by dismissing for want of a substantial federal question.¹³ In terms of the meaning of the commerce clause, therefore, it is now no more than a conscious substitution of rhetoric for analysis to argue that, in the *Hood & Sons* fact situation, "it is a very different thing to recognize the difficulty of a constitutional issue and to point out circumstances in which it would not arise than it is to decide the issue."¹⁴

II.

As the analysis of the *Hood & Sons* remand demonstrates, the concept of an impersonal market is in reality an analytical construct. For a market to function, individuals must agree to transactions that may or may not be profitable, and such individuals by definition possess "inside" information about the market at the moment they enter into transactions. It was to prevent abuse of such information that New Deal legislation has been interpreted as giving both courts and the Securities and Exchange Commission power over a wide range of securities transactions.

In connection with the distribution of securities, for example, the Securities Act of 1933¹⁵ provides a highly detailed body of rules to regulate the activities of underwriters and traders who are "making" markets. The precision of the Securities Act is replicated in the detail that section 16(b) of the Securities and Exchange Act of 1934¹⁶ devotes to describing the persons and situations to which its prohibition of profit from "inside" information is applicable. With the advent of the tender offer as a widely accepted tool for corporate expansion, however, the

12. *Id.* at 231-32, 380 N.E.2d at 188-89, 408 N.Y.S.2d at 358 (Jasen, J., dissenting).

13. 439 U.S. 1040 (1978).

14. 336 U.S. at 576 (Frankfurter, J., dissenting).

15. 15 U.S.C. §§ 77a-77aa (1976).

16. 15 U.S.C. § 78p(b) (1976).

situation arose in which the interests of a person or entity holding ten percent or more of a corporation's stock after attempting an unsuccessful tender offer, and thus qualifying as an "insider" for purposes of section 16(b), was in fact at odds with the interests of persons who actually had access to "inside" information—either existing management who had successfully resisted the tender offer or the person or group whose competing tender offer had won. On the basis that the abuses concerning "inside" information at which section 16(b) was directed could not exist in that situation, the Supreme Court, in *Kern County Land Co. v. Occidental Petroleum Corp.*,¹⁷ held that a binding option granted by the successful aggressor to such "insiders" a month after the initial tender offer (for purchase of the stock more than six months after its initial purchase by the unsuccessful tender offeror) did not constitute a "sale" within the six-month limit¹⁸ provided in the statute.¹⁹

*United States v. Chiarella*²⁰ upheld the criminal conviction of a financial printer who had profited from securities transactions on the basis of information obtained from confidential tender offer documents he was printing. Given his employment as financial printer, he was held by the Second Circuit to be an "insider" in terms of the securities market machinery, a status held sufficient to justify application of statutory prohibitions directed at "insiders" in the corporations whose securities are being traded.²¹ The statutory provision involved, however, was not section 16(b), but section 10(b) of the Securities and Exchange Act of 1934,²² which had specifically been drafted in open-ended terms covering transactions "in connection with the purchase or sale of any security"²³ in order to make it applicable to situations whose novelty

17. 411 U.S. 582 (1973).

18. 15 U.S.C. § 78p(b) (1976).

19. 411 U.S. at 601-04.

20. 588 F.2d 1358 (2d Cir. 1978), cert. granted, 99 S. Ct. 2158 (1979) (No. 78-1202).

21. *Id.* at 1365.

22. 15 U.S.C. § 78j(b) (1976).

23. *Id.* This section makes it unlawful

[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979), was one of the rules adopted by the SEC to implement section 10(b), Securities Exchange Act Release No. 3230 (May 21, 1942), although its language more closely resembles § 17 of the Securities Act:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material

The New Deal and the Burger Court

would permit them to elude more precise regulation.²⁴

Open-ended drafting, because it tends to use nontechnical language, has both advantages and pitfalls for the interpretive function performed by the judicial process. As shown by the majority opinion in *Hood & Sons*, nontechnical language facilitates justification of holdings on the ground that they clearly advance the enactment's objective. It was on this rationale that a district court concluded in *Kardon v. National Gypsum Co.*²⁵ that private parties, as well as the Securities and Exchange Commission, could bring actions under section 10(b) and rule 10b-5, a holding that ensured frequent litigation involving the meaning of the statutory language. The precise distinctions needed by courts in responding to attempts to broaden the applicability of a statute require increasing use of close, technical readings, a technique that took the form of importing such elements of common-law fraud as materiality and scienter into rule 10b-5 actions.²⁶ The exacting and time-consuming nature of this interpretive process, moreover, created a situation in which the technical nature of the issues decided shielded opinions from Supreme Court review. Since litigation was concentrated in the Southern District of New York, the Second Circuit thus functioned as the de facto Supreme Court on the interpretation of rule 10b-5.

In 1975 the Burger Court decided *Blue Chip Stamps v. Manor Drug Stores*,²⁷ which held that "*Birnbaum* was rightly decided."²⁸ In *Birnbaum v. Newport Steel Corp.*²⁹ the Second Circuit held in 1952 that certain corporate transactions, though arguably connected with the purchase or sale of securities, were governed by state law.³⁰ Immediately prior to the *Blue Chip* decision, circuits could be differentiated in their treatment of the *Birnbaum* doctrine only in the extent to which they had abandoned the holding's restriction on federal jurisdiction.

fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

24. See *Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (testimony of Thomas G. Corcoran) ("Commission should have authority to deal with new manipulative devices").

25. 69 F. Supp. 512 (E.D. Pa. 1946) (opinion on motion to dismiss). See also 73 F. Supp. 798, 800 (E.D. Pa.), modified on other grounds, 83 F. Supp. 613 (E.D. Pa. 1947), in which Judge Kirkpatrick reaffirmed his holding that private parties may bring suit to enforce section 10(b) and rule 10b-5.

26. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1970); text accompanying notes 32-36 *infra*. See also *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1968).

27. 421 U.S. 723 (1975).

28. *Id.* at 731.

29. 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

30. *Id.* at 464.

Although it is too early to ascertain whether *Blue Chip* mandates a return to the standing requirements delineated in 1952 or simply draws to a halt the expansion of rule 10b-5 jurisdiction, that *Birnbaum* was itself a Second Circuit decision underlines the fact that, in terms of the politics of the federal judicial hierarchy, *Blue Chip* represents the Supreme Court's reassumption of its de jure position in the area of securities regulation.

Given the political context established by *Blue Chip*, it seems significant that the Second Circuit defended its expansion of the "insider" concept in *Chiarella* by arguing that it would entail "no greater difficulty in resolving close cases than is inherent in determining who is a 'corporate insider' under *Texas Gulf Sulphur*."³¹ *SEC v. Texas Gulf Sulphur Co.*³² was an en banc decision perceived by the bar as an attempt by the Second Circuit to provide a definitive exposition of its views on rule 10b-5. It reversed the lower court, which had relied on the testimony of expert witnesses to establish that the information known by the "insiders" was too uncertain to be material.³³ The basis for the reversal on this point was a holding that "insider trading activity . . . constitutes . . . the only truly objective evidence of the materiality of [the information available to insiders]."³⁴

What is striking about this analysis of materiality is the extent to which it substitutes a single element for the multifactored analysis of statutory language that informed the Supreme Court's reading of section 16(b) in *Kern County*. It is important to remember, moreover, that the provision at issue in *Chiarella* is not section 16(b), whose precision of drafting facilitates an absolute interpretation of its prohibition of the possibility of profit. What *Chiarella* involves is section 10(b), a statutory provision whose open-ended drafting necessarily created the risk of overly broad applicability. What the *Chiarella* appellant argued was that "interpreting Rule 10b-5 to impose an affirmative duty of disclosure on a person other than a corporate insider would be so novel a construction of the Rule as to violate the fair notice element of due process."³⁵

The basis for this argument is that *Chiarella* was neither a corporate insider nor a market "maker" governed by the Securities Act of 1933, but an "insider" only in terms of the financial printing that func-

31. 588 F.2d at 1366.

32. 401 F.2d 833 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971).

33. *SEC v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262, 282-83 (S.D.N.Y. 1966).

34. 401 F.2d at 851.

35. 588 F.2d at 1369.

tions as an essential part of securities markets mechanisms. The “inside” information in *Chiarella*—the identity of the participants in the merger or tender offer—in many instances represents the difference between a profit and a loss for insiders making a market on the possibility that a merger or tender offer will occur. The *Chiarella* majority agreed that the duty to disclose required by its holding is not applicable even to such “insiders” as the persons or entities making the tender offer, at least until after they have purchased five percent of the target company’s stock.³⁶ It nevertheless held *Chiarella* liable because notices warning against misuse of confidential information had been posted in his workplace after the Securities and Exchange Commission had obtained consent decrees against other financial printers who traded on such information.³⁷ The question presented by *Chiarella*, therefore, is whether the notice requirement incorporated in the due process guarantee not only encompasses knowledge of wrongdoing on the part of the malefactor, but also ensures that sufficient precedent exists to justify application of the statutory provision despite the absence of statutory liability in arguably similar circumstances.

Stressing that what is at issue is a criminal prosecution rather than civil liability, the dissent concluded that

[t]o identify judicially a new triggering circumstance—regular receipt of market information—if appropriate at all, is not appropriate here. The criminal aspects of 10b-5 have been neither extensive nor significant prior to today The ability of the SEC to function will not be severely hampered if it must await congressional action or action by its own rulemakers to correct any market distortion caused by wayward printers. As would any agency, the SEC would like to keep as many weapons in its arsenal as possible. But there are rules of combat, and our job is to see that the amenities are observed when the SEC embarks on a new crusade.³⁸

III.

The *Chiarella* dissent’s focus on adherence to “rules of combat” constituted the institutional rationale for Justice Black’s dissent, joined by Justice Murphy, in *Hood & Sons*. Because “Congress and its authorized federal agency [had] knowingly acquiesced in, if they [had] not actually encouraged and approved, enactment and enforcement of

36. *Id.* at 1366.

37. *Id.* at 1369.

38. *Id.* at 1378 (Meskill, J., dissenting).

the New York law here held invalid,"³⁹ Justice Black concluded that the Court now steps in where Congress wanted it to stay out. The Court puts itself in the position of guardian of interstate trade in the milk industry. Congress, with full constitutional power to do so, selected the Secretary of Agriculture to do this job. Maybe this Court would be a better guardian, but it may be doubted that authority for the Court to undertake the task can be found in the Constitution—even in its "great silences."⁴⁰

Black's unwillingness to let courts curtail the regulatory efforts of administrative agencies had its roots in the Supreme Court's attempt to nullify the institutional changes that characterized the New Deal:

The judicially directed march of the due process philosophy as an emancipator of business from regulation appeared arrested a few years ago. That appearance was illusory. That philosophy continues its march. The due process clause and commerce clause have been used like Siamese twins in a never-ending stream of challenges to government regulation The reach of one twin may appear to be longer than that of the other, but either can easily be turned to remedy this apparent handicap.⁴¹

That this position in fact freed administrative action from compliance with the processes of law was made clear in 1943, when a Black dissent complained:

Of course, the [Securities and Exchange] Commission can now change the form of its decision to comply with the Court order. The Court can require the Commission to use more words; but it seems difficult to imagine how more words or different words could further illuminate its purpose or its determination. A judicial requirement of circumstantially detailed findings as the price of court approval can bog the administrative power in a quagmire of minutiae.⁴²

The Supreme Court opinion from which Black dissented, *SEC v. Chenery Corp.*,⁴³ concerned an order under the Public Utility Holding Company Act⁴⁴ requiring the surrender by management of preferred stock acquired while the Commission was considering a plan that would have converted such stock into securities of the reorganized company. Holding that the judicial precedents on which the Commission relied did not support the substance of its order, the Supreme Court, in an opinion by Justice Frankfurter, based its refusal to enforce the Commission's action on the fact that management had not been

39. 336 U.S. at 559 (Black, J., dissenting).

40. *Id.* at 561-62 (Black, J., dissenting).

41. *Id.* at 512 (Black, J., dissenting).

42. *SEC v. Chenery Corp.*, 318 U.S. 80, 99 (1943) (Black, J., dissenting).

43. 318 U.S. 80 (1943).

44. 15 U.S.C. §§ 79 to 79z-6 (1976).

The New Deal and the Burger Court

found to have committed fraud or to have violated any duty of disclosure, and that no general rule under which action could be taken had been promulgated by the Commission.⁴⁵

Insistence that a nonjudicial agency promulgate general rules rather than adjudicate specific claims ensures only that more persons possibly affected by the proposed action will insist on being heard. Consequently, as Black argued, adherence to the holding of the first *Chenery* decision would sacrifice efficiency in implementing government policy. The resultant loss, moreover, would accomplish no more than to replace the logical consistency with which bureaucratic organizations apply rules with the demand for consistency over time embodied in the judicial tradition of reliance on precedent.

Four years after the first *Chenery* decision, the Supreme Court approved a new Commission order that differed from the one it had earlier refused to enforce only because “[t]he latest order of the Commission definitely avoids the fatal error of relying on judicial precedents which do not sustain it.”⁴⁶ The second *Chenery* decision can be read as holding that the specialized nature and narrow scope of the Public Utility Holding Company Act in effect permits bureaucratic decisions that are lawless, in the limited sense of being consistent only in terms of logic, as long as no pretense is made that judicial precedents support the administrative action. If consistent administrative practice can be substituted for judicial precedents in defining the due process notice requirements in a criminal prosecution, then the consent orders negotiated by financial printers and the Securities and Exchange Commission constitute a sufficient basis on which to uphold Chiarella’s conviction. Whether the costs of inefficiency in the execution of the regulatory authority of administrative agencies are sufficiently great to justify such a rule is the question posed by *United States v. Chiarella*.

45. 318 U.S. at 92-93.

46. SEC v. *Chenery Corp.*, 332 U.S. 194, 199 (1947).