**Panzirer v. Wolf:**

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1982

**presumption of Reliance on Material Fraud**

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**A Study in Doctrinal Exegesis**

**Jan G. Deutsch\***

*This artice analyzes the Second Circu.it decision of* Panzirer v. Wolf *wh1ch held that secondary rebance on the integrity of the market could support a cause of action based on Rule JOb-5 of the Securities Exchange Act. The author also ex­ amines prior cases relied upon by the Second Circuit and con­ cludes by questioning whether the* Panzirer *holding is justified.*

**Relying on the Integrity of the Market**

Upon reading a favorable article about a company in the *Wall*

*Street Journal* of September 29, 1978, an investor purchased some

?fits stock. Whethe company initiated bankruptcy proceedings m 1979, sh ued tts officers and accountants under Section lO(b) of the Secuntles Exchange Act, 1 alleging that the company's annual report, issued in August 1978, was fraudulent. Although she had never seen the annual report, her compl aint asserted "that the an­ nual report affected the market, and therefore she had relied on the report through her reliance on the integrity of the market." 2

The plaintiff also sought to represent the class of investors pur­ chasing the company's stock after release of its annual report. The district judge denied class certification on the grounds that the weakness of her case concerning reliance on the report made her claim atypical and that her lack of credibility made her an inad­ equate class representative. Affirming the denial of cl ass certifica­ tion on the basis that the numerous changes in the plaintiff's tes­ timony supported the trial judge's ruling on credibility, the Second Circuit *did* not decide "whether [plaintiff's] weak showing of reli­ ance makes her claim atypical under Fed. R. Civ. P.23 (a) (3)." 3

• Professor of Law, Yale Law School.

1 15 u.s.c. § 78j(b) (1976).

2 Panzirerv. Wolf, 663 F.2d 365 (2d Cir. 1981).

3 *Id.* at 368 n.4.

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In dismissing the plaintiff's individual suit on summary judg­

ment, the district judge held that primary reliance h ad been on the newspaper article, and that secondary reliance on the integrity of the market was insufficient to support a Rule 1Ob-5 claim. The Sec­ ond Circuit reversed, noting that "Defendants have introduced no evidence to contradict [the] chain of causation [implicit in plain­ tiff's complaint between the fraudulent report and her share pur­ chase]," 4 and holding that "though, at trial, the validity of the chain of causation will be tested, on summary judgment questions about this chain of causation must be resolved in favor of plaintiff , who in the case of a material fraud on the market enjoys a pre­ sumption of reliance." 5

**What the Second Circuit Holding Does**

**Its Effect**

This holding not only rejects a doctrinal distinction between primary and secondary reliance, but also establishes a cause of action, in that the plaintiff's allegations of "a material fraud on the market" are held sufficient to resist a motion to dismiss in the absence of evidence from either party. The Second Circuit seeks support for this ruling by reference to its 1976 decision in *Com­ petitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Hor­ wath,'* which involved an investment manager's mishandling of an investment fund, and the concealment of his previous mis­ handling of another fund by allegedly false financial statements certified by the defendant accountants. In that case, the district court had granted summary judgment on the ground that the plain­ tiff could not prove reliance on the financial statements, and the Second Circuit reversed, holding that the plaintiff "need not prove direct reliance, but only causation in fact." 7

*4 /d.* at 367.

*aId.*

*'516* F.2d 811 (2d Cir. 1976).

7 Panzirer v. Wolf, note 2 *supra,* at 368.

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Distinguishing *Competitive Associates*

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That *Competitive Associates* is distinguishable is clear. The PUr­ pose of the accountant's certification is to designate information contained in certified statements as having been processed in ac. cordance with professional standards. Such statements are there.. fore relied upon as setting limits to the impact of manipulative fi. nancial devices resorted to by corporate insiders. Annual reports on the other hand, since they carry no such professional impri: matur,8 cannot with equal justification be treated as causing the fraud about which they might have given warning. The relevant question thus becomes why the *Competitive Associates* holding governed the decision in *Panzirer v. Wolf.*

The Second Circuit's Rationale

The rationale of the Second Circuit in *Panzirer v. Wolf* is as follows:

Proving reliance is necessarily difficult where the fraud bas af. fected the market and damaged the plaintiff only through its effect on the market [but] this and other circuits do not require direct reliance where the fraud affects the market, on the ground that an investor relies generally on the supposition that the mar-

a Since annual reports include financial statements, they do, of course, contain such certifications, and on this basis, the decision in *Competitiv Associates* could have been treated as determinative. Indeed, the first foot­ note in *Panzirer* indicates that the accountants were sufficiently concerned at one point to include in their certification a qualification as to the com­ pany's ability to function as a going concern, something which st on y suggests a failure to disclose material information. The Second Circuit, however, cites *Competitive Associates* for the proposition that reliance is established when causation in fact is shown. This doctrinal substitution (of proof of causation in fact for reliance) is based on the Supreme Cou 'a decision in *Affiliated Ute Citizens v. United States,* a case analyzed later m this article.

It is in terms of proof of causation in fact functioning as an effective substitute for proof of reliance that the financial statements in *Competitiv Associates* can be distinguished (as being more directly implicated in the fraud) from those at issue in *Panzirer.* Such a distinction parallel.s the district judge's holding which was based on the con trast between prunary and secondary reliance.

ket price is validly set and that no unsuspected fraud has af-

fected the pnce.

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*llu• Chip Stamps v. Manor Drug Stores*

To ask whether this rationale correctly states the law of Rule lOb-S *is* to ask whether it is consistent with the U.S. Supree Court

inion in *Blue Chip Stamps v. Manor Drug Stores10* wh1ch held

:atthe Second Circuit case of *Birnbaum v. Newport SteeC r . 11* "was rightly decided, and that it bars respondent from mamta g this suit under Rule lOb-5." 12 *Blue Chip* was handed down m

1975, and litigation during the intervening yea.rhas left ncle r the precise connection between the two propos1t10ns contamed m

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the holding. Nor is this lack of clarity surprising. In eed, doc­ trinal distinction between primary and secondary reliance reJect.ed by the Second Circuit in *Panzirer v. Wolf* is itself a model of c an when compared with the distinction drawn by the Sec?nd .C1rcmt in *Birnbaum* between corporate mismanagement, which ts. go:­ erned solely by state law, and fraud affecting the market, which ts subject to federal securities legislation. Yet it ws preci.sely on the basis of the latter distinction that *Birnbaum* differentiated those stock transactions that were covered by Rule lOb-S from those that were not.

*SEC v.* Texas *Gulf Sulphur Co.*

In 1968, *SEC v. Texas Gulf Sulphur* Co. 13 presented the Sec­ ond Circuit with an opportunity to define the circumstances under which stock purchases by corporate insiders created liability under Rule lOb-5. The district court had found that the information on the basis of which the stock had been purchased was not material, a finding based on the uncontradicted testimony of expert wit­ nesses. The appellate court reversed, however, holding that the materiality of the information at issue was not a matter to be

'Panzirer v. Wolf, note 2 *supra,* at 368.

10 421 u.s. 723 (1975).

11 193 F.2d 461 (2d Cir.), *cert. denied* 343 U.S. 956 (1952).

12 Blue Chip Stamps v. Manor Drug Stores, note 10 *supra,* at 730.

13 401 F.2d 833 (2d Cir. 1968), *cert. denied* 404 U.S. 1005 (1971).

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As in *Texas Gulf Sulphur,* the decision in *Panzirer v. JiV lf* . sought to be justified by an appeal to the nature of market acti . 11

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be yresumed to affec.t the information "heard on the street" whtch led Zelda Panz1rer to make her *losing* investment. u

. nfortu ately, thimage of the market as providing all par. lctpants wtth equal tnform tion•. whatever is merits as an analyt­ ICal model, represents a dtstortton of realtty. The view of the market shared by *Panzirer* and *Texas Gulf Sulphur* is an ideal, and cond ct failing to comply with that ideal is treated as justifying *legal* mterference with economic activity. Whether decisions em. bodying that view are consistent with *Blue Chip* remains unclear because Supreme Court decisions interpreting *Blue Chip* remain ambiguous about the extent to which it adopted a doctrine incon­ sistent with the *Texas Gulf Sulphur* view of the market as some­ thing more than a mechanism for the setting of prices.

*Sherwood v. Walker*

Perhaps the clearest example of the deep common-law roots of such a view is provided by *Sherwood v. Walker* (Rose IT of Abalone), 16 the case which held that a mutual mistake of fact about the "substance of the thing bargained for" justifies the ju­ diciary in voiding a contract. *Sherwood v. Walker*, however, also

serves as an example of the effective limits to legal doctrine, since

almost none of the decisions in which it is cited are resolved on the basis of a finding of mutual mistake of fact.

*14Jd.* at 851.

15 Panzirer v. Wolf, note 2 *supra,* at 368.

1 6 66 Mich. 568, 33 N.W. 919 (1887).

'tb the mechantsm of a functwnmg market. The questwn ratsed,

:erefore, is why inconsistency *with* the functioning of a price­

tting mechanism should render a precedent, "revered by teachers

:contract law," 18 ineffective in terms of being applied as well as

cited.

committing Society to the Value of Change

To make possible restrictions on individual behavior, society must agree to at least the possibility of coercing the losing party. Societies permit such coercion to prevent behavior perceived as threatening to the existing social organization. Every market, how­ ever, insofar as it operates to produce new categories of consumers and products, is in fact changing the existing economic and social structure. Thus, the scope and pace of this country's industrializa­ tion in the last half of the nineteenth century inevitably produced legal attempts by existing communities to restrict economic activity. The Supreme Court's designation of those attempts as unconsti­ tutional committed our society to the value of change, to a pref­ erence for the future possibility rather than the preservation of what is. This commitment, contained in decisions interpreting the commerce clause, transformed a set of diverse political and social communities into a single economic unit; those decisions were accepted on the basis that they were compelled by law, that our Consti tution voided not the act of a particular community attempt­ ing to regulate the workings of the marketplace, but any *A* or *B* to

whom the facts of the decision applied.

*17Jd.* at 576, 33 N.W. at 923.

1a H. Kook & Co. v. Scheinmann Hochstein & Trotta, Inc., 414 F.2d 83,

98 (2d *Cir.* 1969).

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Molding Precedents to Get a Desired Result

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an attempt to influence behavior that has not yet occurred. Indeed' the clearer and more uniform a rule is, the more easily it is garded aa for aliy that .cn justifiaby bma ipulated so long

as compliance with Its explicit formulation IS mamtained. As our

ID& h Second Circuit's opinion in *List* demonst rates, courts are

Absl teof deciding cases in accordance w1·th potenti'a11y con:flcit-

: ta:dards. Thus, what *List* held was th at, ?epe ding upon the ts of the case, reliance is an issue to be decided m terms of the

:dividual plaintiff rather than the legal cnst ruct of the reasonable

experience with the tax code has demonstrated, any sufficiently

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law can be defined as a set of formulae that attempts to govern

entrepreneurial activity without distinguishing r ules applicable to entrepreneurs from those that govern the activities of others.

Status of the Individual

This uniform treatment inevitably creates difficulties when the person whose beh avior is being considered is, in vocational terms, an "insider," a "market professional." In terms of Rule lOb-5, *List v. Fashion Park , lnc. 19* is instructive, since the Second Cir­ cuit's basis for refusing recovery in that case appears to have been the plaintiff's status as "an ex perienced and successful investor." 20

Thus, after holding "[t]he proper test .. . [concerning the meaning

of 'reliance' in a case of nondisclosure under Rule lOb-5 to be] whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undis-

19 340 F.2d 457 (2d Cir. 1965).

20 *Id.* at 464.

in *Panzirer v. Wolf* represents an attempt to facilitate such JU g-

ments, to prevent a situation in which market losses a ·e automat­ ically converted into a cause of action at law by tSIIDle state­ ment that the purchase was made in reliance on the mtegnty of the

market."

Doctrinal Distinctions and Pleadings

As is usually the case with doctrinal distinctions, the question reduces to one of pleading. Thus, bad the claim been made that

21 *ld.* at 463.

22fd.

23 Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977) · .

24See, e.g., Dupuy v. Dupuy, 551 F.2d 1005 (5th Cr..1977), w 1cb alated that "the diligence of the plaintiff in lOb-5 cases Judged. su bjec­ tively," *id.* at 1016, and cited as an example "a jur y instructiOn that 1mposed

a duty of diligence 'solely under the ecul ar circumsnceof e ch case, including existence of a fiduciary relat10n b1p . . . po1t1on m the mdustry, sophistication and expertise in the financial communtty and knowledge of

related proceedings.' " *Jd.*

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there was direct reliance on the market price, a case of "fraud

the market" would have been alleged. The precise q uestion r · 00

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**Conclusion**

that other courts asked to apply Section lO (b) should hfollodt?e

Second Circuit in finding "no su pport in the law for t e 1stnct

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The basis for the Second Circuit's ref usal to require that "in­ tegrity of the market" causes of action include allegations of re­ liance on the market price itself was the Supreme Cou rt decisio in *Affiliated U te Citizens v. United States,25* whose application t *Panzirer* the Second Circuit described as follows:

Where, as is here alleged, the fraud consists of a failure to disclose, the difficult nature of plaintiff 's claim-that if there had been disclosu re, plaintiff would not have been harmed-has led the Supreme Court to hold that if the omissi on is material reliance upon the omission will be presumed.26 '

What *Affiliated Ute Citizens* holds, according to its author, is that "bank agents dealing in the stock of a Ute Indian development corporation had a duty to reveal to mixed-blood Indian customers that their shares could bring a higher price on a non-Indian market of which the sellers were unaware." 27 The corporation in ques­ tion had been created by the federal government to hold Indian assets as part of a program aimed at endi ng the system of reserva­ tions by acquainting Indians with a market economy. Given that context, it may have been appropriate to assume that Indian and non-Indian markets existed, that they were identifiably separate and distinct entities, and that mixed-blood Indians failed to un­ derstand that purchases of commercial property are produced by the belief that buyers willing to pay higher prices can be found.

25 406 u.s. 128 (1972).

*26* Panzirer v. Wolf, 663 F.2d 365, 368 (2d Cir. 1981).

27 Chiarella v. United States, 445 U.S. 222, 250-251 (1980) (Blackmun,

J., dissenting).

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·uedly, particular distinctions detract from the clanty o ega

:ctrine; the clarity of the concept of a market provi ing all par­ ticipants with equal information has the appeal of makmg unneces­ sary decisions ( e.g., *List )* which are pplicble only to the par­ ticular plaintiff. Neither of these considerat10ns, however, seems sufficient to justify the r ule of law promulgated by *Panzirer v. Wolf.*

28 Panzirer v. Wolf , note 26 *supra,* at 367.

TRIVIA

The Coca-Cola Compa ny buys a little over 10 percent of all sugar in the

United States.

Parker Brothers prints about the sa me amou nt of money an nually for

Monopoly sets as the U.S. Treasury prints for us.

On a ratio of cost of goods to selling price, pizza is the most profitable

fast-food item. -"The Money Lists" Jeffrey Feinman