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Panzirer v. Wolf: A Study in Doctrinal Exegesis

Jan G. Deutsch*

This article analyzes the Second Circuit decision of Panzirer v. Wolf which held that secondary reliance on the integrity of the market could support a cause of action based on Rule 10b-5 of the Securities Exchange Act. The author also examines prior cases relied upon by the Second Circuit and concludes 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. Whether the company initiated bankruptcy proceedings in 1979, sh used its officers and accountants under Section 10(b) of the Securities Exchange Act, alleging that the company's annual report, issued in August 1978, was fraudulent. Although she had never seen the annual report, her complaint asserted "that the annual 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 purchasing 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 inadequate class representative. Affirming the denial of class certification on the basis that the numerous changes in the plaintiff's testimony supported the trial judge's ruling on credibility, the Second Circuit did not decide "whether [plaintiff's] weak showing of reliance makes her claim atypical under Fed. R. Civ. P.23 (a) (3)." 3

The presumption of Reliance on Material Fraud

In dismissing the plaintiff's individual suit on summary judgment, the district judge held that primary reliance had been on the newspaper article, and that secondary reliance on the integrity of the market was insufficient to support a Rule 10b-5 claim. The Second Circuit reversed, noting that "Defendants have introduced no evidence to contradict [the] chain of causation [implicit in plaintiff's complaint between the fraudulent report and her share purchase]." 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 presumption 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 Competitive Associates, Inc. v. Laventhal, Krekstein, Horwath & Horwath, which involved an investment manager's mishandling of an investment fund, and the concealment of his previous mishandling 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 plaintiff 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

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3 Id. at 368 n.4.
4 Id. at 367.
5 Id.
6 16 F.2d 811 (2d Cir. 1976).
7 Panzirer v. Wolf, note 2 supra, at 368.
Distinguishing Competitive Associates

That Competitive Associates is distinguishable is clear. The purpose of the accountant's certification is to designate information contained in certified statements as having been processed in accordance with professional standards. Such statements are there fore relied upon as setting limits to the impact of manipulative financial devices resorted to by corporate insiders. Annual reports on the other hand, since they carry no such professional imprimatur, 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 affected 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 market price is validly set and that no unsuspected fraud has affected the price.

Ill • Chip Stamps v. Manor Drug Stores

To ask whether this rationale correctly states the law of Rule 10b-5 is to ask whether it is consistent with the U.S. Supreme Court holding in Blue Chip Stamps v. Manor Drug Stores10 which held that the Second Circuit case of Birnbaum v. Newport Drug Stores,11 “was rightly decided, and that it bars respondent from maintaining this suit under Rule 10b-5.”12 Blue Chip was handed down in 1975, and litigation during the intervening years has left no clearer the precise connection between the two propositions. This circuit with the Second Circuit in Panzirer v. Wolf is itself a model of caution when compared with the distinction drawn by the Second Circuit in Birnbaum between corporate mismanagement, which is governed solely by state law, and fraud affecting the market, which is subject to federal securities legislation. Yet it was precisely on the basis of the latter distinction that Birnbaum differentiated those stock transactions that were covered by Rule 10b-5 from those that were not.

SEC v. Texas Gulf Sulphur Co.

In 1968, SEC v. Texas Gulf Sulphur Co.13 presented the Second Circuit with an opportunity to define the circumstances under which stock purchases by corporate insiders created liability under Rule 10b-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 witnesses. The appellate court reversed, however, holding that the materiality of the information at issue was not a matter to be

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10421 U.S. 723 (1975).
11193 F.2d 461 (2d Cir.), cert. denied 343 U.S. 956 (1952).
13401 F.2d 833 (2d Cir. 1968), cert. denied 404 U.S. 1005 (1971).
determined by what the parties thought or reasonably could have thought, but that: "insider trading activity constitutes ... the ... truly objective evidence of ... materiality."  

As in Texas Gulf Sulphur, the decision in Panzirer v. W. P. sought to be justified by an appeal to the nature of market activity.  

Zelda Panzirer did not rely on the integrity of the market.  

Because she did not rely on price, but she did rely on the market in producing the information reported in the Wall Street Journal. Just as a material misinterpretation of omission is presumed to affect the price of the stock, so it should be presumed to affect the information "heard on the street" which led Zelda Panzirer to make her losing investment.  

Unfortunately, the image of the market as providing all factual information, whatever is merits as an analytical model, represents a distortion of reality. The view of the market shared by Panzirer and Texas Gulf Sulphur is an ideal, and conduct failing to comply with that ideal is treated as justifying legal interference with economic activity. Whether decisions embodying 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 inconsistent with the Texas Gulf Sulphur view of the market as something 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), the case which held that a mutual mistake of fact about the "substance of the thing bargained for" justifies the judiciary 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.  

\[14\text{Id. at 851.}\]  

\[15\text{Panzer v. Wolf, note 2 supra, at 368.}\]  

\[16\text{66 Mich. 568, 33 N.W. 919 (1887).}\]  

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, however, 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 industrialization 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 unconstitutional committed our society to the value of change, to a preference 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 Constitution voided not the act of a particular community attempting to regulate the workings of the marketplace, but any A or B to whom the facts of the decision applied.  

\[17\text{Id. at 576, 33 N.W. at 923.}\]  

\[18\text{H. Kook & Co. v. Scheinmann Hochstein & Trotta, Inc., 414 F.2d 83, 98 (2d Cir. 1969).}\]
Molding Precedents to Get a Desired Result

As lawyers know, however, the foregoing significantly over-stabilizes the stability of the law, since any precedent can be accommodated by a court that wishes not to overrule a potentially conflicting opinion, either by stressing more strongly an element that is considered only in passing in the earlier opinion or by expanding the universe of the factors considered in arriving at the result.

The individual plaintiff's reasonableness in deciding to act in reliance on the defendant's disclosure is residual uncertainty about the applicable standard, an uncertainty whose value inheres in the fact that the law is ultimately a control device 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 for an ally that can justify bma imputed so long as compliance with its explicit formulation is maintained. As our experience with the tax code has demonstrated, any sufficiently uniform formula will at some point be exploited by the development of an application not derivable from the regularities in terms of which the formula was developed. Entrepreneurs, in these terms, can be defined as individuals who develop such variations and thus change the definition of the operational market, and U.S. law can be defined as a set of formulae that attempts to govern entrepreneurial activity without distinguishing rules 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 behavior is being considered is, in vocational terms, an "insider," a "market professional." In terms of Rule 10b-5, List v. Fashion Park, Inc. is instructive, since the Second Circuit's basis for refusing recovery in that case appears to have been the plaintiff's status as "an experienced and successful investor." Thus, after holding "[t]he proper test ... [concerning the meaning of] 'reliance' in a case of nondisclosure under Rule 10b-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-

21 "1d. at 463.
22id. at 463.
24See, e.g., Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir. 1977)."
there was direct reliance on the market price, a case of "fraud
the market" would have been alleged. The precise question raised
by the Second Circuit, however, it was the fact that
no such claim was made justifies application of a doctrinal dis-
tinction between primary and secondary reliance to designate circumstances in which claims of reliance on the "integrity of the mar-
et are insufficient to state a cause of action.

Conclusion

The basis for the Second Circuit's refusal to require that "integrity of the market" causes of action include allegations of reliance on the market price itself was the Supreme Court decisio
in Affiliated Ute Citizens v. United States, were application to
Panzeri v. Wolf 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-tha that if there
had been disclosure, plaintiff would not have been harmed-had led the Supreme Court to hold that if the omission is material reliance upon the omission will be presumed.

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." The corporation in question had been created by the federal government to hold Indian assets as part of a program aimed at ending the system of reservations 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 understand that purchases of commercial property are produced by the belief that buyers willing to pay higher prices can be found.

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


TRIVIA

The Coca-Cola Company buys a little over 10 percent of all sugar in the United States.
Parkers Brothers prints about the same amount of money annually 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