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The Wharf (Holdings) Ltd. v. United International Holdings, Inc.: The Supreme Court Breaks Old Ground

Mark J. Loewenstein *

*This article analyzes the Supreme Court's decision to decide only one federal securities law case, *The Wharf (Holdings) Ltd. v. United International Holdings, Inc.* On the face of it, the Court simply affirmed long-standing, uncontroversial tenets of Rule 10b-5. However, the article provides different explanations to the Court's decision.*

Introduction

In its 2000–01 Term, the United States Supreme Court decided one federal securities law case, *The Wharf (Holdings) Ltd. v. United International Holdings, Inc.*¹ The fact that the Court took only one securities law case is unremarkable. Its decision to take this case, however, and the outcome it reached are somewhat remarkable. This is not because the Court altered existing law or resolved a conflict among the circuits, but rather just the opposite: the Court took an uncontroversial case that raised no novel issues, and unanimously affirmed the decision of the Court of Appeals for the Tenth Circuit.² One might then reasonably inquire as to why the Court granted certiorari in this case. I will return to that question in the conclusion to this article.

Wharf involved an oral option contract between plaintiff and defendant, pursuant to which defendant orally agreed to sell to plaintiff 10% of the stock of a new cable system in Hong Kong that defendant was developing, in consideration for consulting services that

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¹121 S.Ct. 1776 (2001).

²The Tenth Circuit decision is reported at 210 F.2d 1207 (10th Cir. 2000).

plaintiff was providing for the cable system.³ Although plaintiff sought to exercise the option, defendant refused to accept plaintiff's payment or issue the stock.⁴ Plaintiff brought suit under Rule 10b-5 (and various state law claims), alleging that defendant fraudulently misrepresented that plaintiff could acquire stock pursuant to the option. In fact, plaintiff alleged, defendant never intended to honor the option contract. As the option contract constituted a contract to sell a security, the Court held that defendant's misrepresentations were made in connection with the sale of a security and thus actionable under Rule 10b-5.

The plaintiff prevailed in a trial before a jury, which awarded it \$67 million in compensatory damages and \$58.5 million in punitive damages on the state-law claims. The Court of Appeals for the Tenth Circuit and the Supreme Court affirmed.⁵ There were two issues before Court: first, whether an oral agreement can be the basis for a claim under Rule 10b-5; and second, whether an undisclosed reservation not to permit the exercise of an option falls outside of § 10(b) (and, hence, Rule 10b-5) because the misrepresentation does not relate to the value of the security and therefore does not implicate § 10(b)'s policy of full disclosure.

The Issues in Wharf

Oral Contract Within Antifraud Provisions

The Court was little troubled by either issue. On the argument that an oral agreement is outside the purview of a Rule 10b-5 claim, the Court found nothing in the securities acts or its own precedents to support the defendant's position. The Court noted that oral contracts for the sale of securities are "sufficiently common that the Uniform Commercial Code and statutes of fraud in every State now consider them enforceable."⁶ The Court also noted that excepting oral contracts from the coverage of the Securities and Exchange Act

³121 S.Ct. at 1779.

⁴Id.

⁵Id. at 1780.

⁶Id. at 1781, citing U.C.C. § 8-113 (Supp. 2000).

of 1934 “would significantly limit the Act’s coverage, thereby undermining its basic purposes.”⁷

Rule 10b–5 Covers Misrepresentations Regarding Intentions

On defendant’s second argument — that Rule 10b–5 did not forbid misrepresentations regarding defendant’s intentions — the Court decided that this sort of misrepresentation is actionable. Defendant was essentially claiming that its misrepresentation did not go to the value of the security and that disputes over the ownership of securities are not actionable under Rule 10b–5. The Court responded that a misrepresentation relating to defendant’s intentions did affect the value: “[s]ince [defendant] did not intend to honor the option, the option was, unbeknownst to [plaintiff], valueless.”⁸ Thus, this dispute was over more than mere ownership.⁹

Several observations about this case center on this second argument. First, although not critical to the outcome of the case, the Court’s last–quoted statement was obviously incorrect. Even if the defendant did not intend to honor the option, the option still had value. Plaintiff may not have paid as much, knowing it might have to litigate to perfect its rights, but surely the contract right it acquired was not valueless. A cynic might say, noting the considerable damages that plaintiff recovered, that plaintiff underpaid for its option.

Deception Within Antifraud Rule

Second, the case did not really involve an active misrepresentation. Rather, the defendant had a “secret reservation” (that it would not honor its contractual commitment), which the Court simply characterized as a misrepresentation. The Court supported this characterization with a citation to a comment to § 530 of the Restatement (Second) of Torts that indicates that a promise made without an intention to perform is “fraudulent.”¹⁰ By relying on the Restatement of Torts, the Court avoided analysis under its established Rule 10b–5 jurisprudence. Traditionally, the failure to disclose (in this case that the defendant did not intend to honor the

⁷ Id.

⁸ Id. at 1782.

⁹ Id.

¹⁰ Id.

agreement) is only fraudulent if there is a duty to disclose. In *Chiarella v. United States*,¹¹ the Court held that an employee of a printer had no duty to the sellers of stock to disclose the nonpublic information that he had acquired through his employment and, therefore, his failure to disclose (or to refrain from trading) could not constitute a manipulative or deceptive device or contrivance under § 10(b). Similarly, in *Dirks v. Securities and Exchange Commission*,¹² the Court held that a financial analyst who passed along to his clients nonpublic information about a company that he received from an officer of the company did not violate § 10(b) or Rule 10b-5, because the officer who disclosed the information to the analyst did not breach any fiduciary duty to the company in making the disclosure and, therefore, the analyst could not have breached a fiduciary duty.

Applying *Chiarella* and *Dirks* to the facts of *Wharf* suggests that the defendant in *Wharf* violated Rule 10b-5 only if it had a duty to disclose its intention not to honor its contractual commitment. In fact, it had no such duty. The source of this duty could not be a fiduciary duty, as parties contracting with one another at arm's length (as were these parties) generally do not owe fiduciary duties to one another, nor could the duty arise under general notions of good faith and fair dealing, as this duty generally arises only after the parties have contracted. Thus, defendant's liability for securities fraud turns not on a failure to disclose or an active misrepresentation, but rather on the notion that defendant's conduct falls within the tort of deceit and, therefore, violates Rule 10b-5.¹³

This conclusion is not remarkable and is consistent with *United States v. O'Hagan*,¹⁴ the Court's most recent pronouncement on Rule 10b-5. In *O'Hagan*, the Court upheld the defendant's securities fraud conviction even though the "defrauded" party was not the seller of the securities, but defendant's client. Defendant was a lawyer whose firm represented the bidder in a hostile takeover. In advance of the bid, defendant purchased securities in the target

¹¹445 U.S. 222 (1980).

¹²463 U.S. 646 (1983).

¹³That Rule 10b-5 covers conduct other than misrepresentations seems uncontroversial. *United States v. O'Hagan*, 521 U.S. 642 (1997), discussed in the text, did not involve a misrepresentation or a failure to disclose. Similarly, cases such as *Costello v. Oppenheimer & Co.*, 711 F.2d 1361 (7th Cir. 1983), involving a claim of churning by a broker, do not involve misrepresentations.

¹⁴521 U.S. 642 (1997).

company. Because defendant was not an insider of the target, he owed no fiduciary duty to the target company or its shareholders. As a partner in the law firm that represented the bidder, however, defendant did owe a fiduciary duty to the bidder not to misappropriate the confidential information that had been entrusted to him. His misappropriation, the Court concluded, was a fraud on his client, which fraud was “in connection with” his purchase of securities and thus a violation of Rule 10b–5.

“In Connection Requirement” Not Expressly Considered

This raises a final aspect of *Wharf*: the Court avoided a potentially troubling “in connection with” issue when it decided that the “misrepresentation” did go to the value of the security. In *O’Hagan*, the Court found that defendant’s fraud on his client was connected closely enough with his securities transactions to be “in connection with” those transactions. In *Wharf*, the Court might have considered whether plaintiff would still have a claim if defendant’s misrepresentation was clearly collateral to the value of the security, as arguably it was. If, for instance, defendant had represented (falsely) to plaintiff that plaintiff’s stock acquisition would enhance plaintiff’s reputation in the cable industry and on the basis of that misrepresentation plaintiff purchased the option, would plaintiff be able to bring a claim under Rule 10b–5?¹⁵

The “in connection with” requirement of Rule 10b–5 is one of the murkier areas of the Rule’s jurisprudence.¹⁶ The Court’s 1971 decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,¹⁷ and its more recent decision in *O’Hagan*, give a liberal reading to the “in connection with” requirement, insisting only that the fraud “touch” upon the sale of securities for the Rule to be applicable. More to the point, lower court cases have rejected the no-

¹⁵Even this representation arguably goes to value, as plaintiff might claim that a security that enhances its reputation is more valuable to it than one that does not.

¹⁶See, e.g., James D. Cox, Robert W. Hillman and Donald C. Langevoort, SECURITIES REGULATION at 710 (3d ed. 2001) (“Unfortunately, the ‘in connection with’ standard is little understood, and a close look at the cases that have invoked it shows no consistent judicial treatment or prevailing interpretive principle.”)

¹⁷404 U.S. 6 (1971).

tion that the misrepresentation must go to the value of the security.¹⁸ In any case, the Court seems to have intentionally avoided revisiting the “in connection with” question in this case. By avoiding this issue, and relying on the tort of deceit, the Court’s decision in *Wharf* is simply that an intentional misrepresentation by a seller of a security that relates to the value of the security being sold violates Rule 10b–5. This is hardly a controversial conclusion and is indeed “old ground.”

Conclusion

Inasmuch as the Court simply affirmed long-standing, uncontroversial tenets of Rule 10b–5, why did it take the case? One might speculate that it took the case because defendant’s misrepresentation did seem collateral to the value of the security and thus did raise an “in connection with” issue worth considering, especially if the Court was looking to restrict the reach of Rule 10b–5. Then, one might speculate, the justices became convinced, as Justice Breyer stated in the opinion, that the misrepresentation did affect the value of the security, thus mooted the issue. So what seemed like a case with a meaty issue turned into one with no issue at all.

A second possible explanation — and one directly contrary to the first — is that the Court is signaling a renewed respect for Rule 10b–5. In a series of decisions, starting with *Blue Chip Stamps v. Manor Drug Stores*¹⁹ in 1975 and culminating with *Central Bank of Denver v. First Interstate Bank of Denver*²⁰ in 1994, the Court systematically and consciously trimmed back the scope of Rule 10b–5, but may now be reversing that trend. *O’Hagan*, and now *Wharf*, both represented opportunities to further limit the scope of the Rule. *Wharf* seemed like a good vehicle to do that, especially because the case seemed more like a state claim for breach of

¹⁸E.g., *SEC v. Jakubowski*, 150 F.3d 675 (7th Cir. 1998)(lawyer committed securities fraud by misrepresenting the identity of the purchaser of the securities); *Threadgill v. Black*, 730 F.2d 810, 811–12 (D.C. Cir. 1984)(“fraud in the purchase or sale includes ‘entering into a contract of sale with the secret reservation not to fully perform.’”)(citing *Walling v. Beverly Enterprises*, 476 F.2d 393, 396 (9th Cir. 1973)); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)(customer’s misrepresentation that he would pay for stock when his intention was to pay only if it increased in value violated § 10(b)).

¹⁹421 U.S. 723 (1975).

²⁰511 U.S. 164 (1994)

contract than a federal securities fraud case. So characterized, the case seemed to fit within the Court's philosophy that the federal courts ought not to recognize an implied cause of action under federal statutes when there is an adequate state law remedy.²¹ By not taking that stance, it is clear that Rule 10b-5 remains an important antifraud claim, not to be displaced by state law remedies.

As between these competing explanations of the *Wharf* case, the first seems to be the more plausible. It seems unlikely, as the second rationale requires, that the Court would consciously engage in signaling in this area. What purpose would it serve — to encourage skittish plaintiffs to file securities fraud claims? Moreover, it is doubtful that the Court is looking to increase the role of the federal courts. Indeed, its decision in the same term in the case of *Alexander v. Sandoval*,²² in which it refused to recognize an implied cause of action under Title VI of the Civil Rights Act of 1964, clearly “signals” that the Court's distaste for implied causes of action continues.

²¹*Sante Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977)(plaintiff's claim, essentially alleging a breach of fiduciary duty, could not be maintained as a securities fraud claim).

²²121 S.Ct. 1511 (2001)(holding that there is no private right of action to enforce disparate-impact regulations promulgated under Title VI of Civil Rights Act of 1964).